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# **DEVELOPING TRADE AND TRADE POLICY RELATIONS WITH THE EUROPEAN UNION**

**Experience of Visegrad Countries and  
Implications/Lessons for Eastern Partners**

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## FOREWORD

The volume consists of the studies prepared in the framework of the project ‘Developing Trade and Trade Policy with the European Union. Experience of V4 countries and Implications/ Lessons for Eastern Partnership Countries’. The project was financed by the International Visegrad Fund and it was executed under the leadership of the Institute for World Economics of the Research Center for Economic and Regional Studies of the Hungarian Academy of Sciences with a contribution from various institutes and think-tanks from Visegrad- and Eastern Partner countries.

The study of Tamás Szigetvári gives a general overview on the development of EU trade policy with the neighbors, analyse the different forms of trade relations (European Economic Area, customs union, Euro-med agreements, deep and comprehensive free trade agreements) and an evaluation on current trends and some future prospects.

The following studies of the volume deal with the experiences of the V4 countries from the early 1990’s when three countries from Central and Eastern Europe (Poland, Hungary and Czechoslovakia) officially applied for an association agreement. On 16 December 1991 the bilateral association agreements were concluded between the European Communities and the three countries. The joint study by Elzbieta Kawecka-Wyrzykowska and Sándor Meisel draws up the framework in which the so called Europe Agreements were established, and gives an overview on the steps made in the framework of the agreements. Then two country studies (on Poland and Hungary) give a detailed analysis on the initial presumptions and motivations of the given Visegrad countries but also deal with the negotiation strategies and tactics, the main hori-

zontal and sectoral problems, the compromises and outcome of the agreements. The studies analyse the legal harmonisation in the field of trade related issues (main fields, sequencing, internal problems, slippages and backslidings) and the institutional questions (organisation and institutional set-up of the negotiation, implementation and harmonisation phases). The two studies try to draw up some relevant conclusions for the Eastern partner countries.

The country studies from the Eastern Partners' side deal with four countries (Ukraine, Moldova, Georgia and Azerbaijan). The structure of the studies is similar. Firstly, they give a brief description on the actual state of country specific EaP process by showing the general features, statistics and trends of bilateral economic relations. They also analyse the actual state of the DCFTA process, with a special regard on the main problems and expectations concerning the DCFTA from the EaPs point of view. They elaborate on the major impacts in a sector specific approach as well by focusing on the interests of the EaP countries and on the major barriers to their enforcement. Finally, they give suggestions related to DCFTA between the EU and the individual EaP country as well as recommendations on how the EU could do a better job within Eastern Partnership initiative in general and DCFTA talks in particular.

At the same time, each study deals with the topic on its own way. The study on the Ukraine by Lidia Shynkaruk, Iryna Baranovska and Olena Herasimova concentrates more on the technical analysis of the relations, and considers the expected benefits and possible hazards for the core sectors of the Ukrainian economy. The country study on Moldova by Adrian Lupusor draws up a broader framework of the EU-Moldova relations, but similarly deals with the sectorial issues, and with the special problems of Transnistrian territory. The study on Georgia written by Merab Kakulia puts its focus on analyzing the difficulties of Georgia concerning the DCFTA agreement. The study on Azerbaijan by Vugar Bayramov has a different approach since Azerbaijan is not member of the WTO yet so the country has not started negotiations on DCFTA. The last study in our volume is by Zsuzsa Ludvig, who takes the im-

pacts of the Russian factor into consideration. As the events in late 2013 clearly proved, the Russian interests in the region basically influence the framework in which the EaP countries and the European Union develop their bilateral relations.

Tamás Szigetvári  
editor

Budapest, January 2014

# THE DEVELOPMENT OF EU TRADE POLICY TOWARDS NEIGHBORING COUNTRIES

*Tamás Szigetvári*

## **Introduction**

The European Union had been the largest trading power of the world for several years. Successive enlargements as well as special bilateral and multilateral trade agreements helped to foster this position. The leading trade position has contributed to an increasing EU role in global economy, and probably going to contribute to it in the next decades.

The European Union, however, has a vital interest in seeing stability, better governance and economic development at its Southern and Eastern borders. Trade policy was and still is one of the most effective instruments to reach this purpose. A great variety of trade related agreements characterise the current structure of relations with the neighbors: agreements allowing the free movement of goods, services and production factors, customs union agreements, free trade agreements with higher or lower harmonisation commitments to EU regulations. The EU has to find optimal solutions that increase the competitiveness both of the EU and the neighboring regions, but also solutions that are politically mutually acceptable and sustainable. In our study we give a short summary of the development of EU trade policy with the neighborhood and an evaluation on current trends and some future prospects.

## The Structure of Trade Relations with Neighbors

### EFTA/EEA

The European Economic Community as an economic integration shaped its foreign economic ties with its neighbors from the beginnings. As a concurring institution to the EEC, the EFTA (the European Free Trade Association) was established by the Stockholm Convention in 1960, for countries not willing (or not able) to join to a more centralised integration. The EFTA have dismantled tariff for industrial goods among members, but did not harmonize the external tariffs. Although the EFTA turned out to be effective in fostering foreign trade inside the area, the attractiveness of the EC/EU was stronger: in 1973 Britain and Denmark, in 1986 Portugal joined the EC, while Austria, Sweden and Finland became EU members in 1995.

Before the first wave of accession, in 1972, the EEC signed free trade agreements with the EFTA countries. The agreements abolished customs duties and restrictions for all industrial goods.

In 1992, just as the Single Market was supposed to become a reality, the EU and the remaining EFTA countries – except Switzerland – signed the Treaty about the European Economic Area. The EEA was definitely created for those EFTA countries, which were not willing to join the European Union as full members, but willing to become members of the Single Market. Currently Norway, Iceland and Liechtenstein are the non-EU-member countries in the EEA. Switzerland, also in the group of these EFTA countries, signed bilateral agreement with the EU, with more or less similar content. The EEA offers the four freedoms (free movement of goods, services, labor and capital), and thus the access to the internal market. These countries are not part of CAP, however, and their agricultural products have to face quite high tariff barriers (and quotas) when entering the EU internal market.

Their status contains a limitation of sovereignty for the non-member EEA countries: they are adopting the changes of the *acquis* automatically, without taking part in the institutions and thus in the decision making on the given issues. The Swiss bilateral

agreements with the EU lack this automatism. Overall, the EEA remains a club for those rich European countries who could but do not want to join the EU.

## **Trade policy with the Southern neighbors**

The Mediterranean has always received much attention from Europe (and the EC) due to its geographic proximity and the former colonial ties. However, there was no such conception towards the Mediterranean like the one governing the relations between Europe and the former African, Caribbean and Pacific colonies under the Lomé Convention. The Community showed a reactive Mediterranean policy, rather than a proactive one, mostly followed the events and not shaped them.

The Community signed several bilateral preferential trade agreements with the countries of the region. The first generation of partnership contracts was signed with the South-European countries. The Community's Association Agreements with Greece in 1962 and with Turkey in 1963 aimed primarily at the reinforcement of the Southern wing of NATO, due partly to some pressure from the USA. Under the AA's the parties wanted to create a customs union for industrial goods in a period of 20-22 years. In the early 1970's two other Mediterranean countries, Malta (1970) and Cyprus (1972) concluded similar agreements with the Community. In all of these cases, the contracting parties were European states, (although it might be a question, as geographically partly (Turkey) or totally (Cyprus) are located in Asia), with the expectation of achieving full membership in the future.

Morocco and Tunisia, as former protectorates of France, had already been treated in a special way based on the protocol of the Rome Treaty. In 1963, they restarted the talks in order to renew the negotiations and they agreed in a 5-year program on partial partnership in 1969. The agreements mainly included trade preferences. As the preferences given for the Maghreb countries would have meant the discrimination of other Mediterranean countries, the EC gradually made agreements for preferential treatments with the other countries of the region. As a result, by the early 1970s the regional agreements involved 15 countries.

The agreements resulted in disputes, as the Mediterranean countries – depending on the interests of the single EC states – were treated differently and their exports from agriculture could not develop due to the CAP. The problematic areas included the food and textile industries as well. The economically underdeveloped countries were offered special preferences by the GSP. With the joining of Great Britain, however, the preferential treatment of Commonwealth countries decreased the value of these agreements.

The Global Mediterranean Policy (GMP) introduced in 1972 aimed at making up the deficiencies of the bilateral agreements and was meant to compensate for the Northern enlargement of the Community in 1973. It wanted to provide free-trade (one-sided) for the industrial goods (except for some critical products, e.g. textile, etc.) within 5 years and the EC treated some 80 % of the exports of agricultural goods of the Mediterranean countries preferentially and offered financial aids and the unified treatment of the labor force issue. Within the GMP, several new agreements had been made from 1974 onwards: Association Agreements with Morocco, Algeria, Tunisia in 1976, and with Egypt, Jordan, Syria and Lebanon in 1977. Due to political reasons not an association agreement, but a free trade agreement was signed with Israel in 1975, while Libya did not want to sign any agreement with the Community.

After the 1973 crisis, the chances to achieve a general agreement decreased. The EC protected its agriculture with one-sided actions, if needed, and the development of the light industry was hampered by the restrictions concerning textile exports. The partnership agreements provided more advantages than a free-trade agreement in theory, although they offered few consultation rights and did not mention the prospect of full membership at all. As a result of protests from the USA, the Mediterranean countries were unable to provide the EC with a preferential treatment themselves. The Southern enlargement of the EC in the 1980s had a further negative effect on the Southern Mediterranean countries, since the agriculture products of Spain, Portugal and Greece entered the EC markets freely, leaving no room for the products of the other states of the region.

By the 1990s, the policy of the EC concerning the Mediterranean changed. With the disappearance of the confrontation between the two systems, the threats moved from the Eastern part of Europe to the South, therefore the states of the Community introduced a new Mediterranean policy. Maastricht and the peace settlement in the Middle-East made it possible to give new dimensions to the relations.

The approach sped up within the frames of the Euro-Mediterranean Partnership (EMP) from 1995. The Euro-Mediterranean partnership agreements, upon which the free-trade zone could be formed, replaced the former agreements made with the Arab countries.

The new, global Euro-Mediterranean partnership consists of three separate, but complementary 'pillars':

- the pillar of politics and security, aiming to define the region of peace and political stability,
- the economic and financial pillar, providing the setup of a mutually booming area,
- the social, cultural and humanitarian pillar, which aims at developing the human resources and the understanding between the different cultures and relations between the civic societies.

The realisation of the process started with bilateral agreements between the EU and certain countries of the region. Most of the Mediterranean countries has signed Euro-Med contracts (Tunisia, Morocco, Israel, the Palestine Authorities, Egypt, Jordan, Algeria, Lebanon), while with Syria the negotiations are finished, but the agreement has not been signed.

Although the contracts signed are not identical in every detail, their structure and the main points are the same. Besides the free flow of goods, they include some minor specifications on the flow of capital, the law of competition and the protection of investments. In addition to the financial and economic co-operation, the political dialogue and the social- and cultural co-operation were also included in the agreements. Overall, the Euro-Med agreements are rather establishing a free-trade "light", without too many strict harmonisation requirements in crucial areas related to trade.

Table 1 EU Trade Relations with Neighbors

Type of relations	Countries	Entry into force	Key characteristics
Accession countries	FYROM Turkey, Iceland, Montenegro, Serbia	Turkey (2005), FYROM (2005 – no negotiations opened), Iceland (2010 – pending), Montenegro (2012), Serbia (2013)	Towards full participation in EU Single Market, CAP, Fisheries Policy
European Economic Area	Norway, Iceland, Lichtenstein, Switzerland	EEA in force since 1994, Swiss Bilateral I 1999	Full participation in Single Market (four freedoms), autonomy in adaptation (except Switzerland), No agriculture included (by Swiss partly), External trade autonomy remains.
Customs union	Turkey, Andorra and San Marino	1995, 1991, 2002	Applying Common External Tariffs of EU. Agriculture not included. Harmonisation in several trade related areas, but not all.
Stabilisation and Association Agreements (SAA)	Ukraine, Moldova, Georgia, Morocco offered for other ENP countries	2013-	Duty and quota free trade for manufactured goods, partly for agricultural goods as well. Advanced liberalisation in service sector and public procurement Domestic market rules have to comply with EU regulations.
Euro-Med Agreements	Jordan, Lebanon, Israel, Egypt, Tunisia, Algeria, Morocco	1998-2006	Focus on tariffs in goods. No harmonisation requirements in standards and domestic regulations, no liberalisation requirements in several trade related field.
Common Economic Space	Russia	Projected, stalled	Unclear, but projected liberalisation in trade and other field as well.
Others	Azerbaijan, Syria, Libya		n/a

Source: own, based partly on Dreyer (2012)

## Turkey

The Association Agreement with Turkey ('Ankara Agreement') was signed in September 1963, more than 50 years ago. Similar to the agreement signed with Greece in 1961, the Ankara Agreement provided for a customs union between the country and the Community at the end of a transitional period of two decades, together with other gradual liberalisation and harmonisation processes. The establishment of the free movement of labor and capital were also among the goals, and the agreement let the possibility of a full-fledged membership of Turkey in the Community open. The Additional Protocol from 1970 set the timetable of the transition process in 22 years, and described the exact trade liberalisation measures to be taken. For the Turkish side, the basic incentive behind the association agreement was rather political than economic, aiming at establishing strong relations with Europe, and following the main political rival Greece. The problems with the implementation of trade liberalisation steps started soon on the Turkish side, as a natural consequence of the trade development strategy followed by Turkey that was based on import substitution with strong protectionist measures. In 1978, Turkey asked for a revision of the agreement, and cancelled the next stage of tariff reductions, but the 1980 military coup in Turkey led to a freeze in bilateral relations anyway. In the 1980's, however, under the lead of the new PM Turgut Özal, Turkey started with economic reforms, changing the state-led import substituting industrialisation process to an export-oriented strategy based on competitive sectors. The new economic strategy was much more compatible with the trade liberalisation requirements of the Association Agreement, and also made Turkey more interested in a better access to the European internal markets. With the ease of political tensions between the two sides, Turkey applied for an EU membership in 1987, as the accession of three Mediterranean countries deteriorated the Turkish positions on the EU markets. Instead of starting accession negotiations, the EU proposed the intensification of economic relations, with a completion of the customs union.

The Customs Union (CU) agreement between Turkey and the EU came into effect on 1st January, 1996. The CU eliminated

most trade barriers between the EU and Turkey, but is also meant a harmonisation process, where Turkish technical standards, competition policy, intellectual property rights were brought closer to EU requirements. Some crucial sectors like agriculture were not included, here bilateral concessions were applied.

Since the EU had already abolished the tariffs on most of the industrial goods imported from Turkey in 1971, the tariff adaptation measures (erasing tariff towards EU members, and reducing tariffs to Common External Tariff (CET) levels with other countries) and also the costs were affecting Turkey.

## **Central and Eastern Europe**

The official relations between the EEC and the Central and Eastern European countries were set up only after 1988, when the systemic transformation in the Eastern bloc countries had started. The first programs (PHARE) included aid and trade facilitation (use of GSP preferences).

The negotiations over a more ambitious plan started in 1990, and ended up in December 1991 with Association Agreements (Europe Agreements) signed by the parties (Poland, Hungary and Czechoslovakia at that time, later followed by other CEE countries). The most important element of the Association Agreement was the free trade for industrial goods regulated in a reciprocal but asymmetric way. It was rather unconventional and due mainly to political motivations that the EU has been opening up sectors where CEE countries were creating competition for EU producers (textile, metal industries, agriculture). Bilateral free trade without obstacles was created by 2002, while in agriculture, the agreement resulted in reduced tariffs and higher quotas. Liberalisation steps allowed larger participation in service supply and in public procurement processes. A gradual approximation of associated countries to the *acquis communautaire* was also included in the agreement.

An important step towards trade liberalisation in the region was the Central European Free Trade Agreement. The CEFTA agreement – came into force in 1994 – created free trade among the Czech Republic, Hungary, Poland and Slovakia, while Slovenia,

Bulgaria, Romania and Croatia joined later. The agreement – a kind of antechamber of EU integration – helped the economic integration process of the CEE countries to the EU and made the region more attractive for foreign investors.

## **EU Trade Policy with Neighbors – Current Trends and Future Prospects**

In 2003, at the Thessaloniki European Council, when the accession treaties with the 10 future member countries had already been signed, the EU created two new groups of non-EU European countries. The Western Balkan countries got the promise of future membership, while other European countries were covered by the "wider Europe" project. The obvious loser of this categorization was Moldova, as full member of the Stability Pact for South Eastern Europe, which was placed to the "wider Europe" group, while all other Stability Pact member countries got the opportunity to become members of the EU.

### **The Western Balkan countries**

For the Balkans – the former Yugoslavian republics of Croatia, Serbia, Bosnia and Hercegovina, Montenegro, Macedonia, plus Kosovo, and Albania (i.e. the Western Balkan countries) – the EU accession is an obvious strategic goal. The Western Balkan countries are surrounded totally by EU member countries. This means that their European future is more or less evident, even if only in the longer term.

The framework invented for the region was the Stability and Association Process. The SAP started in 1999, and was strengthened by the 2003 Thessaloniki summit. In the framework of the Process, the Western Balkan countries signed Stabilisation and Association Agreements with the EU, explicitly including provisions for a future EU membership.

The SAAs are based on the *acquis communautaire*, creating free trade and expecting a gradual harmonisation of policies. The EU offered autonomous trade preferences for Balkan countries in 2000, valid for nearly all exports. An extension of the CEFTA

agreement to Western Balkan countries and Moldova made free trade among countries of the region possible.

From the Western Balkan countries Croatia has already finished the accession process, and joined the Union in July 2013. Montenegro and Serbia are official candidates and have already started accession negotiations with the EU. FYROM, the Former Yugoslavian Republic of Macedonia, a candidate since 2005, was not able to start negotiations due mainly to bilateral disputes with an EU member neighbor, Greece. Albania is waiting for the green light to be accepted as a candidate due mainly to domestic political reasons, while Bosnia-Herzegovina and Kosovo are struggling for their “statehood”. In case of Bosnia Herzegovina, it is the lack of understanding among the three nationalities that is an issue, while in Kosovo the situation is worse, since its independence is not fully accepted by some EU members.

## **Wider Europe**

After the finalisation of the decision on a ‘Big Bang’ enlargement, the EU wanted to initiate a new policy for the Eastern Periphery. The newly formulated policy, however – on the insistence of the Southern member states – included the EMP-participant Mediterranean countries as well.

Originally, the concept of the new European Neighbourhood Policy was intended to be offered (beside the EMP countries) to four Eastern European countries (Russia, Ukraine, Belarus and Moldova). In June 2004, a few months after the ‘Rose Revolution’ in Tbilisi, the decision was made to expand the ENP to the southern Caucasus republics of Georgia, Armenia and Azerbaijan. The largest ‘neighbor’ of the EU, on the other hand, was not included finally: Russia declined to be incorporated into the scheme and opted for developing bilateral cooperation with the Union on an allegedly more ‘equal’ basis, although it was open to accepting similar policies and actions as those implemented with other countries involved in the scheme<sup>1</sup>. The EU intended to encourage those states participating in the ENP to implement serious political and economic reforms along with European standards in order to create conditions for a future common space and market.

## **Eastern Europe**

The EU enlargements in 2004 and 2007 moved the external borders of the EU to the East, changing radically the EU's geopolitical and economic perception of the CIS region (former Soviet republics) and its potential importance as economic and political partner (particularly for the new EU member states). Before the enlargements, CIS countries formed the second, outer 'ring' of the EU neighbors, being geographically separated from the EU by the countries of Central and Eastern Europe. Except for Russia, the CIS countries economic and political importance for the EU-15 was quite limited. The EU-15's real economic and foreign policy interests in cooperation with CIS countries concentrated mostly on oil and natural gas supply from Russia, and on a relative geopolitical stability of the post-Soviet area (avoiding the proliferation of regional and ethnic conflicts).

## **Partnership and Cooperation Agreements (PCA)**

The PCAs with the CIS countries were concluded between 1994 and 1996, and they came into effect' in the period of 1997-1999. The PCAs have established a political dialogue between the parties and provided for a very wide range of issues for cooperation.

Though the PCAs were drafted in similar fashion to the Europe Agreements with CEE countries, there were important features which gave the emerging relationship an entirely different character. Despite the fact that in both types of agreement political dialogue was established, their aims differed substantially: dialogue established by the EAs was used for the pre-accession process, the one provided by the PCAs aims at consolidating the rapprochement between the parties, as well as supporting the political and economic changes taking place in these countries. Although similar to the EAs, the PCA consisted of a 'political conditionality'

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<sup>1</sup> The European Neighbourhood Policy does not cover countries which are in the process of joining the European Union (Turkey, Croatia, Rep. of Macedonia, Serbia, Montenegro) and those covered by the Stabilisation and Association process (Bosnia-Herzegovina, Albania and Kosovo) that have the same aim. The ENP also does not cover the EFTA states (Iceland, Norway, Switzerland and Liechtenstein) as well.

clause, this did not have the same effect, and since the membership incentive was much more powerful than just establishing a wider area of cooperation between the Union and the relevant country. In addition, the institutions provided by the PCAs generally responded to those established by the EAs, which provides for similar institutions referred to as ‘association’ instead of ‘cooperation’. The major difference affecting the nature of the whole agreement, is, that the Cooperation Council established within a PCA is not entitled to take decisions imposing obligations on the signatories, diminishing the importance of this institution.

The lack of incentive and eagerness by both sides to implement the PCAs was central in the failure to achieve the aims of the agreements. The partnership established was ‘a label on a mere trade agreement’, where the parties failed to develop the PCA.

With the EU’s eastern enlargement, the situation changed substantially. Four CIS countries – Russia, Ukraine, Belarus and Moldova – became direct land-neighbors of the enlarged Union. The Caucasian countries still lie some 1000 km apart from the nearest EU member (Romania), and only Georgia share a maritime border with the enlarged EU by the Black Sea. With a Turkish EU accession in the future, the other two states of the region, Armenia and Azerbaijan would also become direct neighbors of the Union.

The ENP has included the PCAs, as a sound basis for developing future partnership. The ‘political dialogue’ feature introduced by the PCA acquired a different nature within the ENP. The ENP intended to be based on political dialogue, instead of a demand-driven approach usual by the PCAs, where there was only one party, which was obviously deciding on the scope, measures and mechanisms of the cooperation.<sup>2</sup>

## Regional versus bilateral approaches

The European Union’s trade policy instruments are based not only on bilateral cooperation, they may have multilateral forms like the

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<sup>2</sup> The necessity of a political dialogue was realised even before the launch of the ENP, when the Council adopted a new Regulation for relaunching TACIS programme basing it ‘on an understanding that co-operation is a reciprocal process, encouraging a move from a “demand-driven” to a dialogue driven approach’ (Ghazaryan, 2008).

former Lomé Convention, and the different initiatives offered for the neighbors: the Euro-Mediterranean Partnership, and later the Union for the Mediterranean, the Eastern Partnership or the Black Sea Synergy.

The ENP itself is primarily bilateral, but interlinks with regional and sub-regional processes. Actually, the countries participating in the ENP are quite different, the ‘common-nominator’ among them being the rather Eurocentric approach based on their neighborhood to EU. But the Eastern partners are all European countries, members of the Council of Europe, and as such, based on paragraph 237 of the Rome Treaty, these countries have the right to appeal for a full membership.

So the question still remains: why not to make the distinction between countries and regions more explicit, and treat the “sub-regional cluster” of the Union’s neighbors separately. The new initiatives of the European Union seem to follow this logic.

### **Black Sea Synergy (BSS)**

With the joining of two Black Sea littoral states, Bulgaria and Romania, the prosperity, stability and security of the neighbors around the Black Sea have become an immediate concern to the EU more than ever before. An EU initiative, called the Black Sea Synergy was established in 2008, to develop the cooperation within the Black Sea region and also between the region as a whole and the European Union, thus adding a regional dimension to the ENP. In this sense, the "Black Sea Synergy" completed the "chain" of regional cooperation frameworks in the EU's neighborhood, adding to the Euro-Mediterranean Partnership and the Northern Dimension.

The Black Sea Synergy has not established a secretariat but tried to help political agreements and actions to be implemented by existing institutions, such as the Black Sea Economic Cooperation group (BSEC) or the Black Sea Forum (BSF). It was co-funded from the EU's "neighborhood policy" and other existing funds. Regular meetings were envisaged between foreign ministers of Black Sea zone states: EU-member Romania, Bulgaria, Greece, EU membership-candidate Turkey, ENP-participant Ukraine,

Georgia, Armenia, Azerbaijan and Moldova, and Russia. Although the Black Sea Synergy is still existing, without strong 'god-fathers' in the EU, the BSS did not become a really influential institution, and the Eastern Partnership Initiative, launched one year later, took away both the political attention and the financial sources.

## **Union for the Mediterranean**

The idea of the Union for the Mediterranean, previously known as the "Mediterranean Union" was proposed by the French President Nicolas Sarkozy, originally implied a selective approach, suggesting that only France, Spain, Italy, Portugal and Malta should confederate with the five North African countries Morocco, Algeria, Tunisia, Mauritania and Libya. The Union was supposed to place emphasis on cooperation in the fields of counterterrorism, illegal immigration, sustainable development and energy security. It was planned as a looser grouping than the EU. Having been backed especially by Italy and Spain, the proposed Union would reduce imbalances between the North and the South of the EU. Later it emerged as a possible alternative to Turkish membership in the European Union, whereby Turkey would instead form the backbone of the new Mediterranean Union.

However, with modifications to the plan in March 2008, it was agreed to be only "completing and enriching" the existing EU structures and policy in the region, and build upon the existing Barcelona process. It was also agreed that the project would include all the EU member states, not just those bordering the Mediterranean, as originally planned by the French President. Once Turkey was given a guarantee that the project would not be an alternative to Turkish EU membership, it accepted the invitation to participate. The Union for the Mediterranean became an international organization initiated in July in 2008, as a development of the Euro-Mediterranean Partnership. The act unites 43 states, every EU member with several non-EU countries that border the Mediterranean Sea<sup>3</sup>.

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<sup>3</sup> Albania, Algeria, Bosnia and Herzegovina, Croatia, Egypt, Israel, Jordan, Lebanon, Mauritania, Monaco, Montenegro, Morocco, Palestinian Authority, Syria, Tunisia and Turkey. Libya remains an observer.

It is still not clear, however, what kind of real novelty the Union for the Mediterranean brings to the EU-Med relations, how the new Union will help to resolve the problems of the region, and whether it will operate better the former Mediterranean initiatives of the EU.

## **Eastern Partnership**

The Eastern Partnership (EaP) is a project which was formally initiated by the European Union. It was presented by the foreign minister of Poland with assistance from Sweden at a meeting of the Council in May 2008.

In their Eastern Partnership proposal, Poland and Sweden suggested that the existing instruments for cooperation between the European Union and its Eastern neighbors would be complemented by an intensified support of the EU. This support would be directed toward those EU neighbors who have advanced furthest in implementing European Neighbourhood Policy (ENP) instruments. It allows for such countries' gradual inclusion in EU policies and programs along with their gradual integration into the EU common market. The plan was open in nature – other countries might join it when willing and ready.

Unlike the Union for the Mediterranean, the Eastern Partnership does not have its own secretariat, but it is controlled directly by the European Commission.

As the Commission projected (EC, 2008), in the medium term the free trade areas with each country and a greater support to meet the related requirements could lead to the establishment of a network of FTAs that can grow later into a Neighbourhood Economic Community. The Partnership also consist a progressive visa liberalisation, a deeper co-operation to enhance the energy security of the partners and the EU, and a support for economic and social policies designed to reduce disparities within each partner country and across borders. A new Comprehensive Institution-Building (CIB) programme was planned to improve the capacity of each partner to undertake the necessary reforms.

Building on previous Commission proposals to strengthen the ENP, the EaP wanted to reinforce the interaction with all six part-

ners, always tailored to each partner's specific situation and ambition. But, as Garcia states, compared to the Barcelona Process, the ENP downgrades the regional dimension to 'a complementary, and in fact optional, element. (Garcia, 2013, p. 530)

## **Bilateral relations**

Currently, from the Eastern partners Ukraine, Moldova and Georgia are in closest relation with the European Union. These countries were the first to have an Action Plan adopted. All of them negotiated an Association Agreement with DCFTA in 2011-2012. At the Eastern Partnership summit in Vilnius, on the 28-29th November, the agreements with Georgia and Moldova were initiated. Ukraine, on the other hand, postponed the signing of her already ratified AA agreement, which led to massive protests in Ukraine.

Azerbaijan also has ongoing negotiation on an Association Agreement with the EU. The WTO membership of the country is a prerequisite, however, to be able to start negotiations on a DCFTA. The third Caucasian country, Armenia, also had negotiations on an Association Agreement and on DCFTA with the EU. The relation, however, cooled down, when Armenia voiced her readiness to join the Eurasian Economic Community, a customs union initiated by Russia, incompatible in its nature with a DCFTA with the EU.

The third Eastern European country, Belarus supports the ENP in general, but Brussels sets political conditions for a full-scale participation of the country. Since 2003, however, Belarus has been taking part in several 'border programs' (with Poland and Ukraine, and with Baltic countries). Closer cooperation with the EU seems to be possible only after a political change in the country.

As far as the Southern partners are concerned, these countries are non-European neighbors. From them, the three Maghreb countries have the closest relations with Europe, mainly due to the former French colonial rule. Morocco asked even for admission to EC in 1987, but the Council refused the request, as Morocco is not a European country. Morocco and Tunisia were the first to sign the Euro-Med agreements and are doing everything to exploit

the possibilities of the agreements. With Algeria there were several problem areas, like the tense, almost war-like political status and the unreadiness of the economy, i.e. the one-sided structure of the exports, the closed market from the outer world. But Algeria's natural resources are indispensable for the EU. Similar is the case with Libya, but in the mid nineties the country opted out of the partnership. Later it became an observant, and, nowadays, both sides try to warm up relations.

The five countries that are in the Eastern part of the Mediterranean and the Palestine Authority are also part of the EU's ENP policy. Although the relation of these countries with the EU is not as close as that of the Maghreb countries, their partnership status existing since the 1970s and the ongoing peace talks in the Near East and the EU's more active role justified their involvement. The co-operation between the Mashrek and the EU countries is rather dependant on the peace talks. Israel has an edge over the others in the region as concerns its economy and is an equal partner of the EU. At the beginning of the partnership process, there was a hope for economic cooperation between Israel and neighboring Arab countries. It did not come up to the expectations, however, and the tension between the Israelis and the Arabs remained.

## **Advanced forms of cooperation**

The contractual frame for a stronger engagement, the **Association Agreements (AAs)** would supersede the current agreements (Partnership and Cooperation Agreements, Euro-med Agreements). The agreements have already been negotiated with Ukraine, Moldova and Georgia, partners that were willing and able to take on the resulting far-reaching commitments with the EU. These new agreements would create a strong political bond and promote further convergence by establishing a closer link to EU legislation and standards. They may also advance cooperation on Common Foreign and Security Policy and European Security and Defence Policy.

The AAs include the goal of establishing a **deep and comprehensive free trade area (DCFTA)** with each of the partner coun-

tries. These DCFTAs can only be established with countries which have joined the WTO<sup>4</sup>. They cover substantially all trade, including energy, and aim at the highest possible degree of liberalisation (with the asymmetry in the pace of liberalisation). The agreements contain legally binding commitments on regulatory approximation in trade-related areas, and they create real perspectives for enhanced movement of goods, capital and the supply of services to be achieved over the long term. In parallel, sectorial measures should be pursued to facilitate market access for partners.

To be able to exploit the fruits of the agreements, the EU will encourage these countries to establish a network of regional free-trade agreements among themselves based on the bilateral commitments undertaken in the DCFTAs with the EU. This would strongly enhance intra-regional trade and economic integration and complement the countries' efforts to better integrate with the EU economy. An important element contributing to further economic integration is the diagonal cumulation of origin.

To promote the legal movement of people, the EU initiated Mobility Pacts with the Eastern Partnership countries. In this framework the EU offered visa facilitation for its partners and, in the longer-term, open dialogues on visa-free travel with all partners. Of course, the speed of establishment always depends on the situation of each partner country. Currently Ukraine, Georgia and Moldova have signed a readmission agreement parallel with visa facilitation agreements with the EU.

In case of ENP countries it remains an important question, however, how far the harmonisation should go in different fields, which regulations of the EU *acquis communautaire* should be adapted by the neighboring countries. They get no full accession perspective, and the more such alignments have to be done, the more costly they are, and their rationality may be questioned by the partner countries.

As a further step, the idea of creating a Neighbourhood Economic Community emerged, similarly to the already existing European Economic Area. In the longer term such a Community

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<sup>4</sup> Currently Azerbaijan, Belarus, plus Algeria, Lebanon, Libya, and Syria have not concluded their WTO accession negotiations.

could be offered full access to the single market.<sup>5</sup> The lack of full accession perspectives, however, makes the reality of such Community dubious.

A further problem could be the financing of the costs of harmonisation. As the case of the Mediterranean countries shows, without substantial foreign investments following the liberalisation, the partners will not be able to enjoy the economic advantages of the decision. Investments are needed both in the productive sectors and in infrastructure, since the official support coming through EU funds (ENPI) are limited. The attraction of private capital to these activities should be a priority agenda.

### **The European Neighbourhood and Partnership Instrument (ENPI)**

Still, one of the major innovations in the Union's relations with neighboring countries consists in the establishment of a unique financial instrument for the ENP as a whole. The European Neighbourhood and Partnership Instrument (ENPI) replaced the TACIS and MEDA programmes in 2007.

For the budgetary period (2000-2006), the funds available were approximately €5.3 billion for MEDA and €3.1 billion for TACIS, as well as approximately €2 billion in European Investment Bank lending for MEDA beneficiary countries and €500 million for TACIS beneficiary countries. For the next budgetary period (2007-2013), €12 billion in EU funding were available to support these partners' reforms, an increase of 32% in real terms. Still, the new endowment lied below the initial requests of the Commission in the 2005 budget negotiations; it incorporated headings that were previously included elsewhere in the EU budget.<sup>6</sup>

The ENPI was designed to target sustainable development and approximation to EU policies and standards – supporting the

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<sup>5</sup> It would require the partners to develop the capacity of their economies to be able to fully withstand the competitive pressures of the single market and to demonstrate not only a willingness to adopt all relevant elements of the EU *acquis* but also a capacity to implement them, with comparable standards and practices. Substantially increased technical assistance and funding will be needed to achieve this objective.

<sup>6</sup> ENPI money has been used for the reconstruction of Lebanon, thus reducing the actual availability of cash. (Missiroli, 2008)

agreed priorities in the ENP Action Plans (as well as the Strategic Partnership with Russia, which was previously also covered by the TACIS programme). The new funding was planned to be much more flexible, policy-driven instrument, where the allocation of funds depended on the countries needs and absorption capacity as well as their implementation of agreed reforms. Based on the 'more-for-more' principle the EU now offers greater incentives to countries that make more progress towards reforms. An important aspect of the ENPI is the improvement in cross-border cooperation with countries along the EU's external land and maritime borders thus avoiding new dividing lines.

For the next budget period (2014-2020) the proposed financial framework of the European Neighbourhood Initiative (ENI, replacing ENPI) will reach 18.2 billion euro, 40 per cent up on the amount available under the ENPI from 2007-2013.<sup>7</sup> How it will be shared among Eastern and Southern countries is still unclear. In the 2007-13 period, the shares have slightly changed: 62 per cent of the Funds went to the South (it was 70 pre-2007), and 38 to the East (30 per cent previously).

## **Evaluation of trade relations with neighbors and conclusions**

How can we evaluate the effects of EU trade policy concerning neighbors? As far as economic achievements of the EMP are considered, the results are mixed. The Southern partners have reduced their tariff levels according to the Euro-med agreements, but they got no access for their agricultural export to the European market as a compensation, although this is the sector where the South has a comparative advantage. And in reality, a further liberalisation by Euro-med agreements was a goal neither for EU nor for Southern regimes.

The Euro-med Free Trade Area was scheduled to be achieved by 2010 but without functioning free trade agreements between the Southern countries, it still relies on bilateral structures<sup>8</sup> and

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<sup>7</sup> Sources of datas: <http://www.enpi-info.eu>

<sup>8</sup> The Agadir Agreement signed in 2004 by Egypt, Tunisia, Morocco and Jordan intends to gradually establish free trade between the signatories.

threatens the region with the negative impacts of ‘hub and spoke’ effect<sup>9</sup>. An indirect proof to that is the fact that – despite previous expectations – the level of FDI coming from European countries to the region remained low. The use of the current system of rules of origins is not attractive for FDI, especially for cross-border production chains in the region. (Dreyer, 2012) A harmonisation of investment and competition policies also stayed outside the scope of the agreements.

To make the system of rules of origin more effective, the EU extended the Pan-European cumulation system to the Mediterranean countries and created the Pan-Euro-Med cumulation of origins. The system operates between 42 countries currently: the EU, the EFTA members, Turkey and Euro-Med countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the Palestinian Authority).<sup>10</sup>

But even with a broad system of cumulations created, the functioning of a free trade area remains complicated and thus less attractive for investors. As Krugman&Obstfeld states, free trade agreements are politically straightforward but administratively a headache, while customs unions are just the opposite (Krugman&Obstfeld, 2002). In case of a customs union, participant countries have to agree on the common external tariffs used by both sides, which generates political debates and needs compromises from both sides.<sup>11</sup> By free trade agreements, the countries preserve their independent trade policy but the necessity of rules of origins makes the operation of the free trade system administratively more complicated.

For the ENP countries, a customs union may be administratively more straightforward than a free trade agreement but politically it

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<sup>9</sup> The ‘hub and spoke effect’ appears, when a large country (hub) has bilateral free trade agreement with other (smaller, developing) countries (spokes), but there is no such agreement among the other countries. The production will rather be in the ‘hub’ and exported to the free trade partners, because a larger area can be achieved freely from there.

<sup>10</sup> The diagonal cumulation means that products which have obtained originating status in one of the 42 countries may be added to products originating in any other one of the 42 without losing their originating status within the Pan-Euro-Med zone. [http://ec.europa.eu/taxation\\_customs/customs/customs\\_duties/rules\\_origin/preferential/article\\_783\\_en.htm](http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_783_en.htm)

<sup>11</sup> By the EU-Turkey Customs Union Agreement Turkey agreed to adopt the Common External Tariffs of the EU and to harmonize its foreign trade regulation accordingly without compromises.

is much more complicated to construct. Here, the ‘neighboring’ countries willing to join the Customs Union, had to accept the already existing Common External Tariffs and so it is not the construction but the sustainability of the agreement which is questionable. Due to fortunate circumstances, the Turkish CU agreement was able to contribute to Turkey’s economic transition and fast economic growth in the last decade. In case of the ENP countries, however, the applicability of the model seems unlikely without a perspective of a full-fledged EU membership.

And even for the EU, the goal is rather a harmonisation of legislation, not the harmonisation of external tariffs. The free trade agreements negotiated by the EU are seen as bilateral means substituting multilateral liberalization and rule making in the WTO framework. Especially, the Deep and Comprehensive Free Trade Areas (DCFTA) are ‘opportunity to negotiate regulatory and beyond-the-border issues that are not included in the Doha Round and also to deal with ‘tough’ issues like agriculture, which seems almost impossible to be solved in the multilateral talks.’ (Liargovas, 2013)

As regards to the ENP, in particular, the main reason for the EU to follow the road of bilateralism is its objective to deepen the substance of trade agreements, enhancing more comprehensive trade relations with its neighbors and thus, bringing its neighbors gradually closer to the Single Market (Petraikos et al, 2013). The EU offers DCFTA not only for Eastern partners but also for Mediterranean partners.<sup>12</sup> The negotiations on a possible DCFTA between the EU and Morocco were started on 22 April, 2013 in Rabat. The DCFTA will extend significantly beyond the scope of the existing Euro-med Association Agreement. The new agreement will include trade in services, government procurement, competition, intellectual property rights and investment protection, as well as a harmonisation of industrial standards and technical regulations or sanitary and phytosanitary measures.

The ENP was aimed to bring the neighbors closer to the Union both politically and economically. The Union can still rely on its

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<sup>12</sup> Currently, potential candidates for negotiating a DCFTA with the EU are Egypt, Jordan, Morocco and Tunisia.

‘high status’ among these countries and motivate them to undertake necessary processes for the possible integration whether within the region itself or with the Union. What is required from the EU is the adaptation of elements in a way which will make it possible to meet the expectations of the neighboring countries concerning integration. At the same time, this would allow the Union to pursue its own interests and guarantee its own security. In order to reach this, the Union would make the ENP a comprehensive policy, where principles of conditionality, joint ownership and differentiation do not contradict each other.

On the other hand, by adding the principles of joint ownership and differentiation, the EU has tried to adapt the pre-accession policy to the ENP as much as possible. However, these principles do not sit well with the main principle of conditionality borrowed from the enlargement experience. Nevertheless, the greatest tension comes generally from the question of using the enlargement policy when membership is not offered, since in case of its success the ENP will result in creating new candidates. Thus the EU cannot demand similar commitments from both the countries who are eventually offered membership and those who are offered just a ‘stake in the internal market’. On the whole, the ENP seems to suffer from being neither enlargement nor foreign policy. (Misroli, 2008): it has elements from both policies but neither from them works properly.

It can be concluded that trade relations and trade policy is continued to be important for the European Union to maintain its the competitiveness but it also remains a foreign policy tool of the EU, especially in case of neighboring regions. But since the EU has much poorer countries in the neighborhood, integrating them to the internal market is costly and may be dangerous: instead of creating stability, it may increase instability in the surrounding regions.

In the neighborhood, rather political than commercial goals and considerations shape the EU trade policy.

So the need for strategic policy is a must for at least three other reasons. First, the still existing framework policy, the ENP has to do with at least 15 countries in four regions (Eastern Europe, the Caucasus, the Levant, and North Africa), and the challenge is not

to tailor ENP policies to individual countries but to address the regional level. Second, the ENP has moved into the Russian sphere of influence and challenges Russian interests and the EU can only hope to cope with Russia if it is clear on its priorities on key issues (trade, energy, democracy). And finally, the ENP overlaps with American interest as well. Geopolitically, the United States has an interest in influencing events in the Eurasian periphery and organizing relationships with local partners that enable this influence (Rynning – Jensen, 2008).

The ENP signals that the EU is more ready and able to engage in this type of partnership but it will depend on future developments how the ENP strategy will be able to handle the challenges coming from the neighborhood.

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# GENERAL PROVISIONS OF THE EUROPE (ASSOCIATION) AGREEMENTS

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## Introduction<sup>1</sup>

Three countries of Central and Eastern Europe (Poland, Hungary and Czechoslovakia) initiated bold reforms of their political systems and economies in 1989. Practically from the very beginning, Central and Eastern European countries (CEECs) sought for closer relations with the then European Community (EC), both for economic and political reasons.

In the middle of 1990 all three countries (Czechoslovakia at this time was still one country) officially applied for a beginning of negotiations for an agreement of association, and the official negotiations with all three countries began in December 1990. Talks were concluded in autumn 1991 and on 16 December 1991 bilateral association agreements were signed between the European Communities and their Member States on the one hand and each of those three countries: Czechoslovakia, Hungary and Poland.<sup>2</sup>

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<sup>1</sup> This chapter bases on the following chapters: Poland prepared by E. Kawecka-Wyrzykowska and Hungary prepared by S. Meisel, published in: *From Association to Accession. The Impact of the Association Agreements on Central Europe's Trade and Integration with the European Union*, ed. by K. Mizsei and A. Rudka, Institute for EastWest Studies, Warsaw, Prague, Budapest, Kosice, New York, 1995.

<sup>2</sup> Later similar association agreements were negotiated with other countries which started transformation, it is: Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovenia. The full name of EA was the following: Europe Agreement establishing an association between the European Communities and their Member States, on the one part, and the mentioned countries that signed similar agreements, on the other part.

The Agreement with Czechoslovakia was renegotiated after the dissolution of the country as of 1 January 1993. At that time a new clause was added to agreements with Slovakia and Czech Republic, making association conditional on political requirement consisting in “Respect for the democratic principles and human rights established by the Helsinki Final Act and the Charter of Paris for a new Europe, as well as the principles of market economy” (Art. 6 of the Association Agreements). Those rules were to be respected by all parties to the Agreements. They were included also in the further Association Agreements signed by the European Communities with their European partners.

In other areas the coverage of the Agreements was almost identical. Differences applied mainly to slightly different timetables of trade liberalisation, of adjustment of national laws to the EU laws as well as timetables of implementation of other liberalisation commitments. The commercial parts of the Agreements entered into force on 1 March 1992 (on the basis of so called Interim Agreements) and the whole Agreements became applicable on 1 February 1994 (after ratification by respective partners).

All CEECs treated the EAs as a first step to full integration and stressed the agreements’ important role in their relations with the EU. This helped to achieve relatively soon the EC decision on membership criteria (during European Council in Copenhagen in June 1993). The Copenhagen meeting, though vaguely, stated formally the possibility of those countries joining the EC if they were willing and able to fulfil the necessary obligations, just broadly defined in the Summit conclusions.

Europe Agreements included the establishment of a political dialogue and the creation of a free trade area in trade in goods between the EC and a respective associated country. Some opening up of the partners’ markets was provided in the field of movement of workers, establishment of companies and supply of services, as well as in the area of movement of capital. Also, EAs included a set of commitments by the associated countries to approximate their legislation to that of the Community (some of them being compulsory for CEECs). As a first step in the process of the approximation of legislation the EAs stressed the necessity to harmonise laws directly related to trade. Provisions on economic and

cultural cooperation were rather general, identifying areas of possible mutual interest. Provisions on financial cooperation offered CEECs some stability in terms of access to financial support under PHARE (Poland-Hungary Assistance for Restructuring their Economies), access to loans of the European Investment Bank and support for special fund to stabilise their currency.

As regards provisions for trade liberalisation, they were different in case of non-agricultural products (industrial goods and raw materials) and agricultural products. The first group provided for creation of free trade area, i.e. elimination of all border barriers. This goal was achieved basing on the asymmetry, it is earlier and faster elimination of trade barriers by a stronger partner (EC) and slower and usually delayed opening up of markets of CEECs.

### **Liberalisation of trade in non-agricultural products**

Regarding trade in non-agricultural products, all parties of the EAs committed themselves to observing the standstill principle, i.e., not introducing any new restrictions or not increasing already existing tariffs. Omission of this clause would make it possible to increase the scope of protection after the entry into force of the Agreements, which would violate the arrangements made earlier. In some exceptional cases defined in the Agreements, it was possible to raise the level of protection by using safeguard clauses. The basis for duty reduction was established in a way that allowed taking into account the outcomes of the Uruguay Round negotiations.

The EAs immediately removed almost all quantitative restrictions (QRs) on industrial imports from the CEECs, except for textiles, steel and coal. They also removed tariffs on over 50% of the EC imports from the region. Tariffs on most of other products were to be abolished over a two-to-five year period (in case of Hungary – lasting to 7 years), except for textiles and clothing. For 1995, the average (weighted) tariff rates for imports from CEECs were estimated at 1.2% for Hungary, 1.1% for Poland and only 0.7% for former Czechoslovakia.<sup>3</sup>

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<sup>3</sup> European Commission: “Trade liberalisation with Central and Eastern Europe”, European Economy, Supplement A. Recent economic trends, No. 7, July 1994; cited from: From Association to Accession, op.cit., p. 5.

Besides textiles and clothing, a few other groups of products (iron and steel, chemicals, furniture, leather goods, footwear, glass and vehicles) were treated as sensitive sectors, so trade of them was also to be liberalised at a slower pace. Moreover, exports of sensitive products from CEECs to EC were subject to liberalisation in the framework of preferential quotas (reduced import duty only for a limited amount of goods). The Copenhagen European Council (June 1993) decided to implement faster liberalisation in those categories. As a result, almost all of the non-agricultural exports of CEECs to the EC were practically liberalised as of the beginning of 1995.

The schemes of CEECs concession on non-agricultural products were much simpler. In Poland, with the entry into force of the Interim Agreement, Poland abolished tariffs on about 28% of the value of industrial imports from the EC, mainly raw materials and capital goods, especially technologically advanced equipment to stimulate the restructuring. Liberalisation of access to the Polish market for the remaining non-agricultural products started on 1 January 1995 (except for cars, which were liberalised only in 10 year period, i.e. till the beginning of 2002). Liberalisation of those products continued in five equal instalments (20% of the basic rate in each year), the last reduction taking place at the beginning of 1999.

The situation was different in Poland for automotive products for which 10 year transitional period for elimination of tariffs was provided for (supplemented with duty free quotas for EC cars exported to Poland).

Let's add that all reductions of customs duties were speeded up by the liberalisation on multilateral forum, as agreed in the Uruguay Round and introduced in several years, starting on 1 January 1995.

The process of duties elimination in the Hungarian non-agricultural imports may be divided into three parts. From the entry into force of the Interim Agreement until 1 January 1994, Hungary eliminated during three years in three equal phases the duties of the so-called "quick list". The share of the concerned products of dutiable industrial imports was about 15 per cent in 1991, but it diminished after the adoption of the EA. Imports of goods listed here were marginal both from the fiscal and structural points of

view. The criteria of being listed here were a relatively low level of duties and the minimisation of economic effects (i.e. these concessions were rather symbolic, with no substantial trade effect). Mainly machinery and chemical products, consumer goods, metal and metallic products were included in the so-called “normal list”. The duties on these products were to be eliminated between 1995 and 1997 in three equal steps. The share of these goods in the Hungarian industrial exports was about 20-25 per cent. The structure of the so-called “slow list”, containing products for which duties were to be eliminated relatively slowly and gradually, was similar to that of the normal list with the difference that textile and clothing and metallurgical products were mostly listed here. Part of them was also protected by quantitative restrictions. These duties were phased out by the end of 2000.

As far as the Czech Republic is concerned, imported industrial products were divided into three groups: non-sensitive, moderately protected and sensitive. The termination of tariff protection was differentiated as follows: for non-sensitive products from the date of the EA entering into force, for moderately protected commodities from 1 January 1997 and for sensitive products from 1 January 2001.

### **Liberalisation of trade in agricultural products**

The provisions of the Europe Agreements concerning trade in agricultural products were very complex as they involved the most-ly protected area of the EC activity. The commitments were limited (small reduction, not full elimination of protection) and selective (they included a relatively short list of products and did not cover all products as it was the case with non-agricultural products). Some product groups were excluded from the concessions (e.g. wheat, sugar, most of the milk products, etc.).

As a general rule, the EC granted concessions to CEECs in the form of tariff quotas for defined products with gradually increasing levy or tariff reduction over the coming years. These concessions were valid for defined quantities of products imported from the Visegrád countries. The preferential quotas were increasing from the entry into force of the agreements by yearly 10% over 5 years.

The administration of the tariff quotas in many cases was bureaucratic and sometimes non-transparent.

On the import side the scheme of concessions granted by the associated countries was different. For its part, Poland introduced a one-off reduction of tariffs covering 250 agricultural products. The tariff reduction by 10 percentage points (usually from 35% to 25%) was implemented on the day of the Interim Agreement's entry into force. Products subject to liberalisation in Poland were mostly products not competing with domestic production (e.g. oranges, bananas, rice etc.).

In Hungary the scheme of agricultural import concessions accorded to the EC suppliers followed that on the export side. Nevertheless, the product coverage of the concessions was more limited and the volume of the preferential quotas remained lower than on the export side. The pace of increasing these quotas was only the half as compared to their quotas in the EC.

According to the Hungarian experience, concessions established in the EAs could produce two types of effects. On the one hand reduction of import charges could result in rising selling prices. On the other hand, because the concessions are usually shared by the exporter and importer (in practice, most of it went to the importer), these concessions were able to heighten the interest of importers to buy products from the CEECs, thus to maintain or increase the level of trade. In reality, the reduction of the import burden was not perceptible in the export prices of the most Hungarian products. In many cases even a price decrease was registered or, if prices increased, they did not reflect the amount of the duty and levy reductions. Generally speaking, the concessions were not able to significantly increase the volume of exports either. In the Hungarian imports, since the concessions were limited, the EA scheme itself did not substantially influence imports.

One should also mention the experience of agricultural trade in relation to the protection measures that were taken by both sides. While in the trade of industrial products the EC applied a relatively open treatment towards CEECs products, there were no substantial changes in the Community's restrictive regime in the trade of agricultural and food products (because in spite of the concessions, the EA left untouched the agricultural system of the parties).

Moreover, as a contrast to the industrial sector, limited agricultural liberalisation did not enforce strong adjustment impulses to the agriculture in the CEECs. That became a must only in the period of the accession.

## **Safeguard clauses**

Contingent protection measures (anti-dumping and anti-subsidy clauses and general safeguard clauses) as well as other protection providing rules were contained in the EAs. Most of them referred to standard GATT/WTO safeguard clauses and could be applied by both partners. They included the following.

- The general clause. This allowed actions where “... any product is being imported in such increased quantities and under such conditions as to cause or threaten to cause ... serious injury ... or serious disturbances...”<sup>4</sup> for domestic producers of similar or directly competitive goods. This provision was based on Art. XIX. of the GATT. It allowed, however, for wider use of protection against imports than the GATT clause. Both parties to the Agreement could invoke this clause not only when imports caused serious injury to domestic producers but also when such imports caused or threatened to cause “... serious disturbances in any sector of the economy or difficulties which could bring about serious deterioration in the economic situation of a region”.
- Clause on protection against disruptions of agricultural products<sup>5</sup>. Protective measures with respect to agricultural goods which were subject to concessions under the EA could be introduced if imports of such goods resulted in serious disturbances to the markets of the other party. In this case, contrary to the general clause, a causal relationship between liberalisation and injury to domestic producers had to be established.

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<sup>4</sup> Art. 30. of the Europe Agreement signed by Poland. The numbering of the Articles may vary according to the Agreements, the wording, however was similar in all EAs.

<sup>5</sup> The text reads that “if, given the particular sensitivity of agricultural markets, imports of products originating in one Party, which are the subject of concessions (...) causes serious disturbances to the market in the other Party, both Parties shall enter into consultations immediately to find appropriate solution. Pending such solution, the party concerned may take the measures it deems necessary.”

- Anti-dumping measures clause. It allowed either party to counteract dumping. In order to qualify for anti-dumping measures interested companies had to submit sufficient evidence concerning the existence of dumping and material injury or a potential injury to their already established industries through the effects of unfair competition.
- Clause on protection against shortages or a direct threat of shortages in the domestic market caused by excessive export or re-export of certain goods to a country outside the scope of the countries covered by EAs. This allowed for the imposition of restrictions on exports in cases where there is a serious shortage, or threat thereof, of a product essential to the exporting country.
- Clause on protection against balance of payments disturbances provided for the possibility of introducing import restrictions in order to remedy the balance of payments. However, any restrictive measures could not be applied to transfers related to investment, in particular to the repatriation of the amount invested or re-invested and of any kind of revenues from the investment.
- Clause permitting the introduction of bans and restrictions under GATT rules, justified for instance, on grounds of public morality, public security, historic values etc.
- Clause allowing to resort to extraordinary measures. The aim was to prevent the disclosure of information vital for fundamental security interests and to maintain public security in times of international tension which might threaten peace. This clause allowed parties also to extraordinary measures relating to the production of, or trade in, arms, munitions or war materials, provided that such measures do not impair the conditions of competition in respect of products not intended for military purposes.

There were also a few clauses specific for CEECs which could be used only by those countries (for a limited period of time) as weaker partners. The first two clauses – out of those mentioned below – could be applied to trade in goods and the third one to trade in establishment of new undertakings.

- (a) So called restructuring clause allowing associated countries to apply increased import duties to protect infant industries (i.e.

- new industries with a potential for development) or certain sectors undergoing restructuring or facing serious economic and social difficulties (in particular – a high unemployment or a risk thereof);
- (b) Clause on balance of payments restrictions, which permitted CEECs, in exceptional circumstances, to apply exchange restrictions connected with the granting or taking up of short- and medium-term credits (restrictions should be applied in a non-discriminatory manner).
  - (c) Clause relating to establishment of companies. The clause provided for the possibility to introduce temporary restrictions in some sectors against the establishment of Community companies and nationals, if certain industries (i) underwent restructuring, (ii) faced serious difficulties including social ones, (iii) faced a serious risk of drastic reduction of the total market share held by CEECs' companies or nationals in a given sector or industry in their countries, (iv) were newly emerging industries in associated countries.

In all of the above mentioned cases, the increased protection could only be applied for a limited, previously defined period.

Another specific provision was included in the article on competition and state aid. It stated that any public aid, which distorted or threatened to distort competition by favouring certain undertakings, was incompatible with proper functioning of the Agreement. But the "Parties recognise that during the period of five years after the entry into the force of the Agreement, any public aid granted by CEECs shall be assessed taking into account the fact that they shall be regarded as an area identical to those areas of the Community described in Article 92(3) of the Treaty establishing EEC", i.e. as a region in which the standard of living is low or the level of unemployment is high.

## **Rules of origin**

The rules of origin constituted an important shortcoming of the EAs. These rules in the EAs were at the beginning quite restrictive as they generally required at least 60% of local (including all CEF-TA countries) or EC content for imported goods to receive pref-

erential tariff treatment. Such requirements not only directly limited growth of imports from third countries but also had a negative impact critical for the economic growth and restructuring of their economies. The restrictive effects of the rules of origin were evident in the case of broad cooperation with EFTA member states, originally excluded from the cumulation. During the talks on association the cumulation of origin with EFTA countries was an important request of Hungary (especially taking into account the traditional trade with Austria, non-EU member at that time). In the early 1990s it was far more important for Hungary than the cumulation with other Visegrád countries. Nevertheless, the EC categorically refused it, of course, this problem later was eliminated with Austria's EU membership. The rules of origin also restricted inflow of FDI from outside the EU into the region. A few years later, the EU decided for diagonal cumulation of rules of origin, extending "local" content to include all free trade agreements with all European free trade partners.

## **Approximation of laws**

Approximation of the Central and Eastern European countries' laws to the EC *acquis communautaire* was recognised as a major precondition for their economic integration in the Community. The approximation of laws covered in particular the following areas: customs law, company law, banking law, company accounts and taxes, intellectual property, protection of workers at the workplace, financial services, rules on competition, protection of health and life of humans, animals and plants, consumer protection, indirect taxation, technical rules and standards, transport and the environment.

In several areas legal adjustment of laws to the EU laws was compulsory. These areas included first of all: public procurement, competition laws, trade procedures (as these were part of EC uniform commercial policy).

Let us say something more about competition rules. The Europe Agreements prescribed the (immediate or gradual) application of the Community competition legislation. This was a deeply integrative element of the EAs. Rules prohibiting the restriction and

distortion of competition and the abuse of a dominant position generally were in line with the CEE countries' emerging market economy type competition legislation governing the behaviour of companies. On the other part, the adaptation of the regulations of public (state) aid was much more problematic, at least for Hungary. It was possible to take over these rules only step-by-step as due to technical reasons, secondary legislation could have been incorporated in the domestic legislation only gradually. On the other hand, renouncing state aid immediately risked to cause serious problems in the short run for Hungary, a country that just had entered the period of modernisation and restructuring. The problem was finally resolved as a result of the negotiations on membership.

By the legal harmonisation the EA created a new institutional framework for integrating the CEECs into the EU, speeding up the process of creation of modern laws, adjusted to market economy conditions.

## **Movement of labour**

This was one of the weakest points resulting from the Europe Agreements. During the negotiations, CEECs negotiators requested the free movement of labour. The motivation behind this request (in the case of Hungary) was not to find a solution for the domestic employment problems, but the acquisition of the West-European industrial culture. The EAs offered, however, only very limited access to the EC market for workers from CEECs. This took place in form of self-employment (the right of citizens of CEECs to undertake a job in the EC without a work permit, but only job on their own and not to look for a job in EC firms). Moreover, national treatment (treatment not less favourable than that accorded to domestic workers) was offered to persons already legally employed or engaging in business on a self-employed basis in the EC. In fact it was legal confirmation of the existing right, which was especially important for Poland, to a lesser extent to the other countries, because of a great number of Polish citizens already being employed in the EC and also because of the lower migration potential of other V4 countries' workers. The EAs declared that the parties mutually guaranteed the social benefits and stability

of pensions to which their citizens were entitled. Also, key personnel from CEECs could be employed by CEECs companies operating in the EC without any restrictions on the part of the EC countries. Provisions on key personnel also applied to EC nationals working in CEECs.

## **Right of establishment and supply of services**

The main instrument of eliminating restrictions on establishment of companies was national treatment, i.e. treatment of foreign companies and nationals no less favourable than that accord to their own companies and nationals. On the day of entry into force of the EA, each member state of the EC accorded national treatment for the establishment of companies from CEECs. Some sectors were however excluded from national treatment (e.g. purchase of agricultural land, natural resource, air transport services, legal services). CEECs enjoyed in this field the asymmetry of concessions.

In the field of cross border services, as a general rule, the Europe Agreements did not contain substantial steps aiming at liberalising this type of services. The aim was only gradual, asymmetric abolishment of the existing barriers, respecting the level of development in each other's service sector. Practically, no real development took place in this respect till the accession to the EU.

## **Movement of capital**

Regarding movement of capital, CEECs and EC members have committed themselves to ensure full liberalisation of payments in convertible currencies arising out of trade between them, supply of services and movement of workers (on current account balance). Such liberalisation applied only to payments connected with transactions which were liberalised pursuant to the Agreement. From the entry into force of the EAs all parties undertook to ensure free movement of capital relating to direct investment, including liquidation, repatriation and any profit thereof. Also, parties should refrain from introducing new impediments to the movement of capital. As regards investments connected with the estab-

lishment of companies in the partner countries, the freedom of movement of capital was to be ensured by CEECs and EC by a latest stage (i.e. within five years). In the case of serious balance of payments difficulties, parties could adopt temporary restrictive measures (except for on transfers related to investment).

### **Financial cooperation**

The association agreements concluded between the EC and different partners (e.g. Greece, Turkey) in the 1960s and 1970s provided for a defined financial assistance from the part of the Community in the form of financial protocols. The original expectation of the CEECs was to have a similar provision included in the agreements. The EC was not ready to accept the concept of longer term financial protocols. Thus, a big compromise of the Europe Agreements was to establish only the forms and conditions of potential financial assistance and of financial obligations of the EC (first of all continuation of PHARE assistance) without a financial protocol detailed in years or figures.

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## EXPERIENCE OF POLAND'S ASSOCIATION AGREEMENT

*Elżbieta Kawecka-Wyrzykowska*

### Starting presumptions and motivations

The list of motivations for the association negotiations was quite long. It included both economic and political motivations.<sup>1</sup> From the economic point of view, the association was to improve substantially and in the long term the access to the huge internal market of the EU. Poland enjoyed tariff preferences (in the form of Generalized System of Preferences - GSP) on the EC market (since 1 January 1990) but they were offered on a temporary basis and could be withdrawn, in particular after the improvement of the economic situation in Poland. The prospect of access to the huge single market of the EC, which was to be completed soon (by the beginning of 1993), was very important for the Polish producers. Market access became especially important after the collapse of the COMECON rules of trade and sharp decrease of exports to the Eastern markets (in 1991). Also, the shift to markets of developed economies was to encourage Polish exporters to improve the quality of products as this was the condition to enter new markets and to strengthen the position on those markets.

Integration into the EC anchored the CEEC in market economies and in democratic political institutions.

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<sup>1</sup> E. Kawecka-Wyrzykowska (1995), On the benefits of the Accession for Western and Eastern Europe, *Coming to Terms with Accession*, ed. by L. Ambrus-Lakatos, M. E. Schaffer, Forum Report of the Economic Policy Initiative no. 2, Institute for EastWest Studies.

Competitiveness of Polish products was at the beginning of the nineties much lower than that of EU products. Therefore, several mechanisms were adopted in the Accession Treaty to take this factor into account. The most important of these were: asymmetry of trade concessions (delayed and sometimes slower opening up of the Polish market as compared to the reduction of import barriers in the EC) and safeguard clauses.<sup>2</sup>

Modernization of the CEEC was a condition for their sustained growth. Such modernization was, however, not possible without a large inflow of foreign direct investments. Some sectors were very underdeveloped, including many services sectors. Their potential development raised prospects not only for CEEC consumers but also for foreign investors who could expand their activities and increase profits. All in all, greater integration was to act as a way to multiply benefits and create new opportunities for cooperation in several other areas.

Important benefits were linked to the expected positive effects on the stabilization of policy-making in the CEEC. Legal commitments made under the EA introduced more discipline into domestic policies. They also made a significant contribution towards the consolidation of reforms in CEEC, thus strengthening the confidence of the general public and investors, including foreign ones, and reducing uncertainty of doing business in those countries.

Since the very beginning of negotiations, Polish authorities made it clear that gradual liberalization was to be an important instrument of injection into Polish economy of foreign competition in order to force domestic producers (occupying in many sectors quasi-monopolistic position) to adjust to market conditions. Such an approach assumed that all firms had to adjust not only to new legal requirements (e.g. on safety of products) but also to reduce costs of production, improve technologies of production, improve organization of work etc. Without such comprehensive adjustments, producers would not be able to stand EU competition and stay

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<sup>2</sup> For example: EU started to liberalize its non-agricultural imports from Poland in 1992 and this process ended in 1996 – except for sensitive products. Poland, apart from one-off elimination of some customs duties in 1992 implemented liberalization of its imports in 1995-1999.

on the market. Such adjustments, introduced in the period of association, became crucial for quite good future competitive position when Poland became the EU member and eliminated all border controls in trade with the EU.

The association agreement had also its political motivations. Poland wanted to be anchored into the market economy and democratic legal system. The Association Agreement with the EC was the best instrument to achieve those goals. An important anchoring role of the Agreement resulted also from the fact that at the beginning of the nineties the political situation in Eastern Europe and the position of the Soviet Union (Russia) on changes going on in Central Europe was not clear. Poland wanted to improve its external security by negotiating membership in NATO but also by legally binding deep economic and political relations with the EC.

## **Strategic Goals**

An important negotiating strategic goal for Poland was to include a clause into the Association Agreement on the important role of this Agreement in preparing Poland for the future accession to the EU. Future accession to the EU has been the strategic objective of successive Polish governments since the very beginning of transformation. In this way, the Government wanted to give Western partners a clear signal on this priority and to have a reference point for further talks; also to give the Polish society a clear signal that adjustment costs to association would be rewarded in the future in form of benefits resulting from membership in the EU.

During the first stage of negotiations, the EC did not want to hear about Poland's ambitions relating to the future EC membership. In the final stage of negotiations Poland succeeded to include the unilateral clause into the preamble. It stated the point that "Poland's ultimate aim is the membership of the Community." In this way, the EC accepted that the Association Agreement was treated by Poland as an instrument to prepare the country for the future integration into the Community. Later on, this clause made it easier for Poland to refer to her historical aspirations for the EU membership.

Originally, Poland wanted to negotiate the customs union under the Association Agreement in order to achieve higher benefits from mutual opening of the market. Also, the customs union (with common external tariffs) would be a kind of first step to participate in the EU decision making process (on Common Commercial Policy), thus making future accession easier. This proposal was rejected by the EU at the very beginning of the negotiations.

Also, Poland wanted to negotiate a separate financial protocol specifying priorities, timetable and size of the financial support to Poland. Without such a detailed protocol, the risk was that in the next few years financial support would be withdrawn under the pretext of economic progress made by the Polish economy and even greater needs of the other transforming countries. Instead of that the general clause on PHARE financial assistance was included.

### **Main Horizontal and Sectoral Problems, Compromises and Outcomes**

The most difficult topic for Poland was agricultural concessions relating to the market access. Poland wanted to negotiate completely free trade in agricultural products being aware of relatively high competitiveness of many of them (usually in terms of lower prices and not better quality). In the first phase of the negotiations (till summer break in 1991) the EC did not want to hear about it under the pretext of risks of excessive imports from Poland. The situation was so strained that Poland threatened to deadlock the negotiations in case of no progress on the EU side. Only after the Janajev coup, the EC changed its mind and accepted some liberalization of its agricultural market. This liberalization was modest, both in terms of products covered and depth of import barriers' cuts, but allowed for some increase of Polish exports. In exchange for that Poland reduced protection of some agricultural products imported from the EC.

The second difficult issue was automotive industry. Poland decided to ask for long liberalization period, lasting for 10 years, i.e. till the beginning of 2002. The reason for so long protection was the hope that long and high protection against imports would attract

foreign investors to come to Poland. To this aim, Poland decided to increase import tariffs on cars soon before the commercial part of the Association Agreements entered into force, i.e. on 1 January 1992 (from 15% to 35%).<sup>3</sup> The assumption was that, in view of such high and long protection, foreign investors would decide to invest in developing car production instead of trying to export cars from their home countries. As a result of increased FDI, more jobs were to be created in Poland and, equally important, technological level of car firms and many cooperating Polish firms would improve, impacting positively many Polish producers.<sup>4</sup>

On the EU side, the main sectoral issue, apart from agricultural products, was the fear of cheap Polish clothing and textile products and steel products. Therefore, the EU liberalization period for those products was the longest one (lasting 5 years).

## **Trade and Trade Policy Effects**

A few studies were conducted in Poland to calculate the standard trade creation and trade diversion effects (static effects) of trade liberalization under the EA and also under other regional trade agreements implemented at that time (especially under CEFTA). The most important variables for analyzing possible results of trade liberalization between Poland and the EU were: the level of the initial (base) customs duties, i.e. the duties, which were subject to reduction; the price elasticity of domestic demand for liberalized imports and external demand for domestic products. Also, the distribution of overall gains potentially attainable through liberalization among consumers, exporters and importers was taken into account. According to the majority of quantitative studies, the estimated liberalization effects have been rather low in absolute and relative terms. The cumulative increase of trade resulting from lib-

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<sup>3</sup> This decision did not violate GATT commitments as customs duties on cars were at the time in Poland unbound.

<sup>4</sup> From the historical point of view, this decision seems to have been justified. In the years following the entering into force of the EA, motor vehicle production expanded significantly and attracted about 23% of foreign investment. Daewoo and FIAT bought two major car factories in Poland, while some other foreign companies (among them Opel) started their green field investments in Poland.

eralization was estimated at 5% to 9% depending on the assumptions.<sup>5</sup> The creation and diversion effects did not cover, however, all trade effects. In particular, the so called dynamic effects, which are difficult to calculate, were not taken into account in the above cited studies, though they are estimated to be several times higher than static trade changes. Among such dynamic effects, the most important ones include the economies of scale, enhanced competition which induces firms to adjust to liberalized and more competitive environment, learning by doing, growth of intra-industry trade, increase of predictability of trade policy, which in turn encourages FDI inflows, etc. Very few measurements of dynamic effects of trade liberalization were made in Poland, which usually used gravity models.<sup>6</sup>

Since the very beginning, trade deficit was forecasted. In the first years of association was inevitable, despite the rule of asymmetry of trade concessions. This forecast resulted from a number of factors, including: a) much lower import tariffs in the EU than in Poland (4% and 18% on industrial products, respectively) which had to result in greater demand reaction to elimination of tariffs in Poland than in the EU, b) poor competitiveness of Polish products and limited possibilities of fast increase of Polish exports to the EU, irrespective of market access conditions. These factors were not compensated enough by asymmetry of trade liberalization process (longer opening of the Polish market combined with later start of liberalization). Later on, trade balance was to be restored and reversed. This assumption was confirmed by quantitative studies on expected trade effects of the creation of free trade between Poland and the EU.<sup>7</sup> In reality, the deficit turned into surplus only in 2003 followed by deficit in 2004 and later by trade surplus.

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<sup>5</sup> E. Kawecka-Wyrzykowska, ed. E. Kończyk, K. Marczewski, M. Mroczek, E. Synowiec (1994), *The Europe Agreement's Effects on Poland's Industrial Trade with the European Communities*, „Discussion Papers”, No. 56, Foreign Trade Research Institute.

<sup>6</sup> On comparison of different studies on Trade effects of the Europe Agreement see: K. Marczewski (2003), *Wejście do Unii Europejskiej a zmiany w strukturze handlu zagranicznego Polski*, (w) *Gospodarka Polski przed wejściem do Unii Europejskiej* (red. J. Lipiński i A. Sławiński), Polskie Towarzystwo Ekonomiczne, Warszawa, s. 51-81; see also: W. Orłowski (2000), *Koszty i korzyści z członkostwa Polski w Unii Europejskiej. Metody, modele, szacunki* (Costs and Gains from Poland's Membership in the EU. Methods, Models, Estimations), CASE, Warsaw.

<sup>7</sup> See e.g.: E. Kawecka-Wyrzykowska (1996), *Prospects for Trade Developments between Central and Eastern Europe and the European Union*, „Working Papers” No. 153, Warszawa: Szkoła Główna Handlowa.

As mentioned above, quantitative studies on the increase of trade showed positive, albeit not very impressive trade growth and increasing trade deficit in the first years of association. Let's stress, however, that quantitative changes, albeit positive, did not cover all important effects of the EAs. From the longer perspective, the non-economic effects seem to be equally important. They included, among others, anchoring Poland on the track of market oriented reforms, preparation of Polish society (especially young generation and businessmen) and economy (through injection of competition and resulting restructuring of outdated Polish industry)<sup>8</sup> to future EU accession and to more advantageous cooperation with foreign countries, as well as stronger political position of Poland and strengthened security.

The positive results of the initial period of Poland's association with the EU did not rule out, of course, one-off negative effects for individuals, companies and even larger social groups.

Altogether, integration and transformation were closely interrelated: without integration into the EU, Poland's transformation would have been delayed, at the same time the deep integration into the EU was impossible without radical changes in the economic and political system in Poland;

## **Legal Harmonisation in the Field of Trade Related Issues**

In some areas legal adjustments were necessary conditions of compliance with EU provisions (see previous chapter).

In many areas, adjustments were dependant on Polish decisions, e.g. in the area of harmonization of technical standards. Generally, Poland tried to make legal adjustments as fast as possible, hoping that in this way the legal system would be better prepared for fu-

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<sup>8</sup> Positive changes in the economy can be attributed, to a great extent, to the strong restructuring that has taken place in many Polish companies in the 1990s (as a result of transformation and integration) and aimed at cutting costs, upgrading their technologies, switching to more highly processed and technology intensive products and at improving their price and quality competitiveness. Those developments were enhanced by FDI, which – after several years of building its competitive edge on the domestic market – started to gradually re-channel its sales to export markets.

ture membership.<sup>9</sup> This rule did not apply to areas where adjustments were costly for Polish economy and were not necessary to be introduced quickly, e.g. in the area of environmental protection.

Legal adjustments were well organized by the Polish public institutions.<sup>10</sup> Program of activities on adjustment of Polish economy to the requirements of the EA was prepared by the Government and adopted in November 1992. A similar Program of legal adjustments was adopted in January 1993 and included compulsory and non compulsory adjustments. On the basis of those documents a timetable of adjustments of Polish economy and legal system was prepared for 1995-1996. Later it was updated and extended.

Implementation of the Program of legal adjustments was coordinated and monitored in the form of yearly reports by the Office of Government's Plenipotentiary for European Integration and Foreign Aid, which was established at the beginning of 1991 and subordinated to the Council of Ministers. Its main function was, apart from dealing with foreign aid, to coordinate and monitor adjustments and integration processes in Poland. In 1996, integration functions were overtaken by the Office of the Committee for European Integration and Committee for European Integration. The former institution's personnel consisted of ministers of almost every ministry and was headed by Prime Minister who was empowered to make necessary decisions. Each Ministry had to set up a unit in charge of European integration. Successive Offices prepared reports on the implementation of the Adjustment Program. Reports were presented to- and accepted by the Parliament.<sup>11</sup> On the basis of 1994 decision of the Council of Ministers additional solutions were adopted with regard to legal adjustments in order to ensure compatibility of new legal acts in Poland with the EU *acquis*. Both Offices issued opinions on all government's pro-

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<sup>9</sup> Adjustment of laws was partially financed from PHARE funds,

<sup>10</sup> *Unia Europejska. Integracja Polski z Unią Europejską* (European Union. Poland's Integration into the European Union), (1997), ed. By E. Kawecka-Wyrzykowska and E. Synowiec, Instytut Koniunktur i Cen Handlu Zagranicznego. Warszawa, p. 480-484.

<sup>11</sup> In 1992, a separate Commission for European Integration was set up in Polish Parliament – in charge of implementation of the provisions of the EA and adjustment of Polish economy as well as preparing recommendations for Polish government with regard to relations with the EU.

posals of changes in the law from the point of view of their conformity with EU laws. In particular, the law establishing the Committee for European Integration provided for the necessity to give legal opinion about the conformity of the draft laws with the law of the European Communities. Unfortunately, this law applied only to proposals prepared by the Government and did not include other legal proposals, including those presented by the President and Parliamentary proposals were included into the mechanism of legal assessments only in 1999. Plenty of draft bills were assessed under this mechanism. Due to this system, the process of legal adjustments was speeded up and new Polish laws were more adjusted to the EU *acquis communautaire* than without such a system.<sup>12</sup> Apart from compulsory adjustments, changes in the Polish law were introduced – among others – in the area of copyrights, company law, accounting in companies – where costs were not high.

In general, due to legal adjustments implemented in a number of areas under the Europe Agreement, later accession and adoption of all legal acts of EU became much easier. Also, due to them Polish legal system became relatively early (in the middle of the 1990s) similar to many EU legal solutions, thus making Polish economy more credible and predictable for foreign investors. Due to technical adjustments, Polish exporters could easier meet the standards in force on the whole European single market, thus having easier access to huge EU market. Thus, as a result of liberalization (opening of the market) and of legal changes, many real economy adjustments took place enabling increased exports and restraining imports of some products.

## **Backsliding**

The most notable examples of “backsliding” trade policy in the second half of 1990s involved the application of different safeguard clauses for Poland's imports from members of European free trade

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<sup>12</sup> Later on, during the accession negotiations, when much longer list of Polish laws had to be adjusted to EU laws, fast track legal procedure was set up. First, in July 2000, Polish Sejm set up an Extraordinary Commission for European Law and a little bit later a similar Commission was set up in Senate – the Upper Chamber of the Parliament.

agreements. All clauses (except for the antidumping clause) were invoked, albeit with different frequency.

The restructuring clause (Art. 30 of EA) was applied several times. For the first time, it took place on August 25, 1994 when customs duties were restored on imported telecommunication equipment.<sup>13</sup> Under the Europe Agreement, the customs duties on imported telecommunication equipment were abolished on 1 March 1992, while those on components for this equipment remained in force. Their gradual liberalization was to start at the beginning of 1995 (a similar pattern of tariff concessions was implemented under the free trade agreements with the EFTA and CEFTA countries). Polish Government argued that it was necessary to restore the profitability of production of telecommunication equipment based on imports of components for this equipment. On 21 September 1994 customs duties on telecommunication equipment imported from the European Union, EFTA, CEFTA and Finland were restored as well.

Box 1.: Use of restructuring clause in telecommunication sector in Poland

The imposition of this duty for telecommunication equipment met formal requirements of the restructuring clause, since: (i) it referred to goods manufactured by the sector undergoing the restructuring, (ii) the new preferential duties did not exceed 25 percent ad valorem, (iii) the preference margin has been maintained (12 percent as compared to 15 percent in imports from third countries), (iv) the overall value of imports subject to this safeguard measure did not exceed 15 percent of total imports, (v) less than three years have passed since the abolishment of all the customs duties and quantitative restrictions, (vi) a program of a gradual phasing out of the revised customs duties has been adopted.

Source: J. Michałek, *The Europe Agreement and the Evolution of Polish Trade Policy* (2000), *Yearbook of Polish European Studies*, No. 4.

<sup>13</sup> Based on: J. J. Michałek (2000), *The Europe Agreement and the Evolution of Polish Trade Policy*, *Yearbook of Polish European Studies*, No. 4.

The restructuring clause was also used in January 1996. Under its provisions, oil-refining products were exempt from the agreed timetable of liberalization. Instead of eliminating of customs duties on oil-refining products till the beginning of 1999, Poland extended the period of reducing customs duties until 2001.<sup>14</sup>

For the third time, the restructuring clause was introduced in January 1997, in this case on steel products in order to postpone liberalization on customs duties on this group of products (till 2000 instead of 1999).<sup>15</sup>

Agriculture was another specific and very sensitive sector, where liberalization was limited in terms of degree of cuts of customs duties and as regards the number of products covered. Special agricultural safeguards and other protective measures were applied several times, among others on imported fodder cereals (in 1997), on flour made of other than wheat cereals, malt, bruised grain and bran (in 1999).

Typical cases of the use of safeguards by Poland are illustrated in table 1.

The EU quite often used anti-dumping procedures against Polish imports. Around 10-15 products were subject to antidumping duties yearly. Among products most frequently covered by this type of measures were different steel products and fertilizers.

## **Organisation and Institutional Set-up of the Negotiations and Ratification of EU**

During negotiations, an advisory committee was set up to support the negotiators. It consisted of academia, representatives of all ministries and of businessmen representing main sectors of the economy. Its purpose was to help to prepare well justified argu-

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<sup>14</sup> On 1 January 1996, in connection with the restructuring clause, the duty applicable to petrol imports was 15 percent (12 percent in 1995) instead of 9 percent envisaged by the agreement, while that applicable to diesel oil was 26 percent instead of 21 percent. The customs duty on fuel oil was increased to 25 percent. In 1997, the customs duties on light and medium oils and gas oils amounted to 13 and 20 percent, respectively, see: Poland's Foreign Trade Policy 1995-1996 (1996), Instytut Koniunktur i Cen Handlu Zagaranicznego (Foreign Trade Research Institute), Warsaw.

<sup>15</sup> The clause was applied on steel products imported from Czech Republic and Slovakia, Hungary and Slovenia as well.

Table 1.: Use of safeguards clauses by Poland under the Association Agreement

Name of the safeguard clause	Products covered	Measures applied	Year of implementation
Restructuring clause (art. 28)	Telecommunication equipment	Higher duties	1994/10
	Petrochemical products	Higher customs duties and licensing	1996
	Steel products	Postponement of liberalization	1997
Antidumping clause (art. 29)	X-ray film		1999
General safeguard (Art. 30)	Motor vehicles	Prohibition of import of cars 3 years old or elder	1994
	Harvester combines	Ban on imports of combines elder than 6 years	1996
	Parts of industrial assembly of motor vehicles	Obligation of applying for a permit	1996
	Export of metal and non-ferrous wastes	Quantitative restrictions	1992
	Various skins	Ban on exports	1993
General exception (Art. 35)	Even-toed animals and products thereof		1993
Balance of payments clause (Art. 64)	All products		1992

Source: J.J. Michalek (2000), The Europe Agreement and the Evolution of Polish Trade Policy, Yearbook of Polish European Studies, No. 4, p. 114-115.

ments and requests for longer period of reduction of trade barriers applied to Polish imports, to pick up possible departures from liberalization (in agri-food sector) or to find other “sensitive” imports, which could threaten interests of Polish producers (which sectors “deserved” longer protection and why), to consult timetable and content of asymmetry of Polish import concessions, etc. The proposal of the association agreement (the draft document) was presented to Poland by the EC. Still, Polish side suggested some modifications and amendments.

During the process of ratification of EA in Polish Parliament, an Extraordinary Commission was set up in the Polish Senate for the purpose of examining the bill for ratification<sup>16</sup>. It was a kind of “public hearing” during which heads of important parts of the EA (trade in goods, in services, competition law etc.) were asked questions in order to better understand the results of negotiations.

## **EaP Relevant Conclusions**

- ▶ Integration into the EU was one of the important pro-development and stabilizing factors in the period of systemic transformation of Poland. Integration and transformation were closely interrelated: radical changes in the economic and political system in Poland helped to meet the requirements of the EA; at the same time implementation of the EA speeded up process of market and institutional changes in Polish economy,
- ▶ Tough positions and relevant arguments presented by Polish negotiators appeared to be crucial for the success of negotiating and implementing the EA (especially in the area of agricultural trade and unilateral safeguards),

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<sup>16</sup> E. Kawecka-Wyrzykowska, E. Kaliszuk, E. Rzesutek (1992), Raport Komisji Nadzwyczajnej Senatu Rzeczypospolitej Polskiej do rozpatrzenia ustawy o ratyfikacji Uk adu Europejskiego ustanawiającego stowarzyszenie między Rzeczpospolitą Polską a Wspólnotami Europejskimi i ich państwami (Report of the Extraordinary Commission of the Senate of the Republic of Poland, *Studia i Materiały*", No. 36, Instytut Koniunktur i Cen Handlu Zagranicznego (Foreign Trade Research Institute) Warszawa.

- ▶ The whole process of preparing the EA proved that domestic political and social support was important for the success of implementation of the EA. Many discussions conducted in the period of negotiating EA and its ratification helped people to understand the mechanism of functioning the EC and possible implications of association.
- ▶ Parallel to the implementation of the EA, promotion policy to attract FDI was conducted. It stressed opportunities of quickly transforming Polish economy, including increasing demand of the population, as well as stabilizing role of the EA for the legal environment of business in Poland.
- ▶ Good public administration was important for the success of negotiations and implementation of the EA.
- ▶ Yearly assessment reports, which had to be debated and accepted by the Parliament, made the association process more transparent, more challenging for ministries induced to introduce a number of changes to be compatible with EC rules etc.,
- ▶ The rule was introduced to have the legal proof of the conformity of domestic draft laws with the EU laws before presenting them to the Parliament,
- ▶ As a part of dissemination of content of the EA and resulting opportunities for business, very detailed information on liberalization schedule (on timetable of reductions of duties year by year) and on safeguards, was prepared for business. Access to the information was disseminated through various instruments (TV advertisements, “hot telephone line”, detailed written information etc. This information appeared to be very useful for business.<sup>17</sup>
- Increased EU competition was one of the most important factors forcing domestic producers to withdraw from inefficient production pattern inherited from the planned system economy. Economic agents had to learn faster EU procedures and laws in order to use rules of preferential access to the EU market,
- Government could introduce faster market economy reforms on the ground of “necessity to meet the EA requirements and not to violate the international agreement obligations”,

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<sup>17</sup> Let's remember that at that time no internet access existed.

- Young generation became more interested in EU matters, European studies etc.,
- Stability of domestic economic laws, somehow guaranteed by the EA, increased predictability and safety (market economy character) of Polish laws and encouraged FDI to flow to Poland,
- Association process resulted in increasing public awareness and knowledge on EU, on integration processes and benefits of closer contacts with the world economy.

In order to prepare the society and business better for the opportunities created by association, a new major European studies, as well as specialized courses relating to EU integration were introduced into the higher school curricula.

### **Policy oriented conclusions** *from Polish experience at the stage of preparing for negotiations and at the stage of negotiations*

- ▶ The timetable of adjusting domestic laws to the EU can be earlier drafted (basing on the list of expected laws to be adjusted – like public procurement, foreign trade procedures, competition law),
- ▶ It's important to fight for safeguard rules, including those of unilateral character,
- ▶ When the importing country decides to apply for safeguards, it is necessary to stick to all legal procedures, including consultations with a partner, meeting all time limits etc. Without meeting this condition a stronger partner can easily impose retaliatory measures,
- ▶ At the same time, the governments of EaPs should be careful with accepting applications of domestic producers to make use of safeguards. Once they agree for increased protection in one sector (under the safeguard) they will face strong pressure from powerful lobbies to continue such practice in the future,
- ▶ Free trade areas of weak EaPs economy with a huge and strong EU economy covering most territory of Europe may be risky. To reduce risks of opening of domestic economy, liberalization should be gradual and based on asymmetry of concessions. However, liberalization cannot last too long, as long time for

adjustments slows down interest in adjustments.<sup>18</sup> Polish experience has shown that many companies realized risks involved in tougher competition only a few years after start of liberalization, sometimes 2-3 years before full opening up of the market and it was too late to introduce changes to adjust. A result was increased number of calls for adoption of safeguard clauses,

- ▶ In order to reduce those risks, an important element of EU integration should be a well designed program of technical assistance aiming at implementation of market reforms in EaPs. An essential part of such program should be gradual anchoring of the EaPs legal system into the selected areas of EU *acquis communautaire*,
- ▶ In every case domestic mobilization, as well as political and social support is necessary,
- ▶ When major economic and legal adjustments are necessary and the institutional support for transition weak, rapid liberalization may not lead to growth. Therefore liberalization should be a supplement to deep structural reforms of the economy and its institutions and to well designed macroeconomic policies.

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<sup>18</sup> Poland negotiated a little bit longer liberalization period than Hungary. At the beginning, such a solution was some assessed in Poland as a better negotiating deal than that of Hungary. In practice it appeared that Polish producers started adjustments only in the end of liberalization period and were not prepared well to compete with EU products on domestic market. A reflection of that was increased number of applications to invoke safeguards in the last two years of liberalization.

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## EXPERIENCE OF HUNGARY'S ASSOCIATION AGREEMENT

*Sándor Meisel*

### **Hungary's expectations**

When Hungary began negotiating the Europe Agreement (EA) on association, one of the most important goals was that it should reflect (as expressively as possible) the ambition of Hungary to attain full membership and that it should establish a kind of link between the process of association and accession. Thus the association was considered as a preparatory stage leading to future membership. This also meant, in Hungary's opinion that the agreement had to contain elements assuring the intention of the partners to go beyond simple free trade and facilitate real integration.<sup>1</sup>

In the field of trade relations, Hungary's basic goal was the creation of free trade in industrial products, including steel and textile products (which were treated as special categories in the European Community and were regulated earlier by voluntary restraint agreements), together with the complete elimination of all trade barriers. In the timetable of achieving free trade, the Hungarian delegation wanted to fully assert the principle of asymmetry, reflecting the different level of the partners' economic development. This meant that by Hungarian intention the European Community (EC) should have consolidated the elimination and suspension of quantitative restrictions (already in force from 1 January 1990).

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<sup>1</sup> Juhász (1993)

Hungary also requested the immediate elimination of the EC duties on as many as possible industrial goods. Hungary for its part was to eliminate its duties as gradually as possible.

Hungary wanted to see substantial and immediate concession in market access for agricultural products. The Hungarian delegation had concrete proposals and a list of requests. The list was rather ambitious: apart from requesting 50-100% levy reduction, it included products considered as the “hard core” of the EC agricultural policy. Among the Hungarian ideas was the aim to form a customs union, as some of the earlier association agreements concluded by the EC included provisions on the creation of a customs union. Including this goal into the EA could have been mainly a symbolic element reflecting the strong intention to become member. On the other side, from economic point of view, creating a customs union in a relatively short time would have risked to raise a lot of problems due to internal difficulties related to the transformation process and to the East European economic environment.

In the field of the opening of the EC labour market the starting expectation of the Hungarian delegation was to establish either EC level or bilateral quotas with member states for Hungarian workers. The Hungarian negotiators’ position was that considerable liberalisation must be reached concerning the possibilities allowing Hungarian labour into Community services (including transportation, which was of particular importance at that time) and that the partners would take steps toward the free but asymmetric movement of capital. It was a Hungarian claim that the EA should lay down concrete forms and possibilities for broad political and economic cooperation and that the EC should offer solid financial assistance. The original concept was that this assistance would have been recorded (with defined annual amounts) in a financial protocol. Concerning the financial protocol the Hungarian delegation did not submit concrete numerical proposals because even the Hungarians did not fully agree on the issue.

## **Outcome and compromises of the negotiations**

During the first stage of negotiations, which can be characterised as an offensive period from Hungary’s point of view, it became

clear that the EC's concept and mandate differed on some points from the Hungarian requests. The Community mandate did not tie, in any form, the association with further full membership. The process leading to industrial free trade was conceived by the EC in two stages (but without a complete timetable) with the insertion of a Community checking, which would make it possible to stop or to delay market liberalisation. In this period of negotiations the EC had no genuine reaction to the basic Hungarian proposals of phasing out duties. The EC mandate did not allow the liberalisation of the movement of labour and did not schedule any engagement for financial assistance.

The continuation of the negotiations and the (even partial) meeting of the Hungarian requests necessitated a modification of the EC mandate. It was done four months after the starting of the negotiations. The second stage of negotiations could be characterised by the tendency that more and more details had been concretely fixed after a modification of the Community's negotiating principles.

A very soft and vague wording about the link between association and full membership became finally acceptable for the Hungarian delegation. This wording without any obligation for the EC was put in the final text of the EA. There was a compromise on this question: the text expressed a much less explicit EC commitment than was originally expected by the Hungarian negotiators. It reflected the EC's view that association and accession were two different processes.

In the question of establishing free trade area between the partners the EC gave up the principle of progressing in stages with interim checking. This opened the way for negotiating concretely the full timetable of the elimination of duties. The EC flatly rejected the possibility of a customs union. At the same time it formulated a proposal for the phasing-out of its industrial duties, which (although with a few Hungarian objections) was not far from the financial version already acceptable for Hungary. On the other hand, the EC asked for a greater degree of liberalisation of the Hungarian import duties than was originally proposed by the negotiators, especially in the first years of the EA. This reflected the EC's intention to weaken the asymmetry. Its proposals con-

cerning the weakening of the right to special, unilateral safeguard measures on the part of Hungary also intended to modify the asymmetry. At the same time, the EC did not show at this stage any willingness to decide the definitive elimination on quantitative restrictions on the textile products and had no real reaction or counter-proposal to Hungarian requests concerning agricultural concessions. In an informal way the EC offered some opening of agricultural markets, but these did not satisfy the Hungarian requests neither for the product coverage nor for the level of levy reductions.

The new EC mandate and the modified and less rigid standpoint of the Community negotiators resulted in some proposals concerning the free movement of workers, services and capital. They offered rather modest changes in the conditions of access to the EC labour market. This was very far from the Hungarian proposals based on explicit quotas for Eastern European workers. On the other hand, concerning capital movement and services, the EC wanted to see much stronger liberalisation in Hungary. At this stage of negotiations no comforting results were achieved in these three areas. The EC's position remained low-key on the question of financial assistance, especially concerning definite amounts. At the same time partners successfully (without major contradictions) fixed most of the parts of the text determining the different fields and forms of economic and political cooperation.

In the middle of negotiations, it became clear and was outlined which questions the partners could successfully negotiate (or were close to a compromise) and which problems could not be settled on the basis of the then mandate because of the differences in partners' points of view. Here we have to mention on the EC side the timetable of liberalisation of textile trade, the opening of the agricultural markets, the possibility of the Hungarian workers to have access to the labour market and the question of the financial assistance. On the Hungarian side the most problematic issues were the opening of the market of services and the degree of the liberalisation of capital flows. Questions about mutual regulation of general and specific safeguard measures were also raised in this phase of negotiations but there were no irreconcilable differences of opinion.

Before the final third stage of negotiations it became more or less clear that the negotiations could only be concluded if the EC modified its position and at the same time Hungary accepted some compromises, changing its standpoint in a way that its original requests were reduced. This re-interpretation of positions took place on both sides before the last two concluding rounds of negotiations.

At that stage, the EC was already inclined to accept (even if indirectly) a final deadline for the liberalisation of trade in textile products. This timetable was (and that was a compromise on the Hungarian part) longer than in the case of most of the other industrial products. It was also an involuntary compromise that the Hungarian delegation modified its first and original proposal concerning the elimination of industrial duties and quantitative restrictions in Hungary. Anyway, the original proposal to liberalise the import regime (especially for the first years of the agreement) was rather modest, was practically no more than a gesture and was based on a long timetable. Nevertheless, Hungary could avoid in a satisfactory degree hurting the principle of asymmetry. The extraordinary pressure coming from the Community delegation concerning bigger and faster industrial trade concessions in the Hungarian import regime could be partly explained by the fact that Polish and (at that time) Czechoslovak negotiators accorded more important liberalisation to the EC in the first stages of free trade than Hungary did. Thus, it may be said, that there is strong link and interaction between similar negotiations conducted by the EC/EU in parallel with several partners.

The proposals of the EC for opening the agricultural market already showed important changes in comparison with its original and more modest concept. This more or less corresponded to the Hungarian request list. The price for this compromise was that the relatively important asymmetry in favour of Hungary had to be reduced. The EC negotiators achieved this by concentrating bargaining on the product coverage and the volume of preferential quotas. It is interesting to note that the final set of requests of the EC represented a sort of shopping list in which specific products and concessions could be linked to concrete member states. The negotiating staff of the Commission evidently tried to "sell the deal" to member states by satisfying the specific requests of each of them.

As a compromise, Hungary had to accept a rather weak commitment from the EC in opening the labour market. At the same time, in the field of liberalisation of capital movement and trade in services, the principal Hungarian interests could be asserted (with some exceptions), since the opening in these areas remained rather limited.

The partners also arrived at a compromise on the issue of financial assistance, which earlier evoked strong aversion within the member states. The agreement, although it did not fix precise amounts of money, determined the possible long-term forms of financial assistance to Hungary (e.g. Phare, EIB loans etc.).

### **Europe Agreement and further steps on the way to EU membership**

Despite its compromises, the Europe Agreement played important and in some field essential role in reorientation and substantial upgrading of Hungary's trade relations, in modernisation of its structure and enforced market economy type trade policy discipline. The EA contributed to the modernisation of the economy, created favourable conditions for a massive inflow of foreign direct investments.

From political and economic point of view and from the point of view of legal harmonisation, the Europe Agreement became an indispensable and decisive step on the way to the accession. It was a sort of starting point and at the same time offered a framework for successful preparation for membership. This process was especially efficient in the field of trade policy integration, since the biggest part of the EA's provisions was directly or indirectly inked to trade and its regulation. Nevertheless, after the entry into force of the Europe Agreement, starting from the mid 1990s, the implementation of the EA and the process of preparation for the accession in the EA framework were going parallel with another new process and framework of deep legal harmonisation.

The Cannes Summit of the European Council in 1995 offered to associated countries willing to become members a well-detailed programme of legal harmonisation and adjustment of the laws to the *acquis communautaire*. The programme took the form of so-

called White Book. On the basis of the principal fields of harmonisation indicated in the White Book Eastern European countries elaborated their national programmes of the adoption of the *acquis*.

The parallel implementation of the Europe Agreement and the Hungarian national program of the adoption of the *acquis* contributed to be prepared from the legal, administrative and institutional point of view to a smooth integration in the EU, in its single market and in its common policies, including common commercial policy. Besides that these two frameworks created a solid staff of specialists and professionals in different ministries and authorities, together with their networks. These were the essential elements of the successful management of the accession process.

### **Trade policy slippages in the period of association**

This chapter contains an overview of those Hungarian trade policy measures taken during the 1990s that meant a certain deviation from the general rule, tendency and logic of the liberalisation process.<sup>2</sup> In most of the cases of the practical application of these measures there is nothing special. They are frequently used in the international trade policy practices. Nevertheless, they reflect a situation when the existing trade policy regulation is being considered not protective enough or when specific public policy and sectoral considerations prevail over the general tendency.

Probably the most important general trade policy deviation from the prevailing logic, having an across-the-board effect was the introduction in March 1995 of the import surcharge of 8 percent, implemented on the *erga omnes* basis. It was one of the main features of the March 1995 package of stabilisation measures designed to address serious macroeconomic imbalances. Its temporary character was stressed from the introduction. This measure was notified to the WTO and justified by the Hungarian government on balance-of-payments grounds. The surcharge was applicable to imports from all sources and covered all products except primary energy products. It was refundable in the case of machinery imported for investment purposes. As the surcharge was in-

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<sup>2</sup> This chapter and the next one are based on Meisel (2005)

cluded in the selling price upon which VAT was levied, the overall restrictive effect of the surcharge considerably exceeded 8 percent. It was gradually reduced to 6% from 1 October 1996, 4% from 10 March 1997 and 3% from 15 May 1997 before being eliminated on 1 July 1997.

As far as the measures taken on the basis of the national customs legislation are concerned, one of them was introduced in 1992, just after the entry into force of the Europe Agreement. At that time Ford was considering to make important investments in Hungary and as part of the incentive package, besides tax and other preferences allowed by the legislation of that time, trade preferences also were shaped. It meant that customs tariff specification of the vehicles of the Ford Transit category were modified so as this vehicle was able to enjoy duty free market access, thus having an important preference as compared to the competitors. In a very short time this measure was sharply contested by the European Commission because of the discrimination incompatible with the Europe Agreement. The Hungarian authorities could not re-establish the original duty because it would have contradicted the stand still provision of the EA. So the 0% duty remained in force for all the types of the vehicles of this category.

The other measure of this kind was the increase of certain not bound in the GATT agricultural duties. At that time a lot of domestic criticism was formulated concerning the agricultural trade scheme of the EA and the sudden increase of agricultural imports from the EU, associated with the impact of the Agreement. Nevertheless, besides the market protection effect, this step may be considered as a symbolic gesture in favour of agriculture, which is reflected by the fact that tropical products were also included in this regulation. The prevailing motivation besides this gesture was budgetary consideration to increase customs revenue.

The Europe Agreement contained unilateral provision allowing the associated states to take exceptional measures to temporarily protect infant industries and those undergoing restructuring. The timetable and conditions of such measures have been fixed in the EA. Shortly after the entry into force of the Interim Agreement, in February 1992, Hungary formulated a request to use this tool in the case of 16 products, among them passenger cars that really

could have been considered as subject to infant industry clause (remember Suzuki and GM that opened new plants in Hungary). After long lasting consultations Hungary withdrew from the request list a lot of products and the EU accepted as justified the temporary increase of duties in the case of 8 products, belonging to 3 product groups. (See Table 1.) So it is justified to conclude that Hungary was able to benefit from this possibility only to a limited extent, especially as compared to some other associated countries.

General safeguard clause was the most frequently used market protection tool of the Hungarian import regime before the accession to the EU. This fact is reflected in Table 2. Hungarian authorities introduced *erga omnes* based safeguard measures in three cases and this happened before the entry into force of the WTO agreement. After 1995 such measures have been taken in trade with Eastern European countries, republic of the CIS, not members of the WTO. Utilisation of this instrument is seemingly concentrated on relatively few industries. Application of the general safeguard clause by Hungary was the most frequent in the steel sector, followed by cement industry including products made from asbestos.

Table 1.

Measures taken on the basis of infant industry or restructuring clause

Legal basis	Application	Content	Countries affected
Art 28. of Europe Agreement	1995-2000	Increase of duties for insecticides, fungicides, herbicides, disinfectants	EU Member States
	1995-2000	Increase of duties for wood-free paper and coated paper	EU Member States
	1995-1997	Increase of duties for tempered glass and laminated glass	EU Member States

Source: Meisel, 2005, p.209.

Table 2.  
General safeguard measures

Legal basis	Application	Content	Countries affected
Government Decree No 113/1993 Art 30. EA Art 28. CEFTA Art 20. EFTA	1992-1993	Import restriction on cement	Erga omnes
		Import restriction on intra-ocular lenses	
		Import restriction on certain paper products	
Government decree No 113/1993	1995-1996	Quota on imports of cement	Rumania
	1998-2002	Quota on steel products	Russia, Ukraine
	1998-2000	Quota on certain steel products	Ukraine
	2000-2004	Quota on steel products	Russia
	1999-2003	Surcharge on imports of ammonium fertiliser	Russia, Ukraine

Source: Meisel, 2005, p.210.

Besides the above mentioned slippages of Hungarian trade policy some other also should be quoted.

In the 1990s Hungary, like almost all of the European trading partners, several times used import restrictions on the basis of phytosanitary and veterinary regulations. From time to time Hungary applied such restriction vis-a-vis the EU members and CEFTA countries.

Speaking of internal measures affecting imports an important step should be mentioned. Under the Customs Duty Law of 1995, imports of cars older more than four years were prohibited between 1995 and 2000, on environmental and safety grounds. An exception involved specialised older vehicles, which were allowed

to be imported, provided they passed a special technical test. Along with rather high tariffs on cars imported from MFN partners this measure benefited domestic carmakers and also EU and CEFTA producers enjoying growing tariff concessions.

Turning now to export regulation, here one can also observe some backsliding. These entirely concern agricultural trade. Hungary during the 1990s several times applied temporary, export restrictions on certain agricultural products (mainly animal feeds wheat and sweet corn) on the basis of shortage clause. As the statistical and information system of the Hungarian agriculture was far from being transparent, it is difficult to judge about the justification of such measures.

### **Determinants of the Hungarian trade policy in the period of association**

It is not easy to point on a few evident determining elements that shaped Hungarian trade policy during the 1990s. Determinants sometimes are hidden and in many cases their impact is not direct but is often interrelated. So the following description is only on attempt to discover some possible elements that played role in the Hungarian trade policy formulation.

Probably, the most important determinant of the Hungarian trade policy during the 1990s was a strong commitment to achieve a successful transition to market economy, to advance in the integration in the world economy and to establish as close links a possible with the European Union, taking into consideration the accession to the EU as a strategic objective. These commitments may explain the fact that the strategic and dominant tendency of economic and trade policy liberalisation – despite some slippages – was maintained. Thus institutional and legal instruments, both GATT/WTO objectives and preferential agreements enforced this general track. Certainly, in some cases and periods, especially in the first years of the 1990s, there was a certain discrepancy between the pace of liberalisation optimal from the point of view of the internal transformation and that prescribed by external commitments. It is also true that external agreements limit the room of autonomous actions. Nevertheless this external institutional set-

ting served as an important stabilising element of the liberalisation. The starting of the accession negotiations even reinforced this impact. Obviously trade policy can be hardly shaped and implemented without certain interactions with other internal policies. The direct link between trade policy and its major backsliding in Hungary during the 1990s is evident in the case of the macroeconomic stabilisation program and the introduction of the overall import surcharge. Apart of this measure, macroeconomic policy did not directly affect trade policy formulation, at least it did not enforce any other deviation from the general line.

Referring to the slippages of trade policy analysed in the previous section, a clear determining impact of financial and budgetary considerations can be observed in the case of the increase of agricultural duties.

Developments and backsliding of trade policy on sectoral level can be explained differently.

In Hungary far most of the protective measures (in the form on safeguards) were taken in steel sector. Here, it seems, the negative consequences of – to some extent – premature liberalisation of the quantitative regime, the lack of a clear industrial policy as well as of regional development policy, and, as a result employment problems were compensated by increasing the level of trade policy protection.

Partly this is true for the cement industry, where the bargaining power of the actors is much stronger, although the economic situation was similar to that in steel production.

In the paper industry, which also enjoyed market protection, a strong foreign company acquired the most important production plants and shortly after this, it was able to prove potential injury of imports that led to the application of a safeguard measure.

These two cases demonstrate the fact – which was predicted in early 1990s – that a more powerful foreign company is better placed in requesting and arguing for protective measures as compared to traditional domestic firms. It should be noted that this situation somewhat changed and domestic companies also have learned how to protect their interests.

A rather coherent picture can be observed in the car industry. In the beginning of the 1990s this was an entirely new industry in

Hungary. During the association talks Hungary was able to resist the strong pressure of the EU aiming at a rather fast liberalisation of this sector. According to the provisions of the Europe Agreement trade of passenger cars was liberalised only at the last stage. A rather strong tariff protection was maintained in relation with MFN countries, which was often subject to criticism, mainly by the USA. This high level of protection was complemented between 1995 and 2000 by imposing ban on the imports of cars older than four years.

It is interesting to note that there were traditional sectors that remained relatively less protected, although professional interest groups of them were permanently arguing for stronger protection. The pharmaceutical industry can be mentioned as examples. One should not forget, certainly, that trade of pharmaceuticals is not a pure trade policy issue and is closely related to the social security system. This trade till 2001 was subject to individual licensing but the representatives of the industry always complained of permanent overlicensing.

As in most of the European countries, including first of all the EU, trade policy regulation of the agricultural sector is a specific issue. Trade policy formulation in this sector is highly influenced by internal political considerations. This is the same in Hungary, as in many Central and Western European states. Internal trade policy disputes in the 1990s were immediately transmitted on the highest political level. That made Hungarian agricultural trade policy rather unstable and vulnerable. But this was only one element of instability.

Probably more important element of instability was, on one hand, the lack of a well-defined agricultural policy. It is rather difficult to build up a consistent agricultural trade policy without the basic policy. On the other hand – interpreting the matter in a simplified way – the system of information on the agricultural sector (who is producing, what is producing, how much is producing?) could be established only with difficulties. It was almost impossible to formulate a coherent trade policy on this unstable basis. This was reflected in symbolic – from political point of view – measures (like tariff increase in 1994), or in sudden and questionable restrictions on exports. Contrary to some other Central and Western

European countries, the political sensitivity and economic uncertainty represented the main determinants of the agricultural trade policy in Hungary and not the existence of a strong agricultural lobby. Nevertheless, it is legitimate to note that in this sector trade policy slippages were not more frequent than in some others.

### **Hungarian experience and general lessons**

During the establishment of the base of a new relationship and cooperation, the parties are usually motivated on the one hand by the external political situation, but on the other hand by their own political and economic interests. For Hungary, the changes in the beginning of the 1990s made it possible to reconstruct, in a political and economic sense, its relations with Western Europe and its integration institutions. In early 1990s the EC was led by the need to react to the changes in the partner countries when offered association agreements. At that time “association” as a form of cooperation had been present since the 1960s and 1970s in the external relations of the EC. Concerning the new content of the association, the EC only had broad ideas based on the precedent of favourable and unfavourable experiences. The lack of a definite association concept had serious disadvantages. However, it should be remembered that precisely this fact could open a relatively clear way for Central European countries to shape the Europe Agreements with definite ideas and to force the Community to renew its concepts. Anyway, a conclusion offered by this experience is that in general the problems to be negotiated are in many cases not EU initiatives but may be presented to a big extent by the negotiating partner as well. The situation of the early 1990s is rather similar to the present one, when EU seeks to find new forms of cooperation (i.e. in the form of DCFTAs) with potential partners in Eastern Europe.

If there is enough political motivation and willingness, the European Union can change its negative or reserved attitude even on the toughest questions. Hungary had a theoretical and practical possibility to influence effectively the provisions and the rules of the Europe Agreement and in many cases was able to overcome the absolute rigidity of the EC in some areas.

However, the Hungarian evaluation of the situation showed some weaknesses. The Hungarian negotiating team was not completely aware of the extent of future problems deriving from the domestic economic situation of that time, from the reorientation of its economic relations and from the inheritance of the past. It is a question to what extent these problems were predictable. Anyway, detailed and well-founded studies on the potential effects of the emerging new trade policy framework would have been needed.

The advantages from the new trade regulations and concessions can be truly exploited only by a dynamic economy. When Hungarian economy was not dynamic and its sectors were not competitive enough (i.e., if there were no products to export and thus the market access possibilities could not be utilised), most of the benefits of the mutual liberalisation go to the strongest and more competitive partner. Hungary had to witness such situations and had to face their consequences. Besides that, when only one of the partners, the stronger one can make use of liberalisation, the original asymmetry is easily eroded.

On the basis of the experience of Hungary (and apparently on that of the other Central and Eastern European countries) some short conclusions can be formulated.

- Political determination seems to be an essential element of elaborating a successful agreement. The concept of negotiations and the process of implementation – if possible - should be backed by broad internal consensus (political elite, government institutions, business, population, etc.).
- Clear definition of the country's interests may influence in an efficient way the course and the outcome of the negotiations. It can only be based on well-developed and prompt cooperation and interaction between the different actors of administration, business and civil society.
- Stability of the trade policy administration is desirable.
- It is important to mention the need to be able to form coalitions with member states. It is not only in Brussels where trade policy decisions are elaborated. A country being in a process of negotiations and close cooperation should not neglect the “capitals” (i.e. administration) of the member states.

- The Hungarian experience shows that trade policy concessions are undoubtedly important, but the stability of domestic macro-economic conditions is even more essential in order to take profit from the renewed framework of cooperation with the European Union.
- A trade agreement incorporates and enforces trade policy discipline and stability. Nevertheless, authorities of an associated country should not be “shy” or “servile” in using trade defence instruments, when needed. On the other hand, they have to resist to misuse them.
- In the process of upgrading the relations with a partner like the European Union, it seems to be essential to establish a workable framework of dissemination of information and dialogue with all partners, practically with the society. Unfortunately this was a weak part of the preparatory work in Hungary before the association. The consequences were unfounded illusions in short run and disillusion after.

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## UKRAINE'S EXPERIENCES ON DEVELOPING TRADE AND TRADE POLICY RELATIONS WITH THE EUROPEAN UNION

*Lidia Shynkaruk – Irina Baranovska  
– Olena Herasimova*

Since 1991, when Ukraine gained independence, the European Union and Ukraine have developed an increasingly dynamic relationship. Ukraine is a priority partner country within the European Neighbourhood Policy (ENP) and the Eastern Partnership.

Relations between the EU and Ukraine are currently based on the Partnership and Cooperation Agreement (PCA) which entered into force in 1998. At the Paris Summit in 2008 the leaders of the EU and Ukraine agreed that an Association Agreement should be the successor agreement to the Partnership and Cooperation Agreement. The EU-Ukraine Association Agreement is the first of a new generation of Association Agreements with Eastern Partnership countries. Negotiations on this comprehensive, ambitious and innovative Agreement between the EU and Ukraine were launched in March 2007. In February 2008, following confirmation of Ukraine's WTO membership, the EU and Ukraine launched negotiations on a Deep and Comprehensive Free Trade Area (DCFTA) as a core element of the Association Agreement.

At the 15th Ukraine-EU Summit of 19 December 2011, the EU leaders and President Yanukovich noted that a common understanding on the text of the Association Agreement had been

reached. On 30 March 2012 the chief negotiators of the European Union and Ukraine initialled the text of the Association Agreement, which included provisions on the establishment of a DCFTA as an integral part. In this context, chief trade negotiators from both sides initialled the DCFTA part of the Agreement on 19 July 2012. Both the EU and Ukraine expressed their common commitment to undertake further technical steps, required to prepare conclusion of the Association Agreement.

Since it will take some time until the EU-Ukraine Association Agreement can enter into force, the sides decided to adopt the EU-Ukraine Association Agenda.

The key parts focus on supporting core reforms, economic recovery and growth, and governance and sector cooperation in areas such as energy, transport and environment protection, industrial cooperation, social development and protection, equal rights, consumer protection, education, youth and cultural cooperation.

The Agreement also puts a strong emphasis on values and principles: democracy and the rule of law, respect for human rights and fundamental freedoms, good governance, a market economy and sustainable development.

The Agreement will be enhancing cooperation in foreign and security policy and energy.

It includes a Deep and Comprehensive Free Trade Area – this will go further than classic free trade areas, as it will both open up markets and also address competitiveness issues and the steps needed to meet EU standards and trade on EU markets.

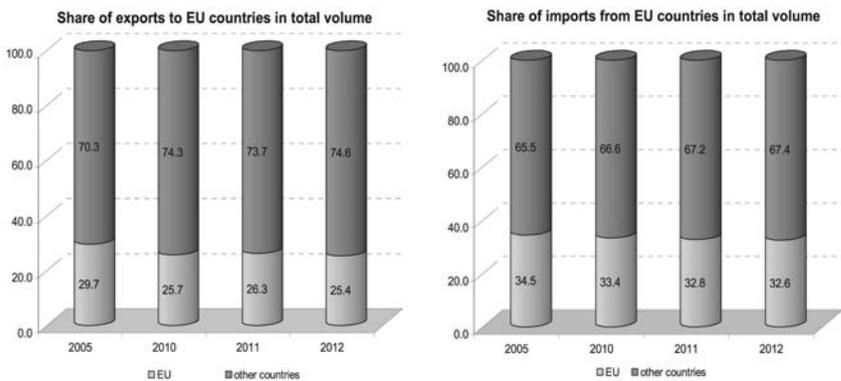
Ukraine's results of the European integration processes will be largely dependent on its external and internal macroeconomic policy and the situation in the national economy.

In this context, it is advisable to consider such specific aspects as the structural characteristics of some components of the economy, the individual components of the agreement on a DCFTA between the EU and Ukraine, the cooperation within the Eastern Partnership and the potential opportunities and risks of the agreement on free trade with the EU.

The European Union is a major trading partner of Ukraine, with about 30.0% total share in goods and services. However, as it ap-

pears from figure 1, the share of the EU-bound Ukrainian export decreased from 29.7% to 25.4% between the years 2005 and 2012, thus reducing Ukrainian presence at the EU markets (see figure 1). The share of imports of goods and services in the total volume of Ukrainian trade tends to be decreasing, although it is a threat-provoking fact that the share of imports dominates the share of exports by 7% in terms of payment balance.

Figure 1.  
Foreign trade of Ukraine in goods and services

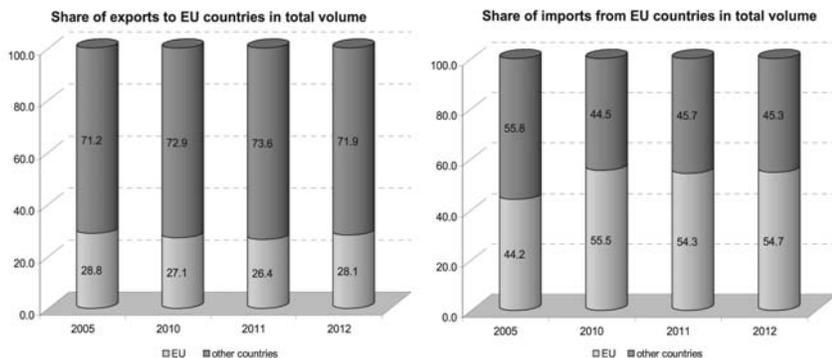


Source: State Statistic Service of Ukraine.

Trade relations with the EU are characterized by decreasing both the import and the export shares of goods and these being replaced by other countries as well as the loss of markets consequently for Ukraine and the EU. Ukraine is currently experiencing trade disbalance which manifests itself in the prevalence of EU imports over exports share (by 6.0%), which reduces the production capacity of the national economy (*see figure 2*).

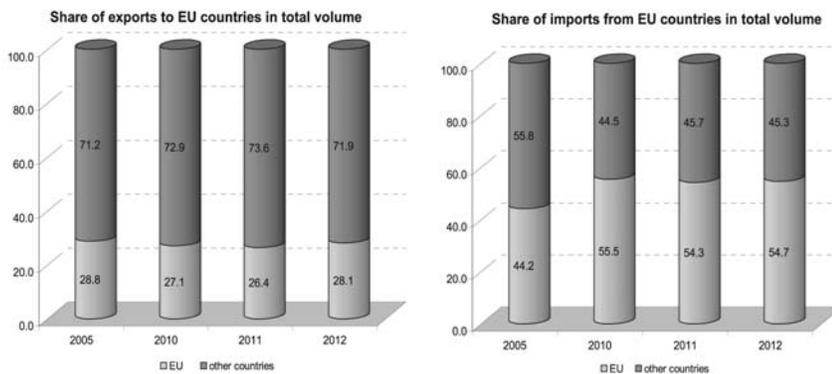
Another insecure structural peculiarity in the domain of foreign trade relations between Ukraine and the EC is a high services import share (54.7%) in the import structure of Ukraine (*see figure 3*).

Figure 2.  
Foreign trade of Ukraine in goods



Source: State Statistic Service of Ukraine.

Figure 3.  
Foreign trade of Ukraine in services



Source: State Statistic Service of Ukraine.

The bulk of services falls on the financial services sector, taking into account the shortfall of funds within the EU jeopardizes the banking system stability. Despite substantial scientific evidence provided by numerous research institutions that the imported financial services are predominantly of Russian and Ukrainian origin, hardly does it alleviate any risks for the economy of Ukraine.

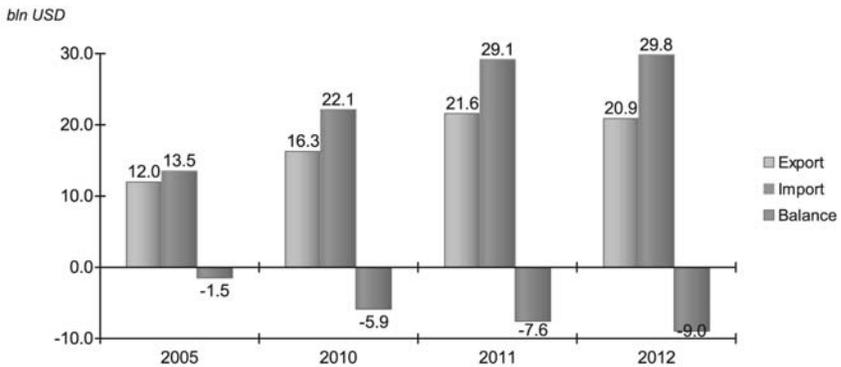
The positive constituent of the trade services structure is a high proportion of transport services both in exports (55%) and in im-

ports (22%), which allows us to consider infrastructure projects as priorities in the cooperation with the EU.

Of current interest is the research tackling not only the structure of foreign trade with the EU but also that of absolute volumes, demonstrating the following features within the time period from 2005 to 2012 (*see figures 4-6*).

Figure 4.

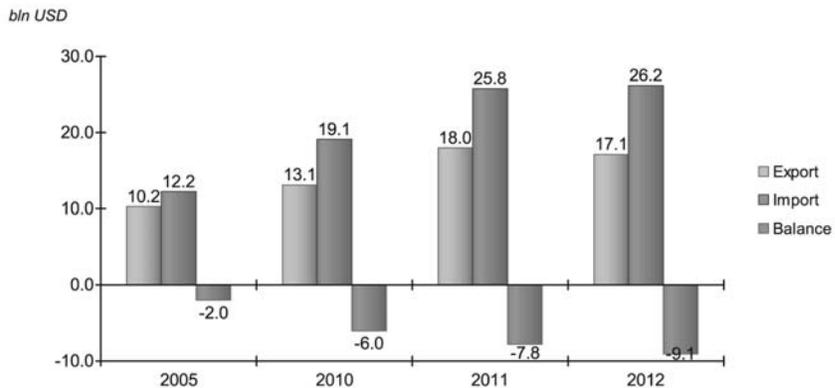
Foreign trade of Ukraine in goods and services with EU countries



Source: State Statistic Service of Ukraine.

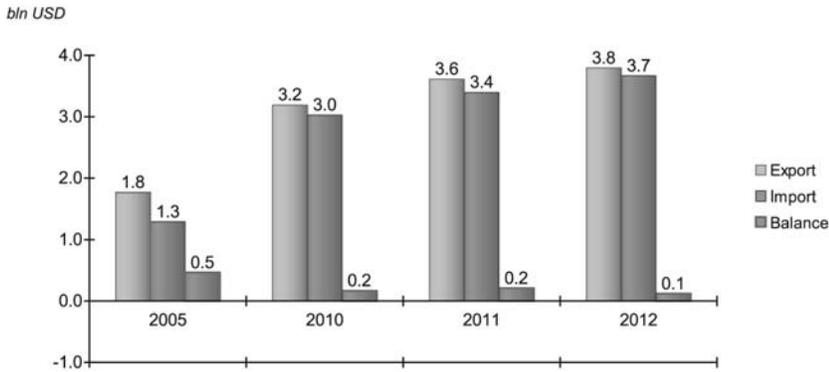
Figure 5.

Foreign trade of Ukraine in goods with EU countries



Source: State Statistic Service of Ukraine.

Figure 6.  
Foreign trade of Ukraine in services with EU countries



Source: State Statistic Service of Ukraine.

Firstly, the formation of a negative trade balance of 9.0 billion US dollars as well as a decline in the foreign currency earnings constitutes certain risks for the payment balance of Ukraine.

Secondly, a negative balance of trade was formed due to excessive imports from the EU. Under the conditions of extreme openness of the Ukrainian market and a small proportion of domestic goods at the domestic market it increases its vulnerability to global crises and reduces the possibility of increasing domestic industry presence at the local market.

Thirdly, the trade balance with the EU in terms of services is positive, implying the flight of funds from Ukraine, the shortage of investment resources and the need to update industry capital (depreciation rate above 50%) raises the issue of the very existence of increasing productive capacities.

Ukrainian producers should modernize their enterprise and improve the quality of their products, so as not to lose in the long run existing and potential niche in both foreign and domestic markets.

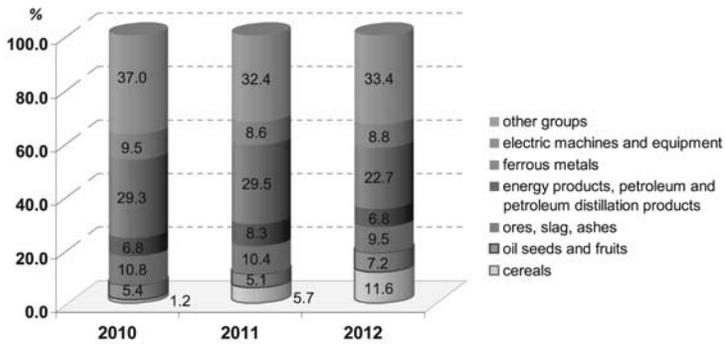
*Structural features of trade with the EU are as follows:*

- as far Ukraine's exports to the EU are concerned, predominant are the goods with low added value: ferrous metals, constituting about 23% corn – 12%, ore – 10% , that is foreign trade is rep-

resented mainly by raw materials thus preventing Ukraine from joining a global innovation value chain in industry (*see figure 7*);

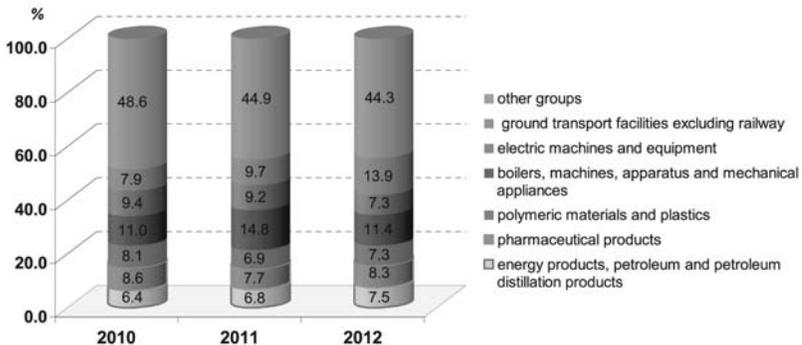
- on the other hand EU imports are represented by the goods with high added value: mechanical (14%) and electrical machinery (7%), pharmaceutical products (8%) which under the conditions of integration processes with the economically strong EU countries represent a major threat to the development opportunities of national producers (*see figure 8*).

Figure 7.  
Commodity pattern of Ukraine's foreign trade to EU countries



Source: State Statistic Service of Ukraine.

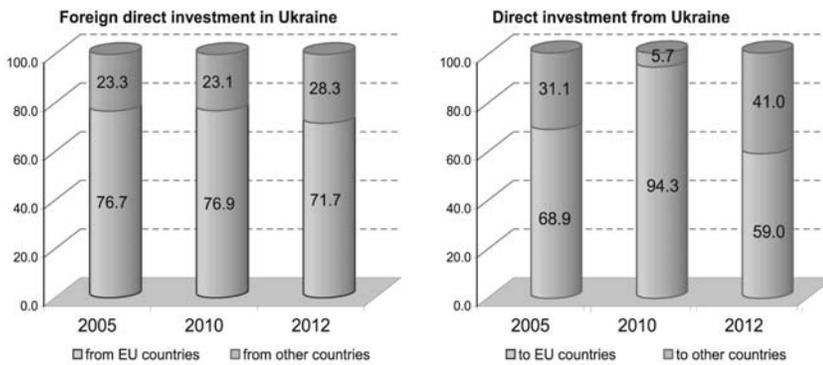
Figure 8.  
Commodity pattern imports from EU countries



Source: State Statistic Service of Ukraine.

The volume of the EU countries’ direct foreign investments to Ukraine has amounted nearly to 43 billion dollars, accounting for over 70% of total direct foreign investments in Ukraine (see figure 9). The main investors are Cyprus, Germany and the Netherlands. Service sector bound investments make up 56%, in industry – 34%, thus reducing the possibility of Ukraine in terms of the import policy implementation.

Figure 9.  
Foreign investments



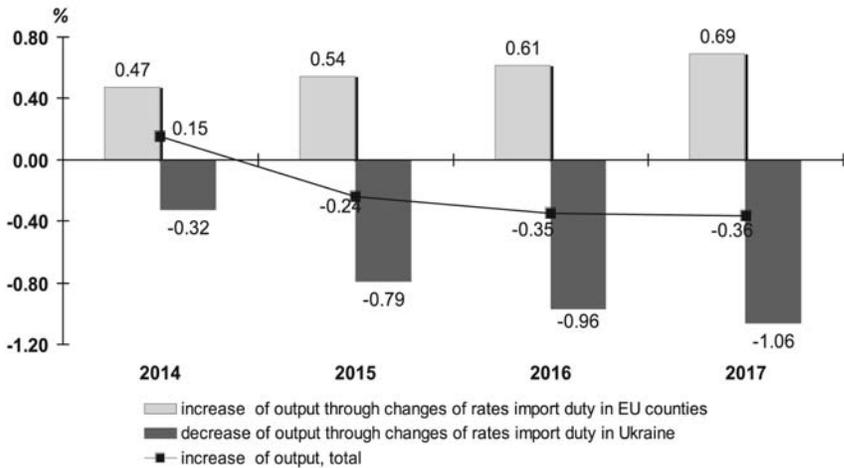
Source: State Statistic Service of Ukraine.

According to the interindustry balance model we have made a prediction of the introduction of tariff rate changes on consumer goods up to 2017 (see figure 10). According to the forecast of the positive impact of reduced rates on the EU bound export goods in the early years will be balanced by more considerable growth in imports from the EU to Ukraine in the coming years.

That is, the trade effects only from the free zone introduction with the EU will not significantly affect the growth of GDP and the volumes of production in Ukraine. They should be complemented by progressive institutional changes, investment effects and the effect of technological convergence.

Figure 10.

The contribution of tariffs changes in the increase (decrease) of output on integration scenario, percent of base scenario



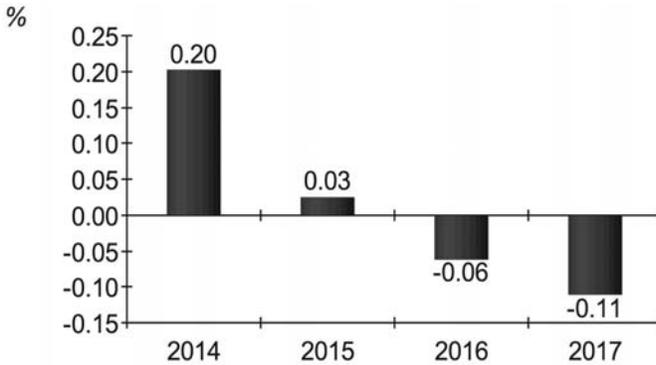
Source: Own calculations on the basis of database of State Statistic Service of Ukraine.

Calculation of the integration effects is performed according to the structure of foreign trade on the basis of 2010-2011. Input-output equation is based on input-output tables on the basic prices in 2010. Elasticities of export and import are calculated by means of econometric equations obtained from the data on foreign trade in Ukraine in 2006-2011.

Calculation results show that the effect of changes in rates of customs duties on imports into Ukraine from the EU is almost entirely balanced by the change of these rates on imports into the EU from Ukraine. Since most rates on imports into the EU for Ukrainian exporters have been cancelled simultaneously in the first year of the Agreement, the trade effect for of most domestic exporters and manufacturers who are suppliers of products for export, will be maximized in 2014 (*see figure 11*).

Figure 11.

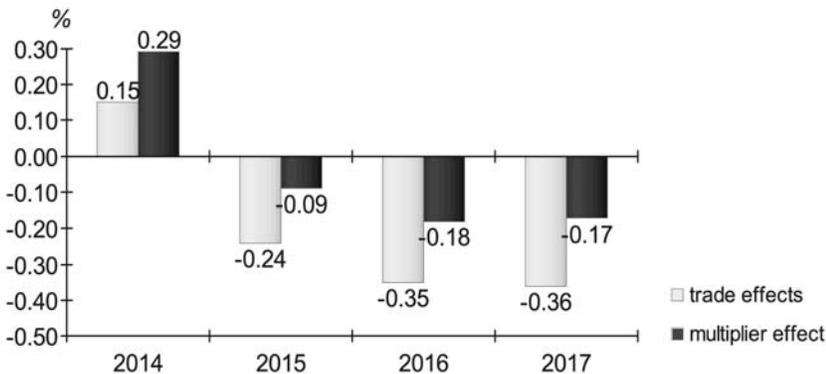
The contribution of changes tariffs in increase (decrease) of output on in-  
tegration scenario, percent of 2013



In addition to the direct impact of changes in tariffs, the change in the income of exporters will affect to the amount of output. This will lead to a redistribution of consumption and gross accumulation. However, although the multiplier effect and improvement in the performance of production and consumption of products as a whole and for individual sectors it does not change the principle regarding trends prevailing. So in the overall economy in the first year of the Agreement, taking into account the multiplier effect as a result of trade and the effects of changes in export revenue production will be increased by 0.29% (*see figure 12*).

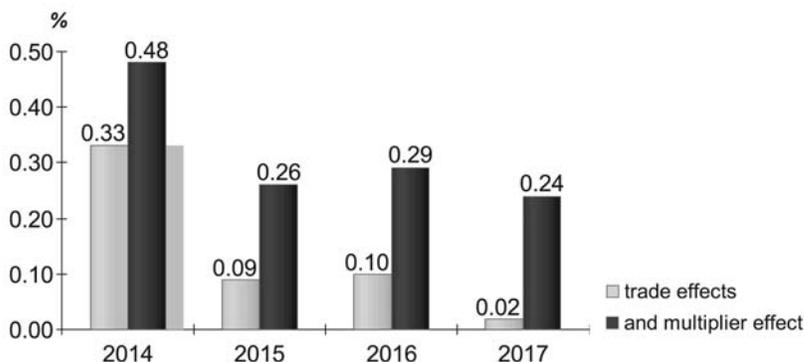
Figure 12.

The change in output due to trade effects and multiplier effect



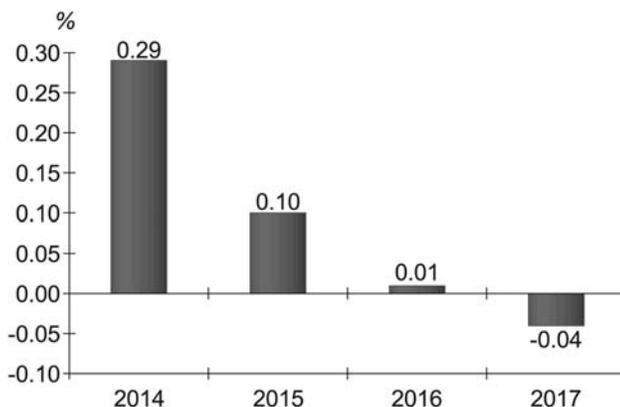
Final consumption of households will increase based on the multiplier effect 0.48% in 2014, followed by reduction effect to 0.2% in 2017 (see figure 13).

Figure 13.  
Change in final household consumption through trade effects  
and multiplier effect



The trend of reducing the total cumulative production growth in 2013 remains based on multiplier effect, the cumulative gain is zero in 2016-2017 (see figure 14).

Figure 14.  
Total cumulative production increase based on the multiplier effect,  
as a percentage of 2013



Calculations by dynamic input-output model suggests that in the early years of the Agreement certain negative consequences associated with replacement chemicals, mechanical engineering and metallurgy, partly reimbursed by the new opportunities that due to lower rates of customs duties emerge for light industry agriculture and some of the food industry. In general, a positive cumulative effect of the Agreement for the first year (2014) offset reduced production in the 2015-2017, and causes negative indicators in 2017. In general there is a slowdown an average of 0.15% per year in production for the years 2015-2017.

However, it should be noted that if the domestic producers of machinery, metallurgy and chemical industry will not take effective measures to modernize production, disproportions of the technological structure of production will be deep and cause further loss on domestic and foreign markets.

In accordance with the provisions of the «Agreement» it is stipulated that import duties on consumer goods for Ukrainian exporters can be expected (*see Table 1*) and import duties for particular goods imported to Ukraine from the EU remain unchanged (*see Table 2*).

It might sound impressive at first sight that the import duties for agricultural products, metallurgy, machine building industry products, food remain unchanged, but taking into consideration the application of EU non-tariff regulation methods as well as the EU countries higher levels of economic development, the risks for the Ukrainian industry remain significant.

Major funding for the specific projects of the Eastern Partnership implemented by NGO in Ukraine fall into three platforms:

- 1) democracy, good governance and stability;
- 2) contacts between people;
- 3) energy security (*see Table 3*).

Table 1. – Expected changes of import duty rates in EU countries for Ukraine produced goods (percent)

Types of economic activity	2013	2014	2015	2016	2017
Agriculture, hunting, fishing and forestry	14.0	0.0	0.0	0.0	0.0
Mining of coal and lignite; extraction of peat; mining of uranium and thorium ores	2.0	0.0	0.0	0.0	0.0
Extraction of crude petroleum and natural gas	2.0	0.0	0.0	0.0	0.0
Mining of quarry, except energy producing materials	0.0	0.0	0.0	0.0	0.0
Manufacture of food products, beverages and tobacco	12.4	0.4	0.4	0.4	0.0
Manufacture of textiles and textile products; manufacture of wearing apparel; dressing and dyeing of fur	10.0	1.5	1.2	0.8	0.3
Manufacture of wood and wooden products; manufacture of pulp, paper and paper products; publishing and printing	2.0	0.8	0.5	0.3	0.0
Manufacture of coke products; processing nuclear fuel	2.0	0.0	0.0	0.0	0.0
Manufacture of refined petroleum products	2.0	0.0	0.0	0.0	0.0
Manufacture of chemicals and chemical products; manufacture of rubber and plastic products	5.0	1.0	0.8	0.5	0.3
Manufacture of other non-metallic mineral products	4.0	1.0	0.7	0.4	0.1
Manufacture of basic metals and fabricated metal products	2.7	2.2	1.5	0.7	0.0
Manufacture of machinery and equipment	2.7	2.2	1.5	0.7	0.0
Manufacturing n.e.c.	2.7	2.2	1.5	0.7	0.0

Source: Own calculations on the basis of database of State Statistic Service of Ukraine and EU-Ukraine Association Agreement.

Table 2. – The expected changes of import duty rates  
from EU countries (percent)

Types of economic activity	2013	2014	2015	2016	2017
Agriculture, hunting, fishing and forestry	10.0	7.0	5.0	3.0	3.0
Mining of coal and lignite; extraction of peat; mining of uranium and thorium ores	1.0	0.0	0.0	0.0	0.0
Extraction of crude petroleum and natural gas	1.0	0.0	0.0	0.0	0.0
Mining of quarry, except energy producing materials	4.0	2.0	1.3	0.7	0.1
Manufacture of food products, beverages and tobacco	10.0	5.0	3.5	1.3	0.7
Manufacture of textiles and textile products; manufacture of wearing apparel; dressing and dyeing of fur	6.0	1.0	1.0	0.5	0.3
Manufacture of wood and wooden products; manufacture of pulp, paper and paper products; publishing and printing	0.0	0.0	0.0	0.0	0.0
Manufacture of coke products; processing nuclear fuel	1.0	0.1	0.1	0.1	0.1
Manufacture of refined petroleum products	1.0	0.2	0.1	0.1	0.1
Manufacture of chemicals and chemical products; manufacture of rubber and plastic products	3.0	0.7	0.3	0.1	0.0
Manufacture of other non-metallic mineral products	10.0	7.0	5.0	3.0	3.0
Manufacture of basic metals and fabricated metal products	10.0	7.0	5.0	3.0	3.0
Manufacture of machinery and equipment	10.0	7.0	5.0	5.0	5.0
Manufacturing n.e.c.	10.0	7.0	5.0	3.0	3.0

Source: Own calculations on the basis of database of State Statistic Service of Ukraine and EU-Ukraine Association Agreement.

Table 3. – The specific projects of the Eastern Partnership implemented by NGO in Ukraine

Projects and programs of the Eastern partnership platforms	Percent of the total projects (%)	Quantity	Estimate (EURO)
<b>2013</b>			
Energy security	0.0	0	0.0
Contacts between people	0.0	0	0.0
Economic integration and convergence with EU policies	0.0	0	0.0
Democracy, good governance and stability	100.0	1	2070.0
Total for the year:	100.0	1	2070.0
<b>2012</b>			
Energy security	6.1	3	48721.0
Economic integration and convergence with EU policies	14.3	7	111441.0
Contacts between people	16.3	8	86347.0
Democracy, good governance and stability	63.3	31	294613.0
Total for the year:	100.0	49	541122.0
<b>2011</b>			
Energy security	1.8	1	13233.0
Economic integration and convergence with EU policies	14.6	8	97872.0
Contacts between people	20.0	11	79099.0
Democracy, good governance and stability	63.6	35	340670.0
Total for the year:	100.0	55	530874.0
<b>2010</b>			
Economic integration and convergence with EU policies	0.0	0	0.0
Energy security	8.4	6	64420.0
Contacts between people	34.7	25	164494.0
Democracy, good governance and stability	56.9	41	362903.0
Total for the year:	100.0	72	591817.0

Source: Delegation of European Union to Ukraine ([http://ccas.europa.eu/delegations/ukraine/projects/list\\_of\\_projects/projects\\_en.htm](http://ccas.europa.eu/delegations/ukraine/projects/list_of_projects/projects_en.htm)); European Union Border Assistance Mission to Moldova in Ukraine (<http://www.eubam.org>);

European Space: portal for pro-European civil society of Ukraine (<http://eu.prostir.ua/themes/rada.html>).

Major funding for the projects implemented in Ukraine by EU funds fall into: governance, democracy, human rights and support for economic and institutional reforms (24.1%); infrastructure, communications and transport (21.9%); trade and regional integration (16.5%) (see Table 4).

Table 4.  
Projects implemented in Ukraine from EU funds

Sector	Quantity	Estimate (EURO)	Percent of the total projects
Rural development, territorial planning, agriculture and food security	1	1200000.0	0.4
Social cohesion and employment	3	1929430.0	0.6
Multi-sectors	3	3207146.0	1.0
Human development	7	3533752.0	1.1
Conflict prevention	2	26500000.0	8.4
Water and energy	24	39764470.0	12.7
The environment and the sustainable management of natural resources	6	41542972.0	13.2
Trade and regional integration	5	51747500.0	16.5
Infrastructure, communications and transport	4	68944166.0	21.9
Governance, democracy, human rights and support for economic and institutional reforms	36	75859860.0	24.1
<b>Total:</b>	<b>91</b>	<b>314229296.0</b>	<b>100.0</b>

Source: Delegation of European Union to Ukraine ([http://ec.europa.eu/delegations/ukraine/projects/list\\_of\\_projects/projects\\_en.htm](http://ec.europa.eu/delegations/ukraine/projects/list_of_projects/projects_en.htm)); European Union Border Assistance Mission to Moldova in Ukraine (<http://www.eubam.org>); European Space: portal for pro-European civil society of Ukraine (<http://eu.prostir.ua/themes/rada.html>).

The initiative "Eastern Partnership" has become a reality. It transferred from phase of discussions – from the wording of the provisions in the phase of discussions over its content and practical projects and undertakings.

We realize that the "Eastern Partnership" is neither a guarantee to achieve the full integration of the Eastern partners into the EU nor a path to EU membership. It is a mechanism, a set of complementary features, tools, whose effective use will bring Ukraine closer to its strategic goal.

Disadvantages of the «Eastern Partnership»:

- lack of funding for the ambitiously stated objectives in multilateral – format forces the EU and partner countries to focus on the implementation of several projects;
- difference between strategic objectives and national interests of the partner countries – might lead to a slowdown in the implementation of multilateral dimensions of the initiative;
- the declared thematic platforms and flagship initiatives do not reflect all major worries of the majority of the partner countries.

Main problems and expectations concerning the Association Agreement between Ukraine and the EU, and in particular to establish DCFTA, are identified based on the research Institute for Economics and Forecasting National Academy of Science of Ukraine.

## **The labor market:**

### **Potential benefits:**

- approximation of the labor legislation of Ukraine with the requirements and standards of the EU;
- making the rules, regulations and labor standards in line with international standards;
- creation of new jobs in export-oriented sectors of the economy;
- improving the investment climate and business environment;
- increasing the competitiveness of the labor force and productivity;

- implantation of a new corporate culture, assimilation of population market labor values and attitudes;
- increasing motivation to content work and the possibility of achievements and value orientation to initiative and success.

### **Potential threats:**

- closing or curtailment some part of non-competitive and production without perspective can lead to tension in the labor market;
- layoffs during restructuring of enterprises;
- loss of jobs because of lower competitive workforce, unwillingness to work with higher intensity on European standards;
- deepening asymmetry in the labor market, from which employers receive benefits;
- deforming economic consciousness, clash of opposing values, difficulties adaptation period;
- increasing the number of young Ukrainian, who will leave for training in universities of EU countries.

### **Trade regime:**

#### **Potential benefits:**

- according to the conditions of free trade agreements by WTO, in particular: full liberalization is covering at least 95% of tariff lines and volume trade between the sides depend on what of that from two indicators was reached first reducing the number of tariff lines excluded from free trade by making the number of sectoral initiatives to "0.0";
- rejection of the use EU export subsidies in bilateral trade with Ukraine;
- provision of Ukraine duty-free market access for the most sensitive EU products within tariff quotas, tariff quotas of compliance for most tariff lines Ukraine export capacity and interests of domestic producers to expand the range of product export;
- protecting markets of the most sensitive goods of Ukraine due to their partial liberalization and tariff quotas for duty-free imports from the EU in a small volume;

- agreement on Ukraine's right to apply special protective measures or additional terms of trade liberalization on the most sensitive products.

**Potential hazards:**

- significantly lower current level of tariff and non-tariff protection in Ukraine than in the EU creates discriminatory initial conditions for regional integration;
- FTA with the EU only partially eliminates asymmetrical trade regimes. From 9699 EU tariff lines only 8674 will be liberalized immediately after the introduction of the FTA, 732 - over a period of 1 to 7 years and tariff quotas will be established in 362 tariff lines, including the vast majority, namely 339 lines, which represent agricultural products. It means that the tariff quotas are set on 15%;
- current inability of most of the domestic producers to satisfy the technical, sanitary and phytosanitary conditions for exporting their products to the EU markets, that will prevent increasing of exports of domestic products under the tariff quotas frame allocated to Ukraine;
- small volumes of the EU tariff quotas of duty-free import products from Ukraine (with some exceptions) and not full coverage commodity nomenclature of agricultural products; in case of renegotiation of the Agreement the substantial reduction of the number of exclusions from the FTA with the EU and the increase of tariff quotas for the remaining tariff lines (especially corn, soybeans, barley, poultry) must be defended.

**Metallurgy:****Potential benefits:**

- eliminates the possibility to initiate trade restrictions on steel production in Ukraine;
- the opportunity to continue the integration processes at steel companies is created;

- expanding of the presence in the EU market through further integration capacities;
- augmentation of the investment flows, including through joint implementation projects (Kyoto Protocol);
- modernization of metallurgical facilities.

### **Potential hazards:**

- cost increasing on reduction of the harmful effects of metal production on the environment;
- dramatically increase the cost of production due to higher costs for raw materials and environmental measures compared to EU companies;
- zero tariffs on steel import will increase competition in the domestic market;
- changes in tariff policy and state aid will lead to a redistribution of income between the sectors of mining, metallurgy and energy;
- reduced subsidies;
- reduced revenues from export duties.

### **Energetics:**

#### **Potential benefits:**

- expanding exports of electricity, and medium and heavy distillates. The economic benefits from expanding exports are valued at no more than \$ 50 million while maintaining exports in 2012;
- according to present active legal documents in the case if the signing of the Association Agreement of Ukraine with the EU occurs, any sanctions or trade restrictions imposed by the Customs Union towards Ukraine as a third party are not expected.

#### **Potential hazards:**

- signing of the association agreement between Ukraine and the EU will not affect the terms of energy trade with third countries, because the terms of the agreement are largely repeated commitments of Ukraine to the Energy Community. Potential risks

such as reducing transit, loss of integrity of the technical energy systems, the formation of monopoly industry structures, the transfer of powers to supranational regulators, etc. are largely politically motivated and depend on the method (consistency and coordination) of liabilities.

## **Machinery:**

### **Potential benefits:**

- acceleration of the modernization of domestic engineering by facilitating access to scientific and technological achievements of the European countries;
- raising of the technical level and competitiveness of Ukrainian products due to the adaptation of domestic production to technological and environmental standards of the European countries;
- abolition of the outdated regulations, which have no analogues in the EU, and the continuation of the development and adoption of the technical regulations subject to the provisions under the EU regulatory framework (*acquis communautaire*), national standards and requirements environmental protection, harmonized with international and European standards;
- reduction of the rates (average about 30%) on importable duty vehicles that come from Ukraine will contribute the increasing of the competitiveness of domestic products;
- the possibility of applying some safeguarding measures in the form of higher tax rates on cars originating from the EU countries (heading 8703), if the quantity of goods imported into the territory of Ukraine, causing a significant damage to domestic industry;
- establishing zero rates importable duty on investment types engineering products, which will accelerate the technological modernization of the Ukrainian industry.

### **Potential hazards:**

- an increase of the competing imports on the domestic market of Ukraine, including cars, tractors, combine harvesters;

- relatively high barriers for entry of domestic producers on the European market, because Ukraine is on a lower level of technological development than the EU;
- increasing dependence of Ukrainian machinery on imported high-tech equipment on both - as end-use products and components used in the assembly of well-known foreign brands;
- a decline in export to the countries of the Customs Union by introducing safeguards to the internal market.

## **Food and Beverage:**

### **Potential benefits:**

- significant reduction or gradual abrogation of tariff rates on industrial food (about 85% of tariff lines) that are not covered by tariff quotas;
- receiving the eligibility for duty-free access to European markets of milk powder and condensed milk, cream, yogurt, butter and milk paste, sugar, syrups, juices, starch, flour and certain other types of food as well as cigars and cigarettes under established tariff quotas;
- harmonization of national standards with the international and the European standards;
- adaptation of the national technical regulations, sanitary and phytosanitary measures in the European and international requirements.

### **Potential hazards:**

- weakening of the competitive position and reduction of the revenues for small and medium-sized domestic food processing enterprises due to increasing competition in the domestic market;
- possible reduction of the amount of production of oil and fat industry due to the elimination of export duties on sunflower seeds;
- risk of significant loss of Ukrainian wineries and cognac food industry market products, which were shaped by the system of protection of geographical indications and industrial products;

- the risk of loss of food industry markets products in the Customs Union.

## **Agriculture:**

### **Potential benefits:**

1. FTA has advantages for agriculture due to:
  - rapid increase in domestic agricultural exports (by 26% in the structure of merchandise exports against 18.7% in 2011), which shows that Ukraine is a net exporter of agricultural products, including in the EU;
  - dynamic growth of exports of agricultural products in the EU: in 2012 the value of agricultural exports from Ukraine to the EU increased by 54% (from \$3.18 billion in 2011 to \$4.92 billion in 2012). Agricultural export to the EU is developing more rapidly than export to the countries of Customs Union. Value of agricultural exports to the EU in 2012 is 1.8 times higher than the value of agricultural export to the EEA.
2. Expanding trade opportunities for agriculture in Ukraine according to FTA is created by partial reduction of asymmetric modes of trade in agricultural products between the EU and Ukraine by:
  - duty-free access for Ukrainian agricultural products under the tariff quotas. The tariff quotas sizes correspond to the traditional imports from Ukraine to the EU on certain goods quotas taken into account the expected trends of domestic production in the country. Ukraine will provide 1.6 million tons of grain duty-free to the EU, with a gradual increase in quotas for 5 years to 2 million tons;
  - rejection of the use of EU export subsidies for agricultural products for export to Ukraine;
  - consolidation of the right for Ukraine to use the protective measures;
  - facilitation for Ukraine under the FTA with the EU of the customs tariff applicable EU agri-food products;

- high probability of an increase in export of certain types of agri-food products, including those that are growing set quota;
- facilitating access to quality inputs (seeds, pesticides, machinery, etc.);
- upgrading and modernization of domestic agricultural and food production.

### **Potential hazards:**

- small amount of import quotas to the EU duty-free importation of goods from Ukraine and not full coverage of the commodity nomenclature of agricultural products. In the case of reviewing the terms of the Agreement, it would be good to defend the significant decrease in the number of exceptions to the FTA with the EU and to promote the increase in tariff quotas for the remaining tariff lines (especially corn, soybeans, barley, poultry);
- current inability of most of the domestic producers to satisfy the technical, sanitary and phytosanitary conditions for exporting their products to the EU markets, that will prevent increased exports of domestic products under the tariff quotas frame allocated to Ukraine;
- weakening domestic producers of meat and meat products, fruits and vegetables as a result of increased imports from the EU. In particular, the establishment of a tariff quota on pork imports from the EU will lead to an increase in imports of pork for a maximum of 8%;
- increasing the competing import in the domestic food market of Ukraine if the restrictions under domestic exports to the EU are active;
- lower revenues for small and medium-sized agricultural enterprises as a result of increased competition in the domestic agricultural markets;
- increasing domestic consumer prices of products that meet the requirements of European and international regulations due to high costs of harmonization;
- increase in the share of low-quality products in the Ukrainian agro-food import that have not found sales on the EU market;

- increasing dependence of domestic agricultural producers on imports of inputs for domestic limited alternative sources of replenishment;
- slight reduction in oil and fat production with all the attendant consequences due to gradual abolishment of export duty on sunflower seeds;
- worsening the problems in dealing with the countries of Customs Union and the likely effect of introducing it in import tariffs for Ukraine;
- the need for additional financial resources for technical and technological re-equipment of enterprises to ensure their competitiveness in the new environment.

For certain groups of agro-food production *potential advantages* can be:

- the introduction of zero tariffs on imports of a large number of products from Ukraine, not only of raw materials (dried peas, oilseeds), but also for deep processing products (oils, some types of canned products);
- temporary storage agreement with the EU (albeit with a gradual decline over 10 years) export duties on sunflower seeds and flax;
- under the FTA with the EU should also be imposed export duties on rapeseed (10 years with a phased reduction).

In the case of integration with the EU on the above mentioned products can be expected *following hazards*:

- gradual strengthening of the European products on the domestic market such as tomatoes, cucumbers, apples, butter, canned and processed vegetables, fruit and vegetable juices;
- application restrictions for Ukrainian exports from the Customs Union.

### **State aid:**

Potential advantages of regulating state aid under the Association Agreement between Ukraine and the EU are as following:

- increasing of the transparency of decision-making on state aid;
- reduction of the state aid and corresponding reduction in budg-

et expenditures due to the abolition of measures which have a negative impact on trade between Ukraine and the EU;

- monitoring of the impact of state aid on competition and the abolition of most adverse to competition of aid;
- control over the legality of state aid stipulates that in case of granting illegal aid granted to the company is obliged to return the money the state and offset other losses in the form of penalties and interest on capital.

### **Potential hazards:**

- narrowing of the space for the application of state aid (primarily industry and to support individual businesses). Potentially, under the frame of abolition or limitation may fall the public support for the coal industry, aerospace, shipbuilding, etc.;
- negative impact on the economy of the elimination of state aid measures for businesses that previously received it;
- loss of the support tool for managing of domestic producers that compete with higher quality products in the EU;
- complexity of bureaucratic procedures in the approval process of the new measures of the state aid. The need for a new level, controlling the provision of such assistance;
- increasing of the budget expenditures related to the control of the state aid;
- terms of the Agreement require amending the rules of the European legislation regarding the recognition criteria in public spending state aid.

## **Conclusions**

Calculations by dynamic input-output model show, that in the early years of the Agreement the negative consequences of the replacement of chemicals, machinery and metallurgy partly can be compensated by new opportunities for enterprises of light industry, agriculture and for a number of food companies. These opportunities arise as a result of lower rates of customs duties. Generally, cumulative positive trade effects of the Agreement for the first year (2014) partly will be leveled by the reducing production

between 2015 and 2017, and will turn to negative in 2017. The slowdown of growth in production is estimated to be 0.15% per year on average between 2015 and 2017. Since trade effects have their positive impact only in a short-term, a technological re-equipment of industries will be necessary, and it is possible only if the implementation of investment programs allows domestic enterprises to upgrade to a modern technological level.

It should be noted, that if the domestic producers of machinery, metallurgy and chemical industry does not take effective measures to modernize production, there will be deep disparities in the technological structure of production, and a possible losing of further domestic and foreign markets will happen along with potential losses in trade with the countries of the Customs Union, especially if they continue the policy of import substitution and the mechanisms of tariff and non-tariff barriers previously declared.

In case of decreasing economic activity there are significant risks for the industries in the commitment to implementation of technical regulations and other acts of the EU in terms of 2-3-5-7 years, due to the problematic implementation of such significant legislative material in the above terms. It is important in the adaptation of legislation to determine the necessary sources and devote significant financial resources for the process of implementation.

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# MOLDOVA'S PROGRESS IN EASTERN PARTNERSHIP: MOVING FROM SUCCESS STORY TO SUCCESS REALITY

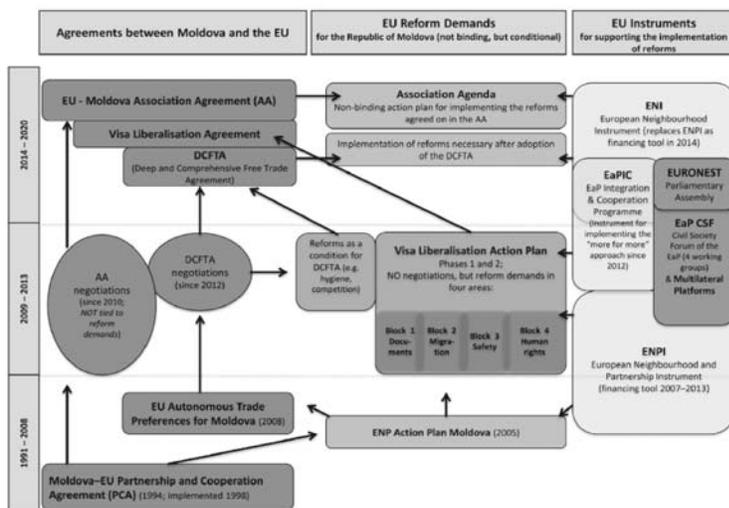
*Adrian Lupusor*

## **Brief Description on Actual State of Moldova's EaP Process**

The initiation of Eastern Partnership (EaP) in 2009 has coincided with a massive political shift in the Republic of Moldova. Thus, a new coalition, named “Alliance for European Integration”, brought the bilateral relations between the European Union and Moldova to a new level. As a result, the communication between the European officials and the Moldovan political elite was intensified on almost all dimensions of country development. It implied a significant institutional and financial backup for promoting a series of systemic reforms in various crucial sectors (e.g. educational system, regulatory reform, implementation of information and communication technologies etc.). In the frame of the intensification of political relations within the EaP platform, the negotiations on the potential Association Agreement (AA) have been launched in 2010. The forthcoming AA is going to replace the Partnership and Cooperation Agreement, which defines the key principles of cooperation between the European Union and the Republic of Moldova since 1998. Thus, the AA will be the most important juridical element of the EaP and the closest form of European integration. As part of the AA, negotiations over visa-free regime with EU have been launched in 2010 and on the Deep and Comprehensive Free Trade Agreement – in 2012. Please see chart 1

for a detailed snapshot about the collaboration between Moldova and the EU.

Figure 1.  
The Collaboration between Moldova and EU



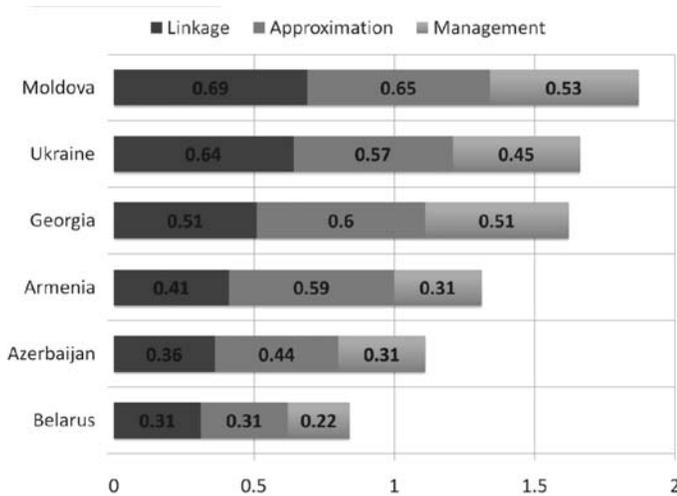
Source: D. Rinnert, “The Republic of Moldova in the Eastern Partnership”, 2013.

Compared to its peers in the EaP block (Armenia, Azerbaijan, Belarus, Georgia and Ukraine), Moldova registered a significant progress, being even labelled as the frontrunner and the “most willing reformer” of the Eastern Partnership (*see figure 2*)<sup>1</sup>.

The most important successes are related to the finalization of negotiations on the Association Agreement in the first half of 2013, which is likely to be initiated during the EaP Summit in Vilnius in November 2013, and ratified in 2014 by the EU member states. Importantly, the successful transition from the phase of ratification of the Association Agreement to the phase of launching the Association Agenda, is conditional on the political situation

<sup>1</sup> “European Integration Index for EaP countries”, International Renaissance Foundation in cooperation with the Open Society Foundation, May, 2012

Figure 2.  
The Eastern Partnership Index, 2012



Source: European Integration Index for EaP countries

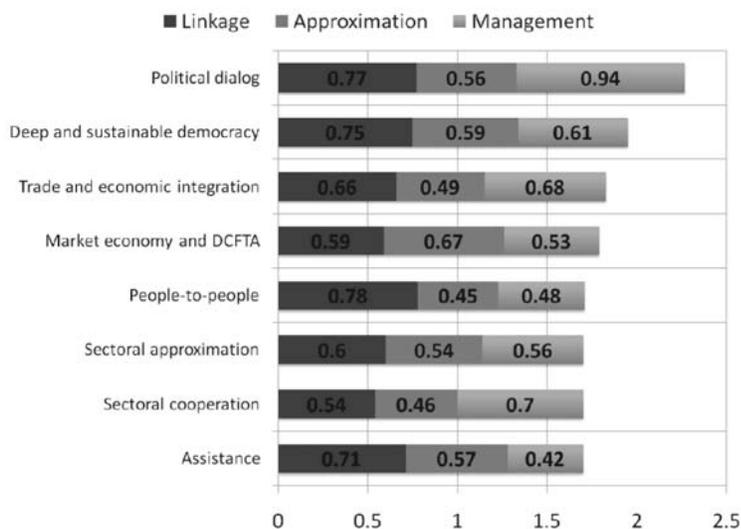
within the country. After the political deadlock from the beginning of 2013, the Parliament voted to a new Government, led by Mr. Iurie Leanca, who is one of the key leaders in the process of European Integration. Hence, this should bode well for the European vector of Moldova. Nevertheless, the previous disputes among the members of the ruling coalition still persist, making the entire political situation quite vulnerable to potential shocks, which may arise especially before the parliamentary elections from 2015.

As a result of these efforts of various public institutions is aligning the legislation and institutional setting to EU norms, Moldova registered prominent successes in fields related to political dialog, deep and sustainable democracy and trade and economic integration (see figure 3). Particularly, it owes to the progress registered in the area of elections, human rights, quality of public administration and accountability. Moreover, Moldova showed a significant progress in the implementation of the Visa Liberalisation Action Plan, outpacing Ukraine, which also had some important evolution in this direction. Other important successes consist of

signing the EU-Moldova Common Aviation Area, the foundation of the National Participatory Council (a platform for the leading NGOs), and, obviously, the finalization in record terms of the negotiations on the Deep and Comprehensive Free Trade Agreement with EU (more on this in section 3).

Figure 3.

Ranking of European Integration Index, per components, Moldova, 2012

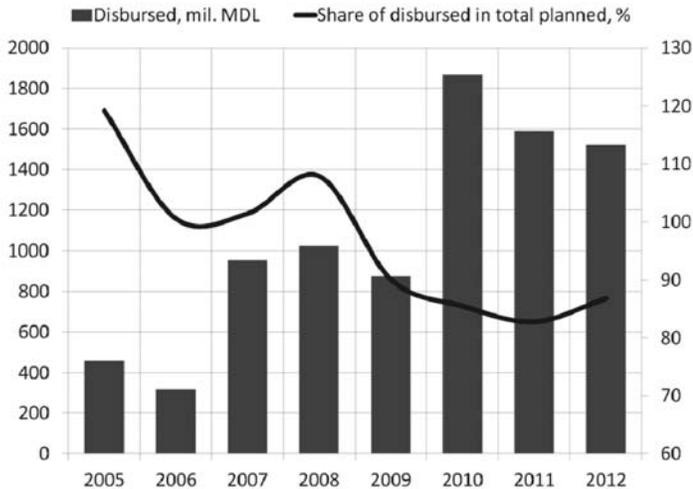


Source: European Integration Index for EaP countries

It is worth mentioning that these successes brought along a strong increase in the amounts of foreign assistance directed to Moldova. Thus, the EU support to the state budget has almost doubled since 2010, which is a direct result of the Eastern Partnership programs, as well as the adoption of the “more-for-more” principle in 2011. Nevertheless, the problem of absorption of these funds remains acute, as the increase in the amount of assistance paralleled with the execution rate (effectively disbursed compared to the plan), as denoted by the figure 4.

Despite these positive evolutions, a lot remains to be done on several crucial domains, which serve as “Achilles heel” for Moldova’s European integration process. The most problematic one is

Figure 4.  
Foreign Grants Disbursed to the State Budget (left axis)  
and the Execution Rate (right axis)



Source: Ministry of Finances

related to the judiciary reform, which is running well behind the schedule due to the insufficiency of financial resources, political disputes, but mostly the persistence of vested interests. Combating corruption and organized crime is an additional area where more actions should be undertaken by the relevant authorities. Due to a poor law enforcement mechanisms and legislative loopholes in this domain, there were repeated abusive takeover attacks on the shares in a number of banks and financial companies over the last years. Moldova has a relatively modest progress in the transport sector, especially in terms of aligning the regulatory environment to the EU principles, which significantly hampers the efforts to modernize the road infrastructure and the overall competitiveness of its exports.

### Snapshot of EU-Moldova Economic Relations

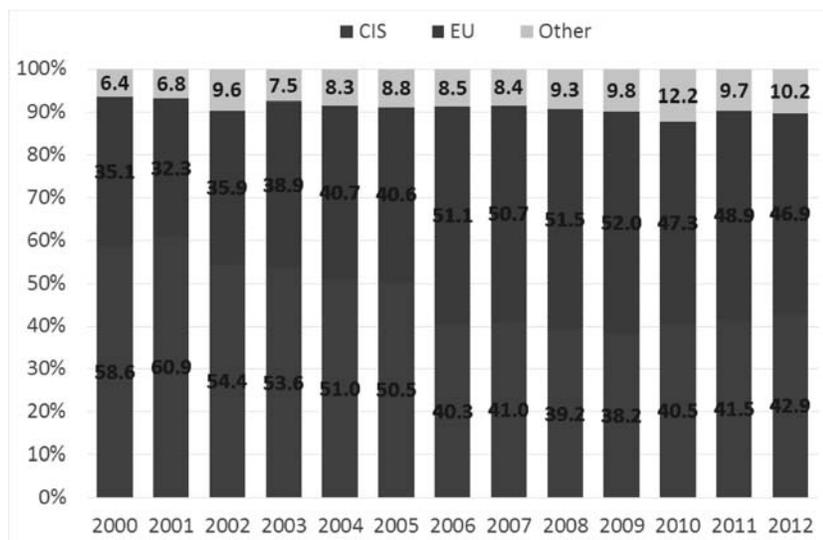
Since 2006, the European Union remains the most important destination for the Moldovan exports, outpacing Russia and other

CIS countries, which traditionally have been the main outlet for the local producers. It was determined by three crucial factors: (i) the export embargo for Moldovan wines imposed by Russia in March 2006, which caused a massive drop of exports to this destination and motivated the producers to switch to EU and other markets; (ii) asymmetric trade liberalisation from EU for the Moldovan exports in the frame of Generalised System of Preferences (GSP), GSP plus and Autonomous Trade Preferences; and (iii) the arithmetic effect of adherence of Romania and Bulgaria in 2007 to EU. Moreover, as a result of several strategic investments which came in 2007-2008, new industrial sectors developed (e.g. machinery, electrical equipment and parts thereof), which are primarily oriented to the EU market.

As a result, the Moldovan economy became well anchored in the EU one. In 2012, Moldova's exports to the European Union were USD 1013.4 million, accounting for a 46.9% of total exports, lower compared to the CIS market, which absorbed 42.9% of total Moldovan exports.

Figure 5.

The structure of Moldovan exports according to the main destinations, %



Source: National Bureau of Statistics

The most important export category electric wires, cables and other insulated electric conductors, which in 2012 accounted for 16.3% of total Moldovan exports to EU. As mentioned previously, this is largely explained by several strategic FDI's that were set up in 2008, that spurred new industries largely oriented towards the EU market (97% of their production is directed towards Romania). Other important Moldovan exports to EU are agricultural commodities such as sunflower seeds (7.7% in total exports to EU) and fresh or dried nuts (6.4%) sold primarily to Italy and Greece. Finally, there is the textile industry with clothing articles accounting for 6.5% and car seat covers accounting for another 5.3% of exports to the EU (*see table 1*).

The European Union is the main trading partner of the Republic of Moldova on the imports' side as well. In 2012, 44.5% of total imports originated from EU member states, accounting for the largest share of total imports. About 16% of these imports are composed of oils such as petroleum, bitumin and distillates, which are mostly bought from Romania, Moldova's most important trading partner from the EU. Other important imports are the insulated wires and cables and optical fibre cables, which are basically the raw materials used for further assembly and processing by two important factories that export their production to Romania, forming the largest export category to the EU. Generally, the imports' structure reflects the competitive disadvantages of the Republic of Moldova compared to the EU. Hence, most of the imports are dominated by technology intensive products (e.g. equipment, machinery), which are very important for the overall modernisation of the Moldovan economy.

Overall, the imports are less concentrated, compared to the exports' structure: top-5 imports account for about 30% of total imports to the EU, whereas in the case of top-5 exports this share is 39.3% (*see table 1*).

Table 1.  
Foreign Trade Structure between Moldova and the EU 2012\*

Exports			Imports		
<i>Item</i>	<i>% in total exports to EU</i>	<i>Main trading partners</i>	<i>Item</i>	<i>% in total imports to EU</i>	<i>Main trading partners</i>
Insulated wire, cable and other insulated electric conductors	16.3	Romania	Oils, petroleum, bitumin, distillates	16.0	Romania
Sunflower-seed, safflower or cotton-seed oil and fractions thereof	7.7	Italy, Romania	Medicaments	5.4	Italy, Germany
Nuts, fresh or dried	6.4	Italy, Greece	Insulated wire and cable, optical fibre cable	4.1	Austria
Seats and parts thereof	5.3	Hungary, Poland	Motor vehicles for transport of persons	2.9	Germany
Women's or girls' suits, ensembles, jackets and other clothing items	3.6	Italy, Germany	Hair preparations	1.6	Romania
Men's or boys' suits, ensembles, jackets and other clothing items	2.9	Poland, Italy	Insecticides, fungicides, herbicides	1.6	Germany, France
Fruit juices and vegetable juices	2.9	Poland, Austria	Made up articles, including dress patterns	1.4	Poland, Hungary
Cane or beet sugar and chemically pure sucrose	2.5	Romania	Parts and accessories for motor vehicles	1.4	Romania, Germany

Exports			Imports		
<i>Item</i>	<i>% in total exports to EU</i>	<i>Main trading partners</i>	<i>Item</i>	<i>% in total imports to EU</i>	<i>Main trading partners</i>
Sunflower seeds	2.1	Romania	Tractors (other than works, warehouse equipment)	1.3	Germany, Netherlands
Wine of fresh grapes	2.0	Czech Republic, Poland, Romania	Other furniture and parts thereof.	1.2	Romania, Italy

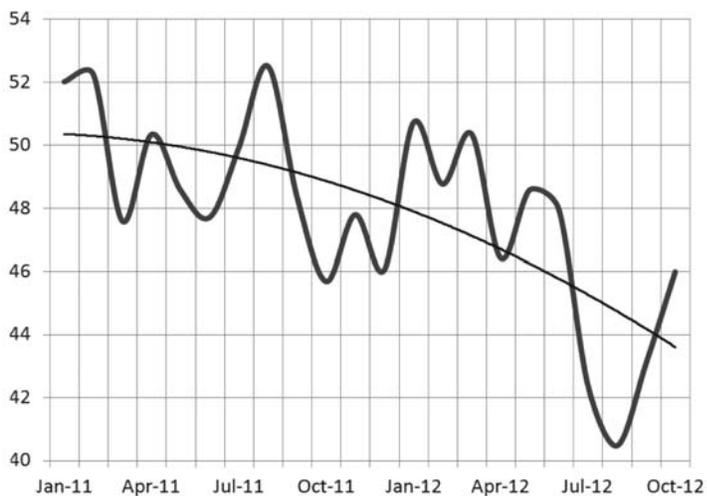
Source: UN Comtrade

\*4-digit level of disaggregation (HS-2007)

As we may notice from table 1, the most important trading partners of Moldova among the EU member states are Romania and Italy, which absorb over half of the Moldovan exports. Both countries suffered a lot during the recent financial and economic turmoil and currently have very fragile economic conditions. It largely influenced the overall performance of Moldovan exports to EU during the last years. As figure 6 shows, the share of exports to the EU in total exports follows a downward trend. However, as argued by empirical evidences<sup>2</sup>, this is a temporary phenomenon and the Moldovan economy remains strongly integrated into the European one (*see figure 6*). Except for foreign trade and budgetary assistance, the EU plays a major role for the Moldovan economy through the FDI channel. Thus, about 70%-75% of total foreign direct investments flowing into the Moldovan economy are originating from EU countries. As a result, compared to other CIS countries, Moldova has a relatively high exposure to EU FDIs (*see figure 7*). Most of these investments are directed into the financial and banking sector, textiles, information and communication technologies, machinery and equipment. The countries of origin are usually Holland, Germany, Italy, Romania or France.

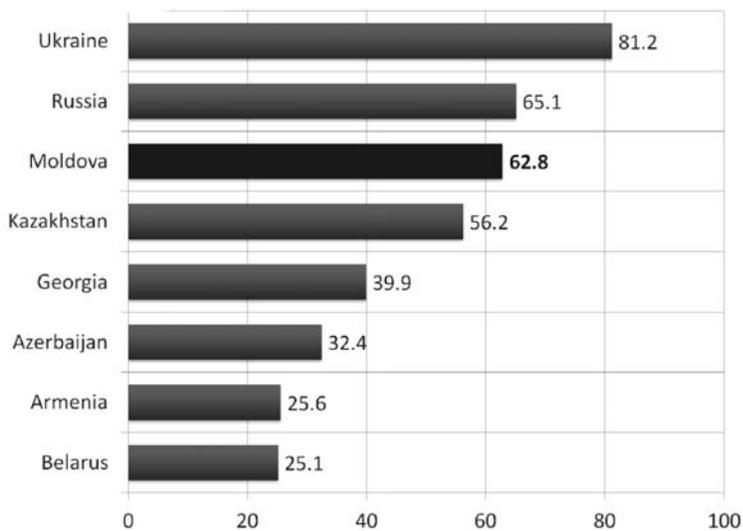
<sup>2</sup> A. Lupusor, "Can the Reduction of Moldovan Exports to EU in 2012 influence the DCFTA negotiations?", Expert-Grup, 2012

Figure 6.  
The Share of Moldovan Exports to EU in Total Exports, %



Source: National Bureau of Statistics

Figure 7.  
FDI from the EU in % of Total, 2011



Source: Moody's Investors Service

## **Actual State of the DCFTA Process**

As previously mentioned, in 2010, Moldova started the negotiations for the Association Agreement, which is going to be the closest form of integration before the adherence stage and is likely to enhance the political dialogue and deepen the sector cooperation between Moldova and the EU. A fundamental part of this Agreement is the Deep and Comprehensive Free Trade Agreement (DCFTA). The negotiations on DCFTA started in December 2011, and were finalized in June 2013. Thus, Moldova and EU managed to conduct all seven rounds of negotiations during the shortest period of time, compared to other Eastern Partnership countries. As a result, the content of DCFTA will most likely be agreed at the Eastern Partnership summit, which will be held in Vilnius in November 2013 and will be signed in 2014.

The eminent importance of this trade agreement is revealed by the fact that it will substitute the current Autonomous Trade Preferences with a much more permissive, predictable and sound bilateral trade regime. Moreover, except for tariff elimination, it will imply a broad institutional adjustment at the domestic level, which will enhance the Moldovan business climate, make public institutions more efficient and the private sector more competitive. Hence, besides increasing bilateral trade between Moldova and the EU, DCFTA will bring more FDI into the domestic economy, which will also imply know-how and technological transfer. As a result, the Moldovan economy will become modernized and competitive, which is likely to spur exports by about 11%, country's GDP – by about 6% and the overall nation's wealth<sup>3</sup>.

However, DCFTA implies a series of risks as well, which stem from the country's low competitiveness, labor market rigidity and high tariff protection of certain agrifood sectors<sup>4</sup>. Therefore, in order to maximize the benefits and minimize the costs associated to the DCFTA implementation, the Moldovan Government has been

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<sup>3</sup> "Strategic comparison of Moldova's Integration options: DCFTA with the EU versus the Accession to the Russia-Belarus-Kazakhstan Customs Union", Expert-Grup, 2012

<sup>4</sup> "National Human Development Report 2012: European Aspirations and Human Development of the Republic of Moldova", Expert-Grup and UNDP Moldova, 2012

very active at undertaking various measures over the last years, involving legal and institutional harmonization to EU norms and standards.

During the preparations for negotiations for DCFTA, the Moldovan Government approved an action plan for implementing the recommendations of the European Commission on legal and institutional adjustment to EU norms and principles. The action plan was based on 13 main areas: overall coordination and administrative capacity building; market access for goods/trade statistics; tariff and non-tariff barriers (NTBs); technical barriers to trade (TBT); sanitary and phytosanitary measures (SPS); trade facilitation and customs administration; rules of origin (RO); services and investment; intellectual property rights (IPR); public procurement (PP); competition; sustainable development (social and labor issues environment); general issues. As a result, we may underline the following important actions undertaken so far by the Moldovan authorities (obviously, the list is not limited to the mentioned actions):

- launching the initiative to elaborate the Combined Nomenclature of the Republic of Moldova HS 2012;
- approval of the Law on Accreditation and Conformity Assessment Activity;
- approval of the law amending Law on metrology of November 17, 1995;
- amending the Law on Standardization of September 22, 1995;
- broad adjustments in the area of services and investments, especially financial-banking sector;
- approval of a new Law on Competition and State Aid and the foundation of the Competition Council;
- amending and supplementing the Law on payment for environmental pollution and the development of a management regulation of packaging and packaging waste and instructions for calculating the payment for environmental pollution has been launched;
- implementation of the National Programme for Law Harmonization.

Nevertheless, there is still a lot to be done by the Moldovan authorities in order to rip the benefits of DCFTA. Particularly, the

quality infrastructure remains weak, the harmonization of standards is very slow, many domestic sectors remain strongly protected through tariff policy, the competition is not entirely free in many strategic sectors and the overall administrative and financial capacities of public institutions are insufficient for a broad and effective DCFTA implementation.

Moreover, the private sector and the civic society are poorly informed about the peculiarities of trade liberalization with EU and DCFTA implementation. Coupled with poor financial capacities and low access to finances, it fuels the reluctance of the private sector in applying the DCFTA requirements, whereas various political forces speculate with the public opinion on this matter.

Last, but not least, the unsolved Transnistrian issue adds to this burden. The unrecognized authorities of this breakaway region do not cooperate and even oppose strong resistance against a closer European economic integration. Given the fact that EU has been conducting the negotiations on DCFTA with the Republic of Moldova as a unitary and indivisible country, the implementation of DCFTA requirements in Transnistria is likely to be one of the most challenging tasks. The most problematic aspects are related to the rules of origin, competition and state aid policies promoted in this region, as well quality infrastructure adjustment, which is currently much more harmonized with the Russian one. Overall, the region's authorities do not cooperate at all levels, whereas the Moldovan Government does not have any control over this break-away territory. Hence, it is going to be one of the most problematic aspects of DCFTA implementation in Moldova.

## **Main Problems and Expectations Concerning DCFTA**

### **Agrifood sector**

Although, the net effects of DCFTA signing are estimated to be positive, it implies a series of short-term costs for the Moldovan economy which can not be neglected. First of all, it could imply a negative competitiveness shock for a number of agrifood sectors, which currently enjoy a relatively high level of tariff protection. This problem is even more acute, as over the last years most

Table 2. – Segments Where Moldova Registers Competitive Disadvantages in Comparison with the EU

SITC code	Commodity name	RCA <sup>5</sup> index of Moldova	RCA index of EU-27	Custom duty applied by Moldova for imports (level of protection)
0222	Milk concentrated of sweetened	0.13	2.12	10%
0230	Butter and other fats and oils derived from milk	0.3	1.1	15%/20% + EUR500/t
0484	Bread, pastry, cakes, biscuits and other bakers	0.5	1.2	10%/15%
0622	Sugar confectionery (including white chocolate)	0.5	1.0	15%
0732	Other food preparations containing cocoa, in blocks, slabs or bars	0.7	1.1	15%
0739	Food preparations containing cocoa, n.e.s.	0.2	1.7	15%
0989	Food preparations, nes	0.04	2.1	0%/15%
1110	Waters	0.3	1.8	15%
1222	Cigarettes containing tobacco	0.9	1.4	EUR 3/1000 units
2321	Synthetic rubber	0.3	1.2	0%/5%
2925	Seeds, etc., for sowing	0.2	2.3	0%/5%/10%/15%
2926	Bulbs, cuttings, live plant	0.3	1.8	5%

Source: NHDR 2012, UNDP Moldova

<sup>5</sup> The estimation of revealed comparative advantages (RCA) based on the well-known Ricardian concept provides a more detailed assessment by revealing the weakest, as well as the strongest segments of Moldovan agrifood sector. The products with the lowest index can be considered the least competitive on the foreign markets

Moldovan agrifood producers did not manage to significantly strengthen their competitiveness. Hence, least competitive sectors ended up being strongly protected, which are currently the most vulnerable to trade liberalisation with the EU (*see table 2*).

Thus, we can notice that milk, butter, bakery, sugar and other food preparations are among the most vulnerable sectors to trade liberalisation, being on the one hand less competitive compared to the EU ones and, on the other hand, highly protected through import tariffs. Moreover, the products of animal origin forms another category of vulnerable agrifood sectors, because they, currently, can not be exported to the EU market due to non-compliance to the quality standards. Therefore, despite a rather liberalised trade regime enjoyed by the Moldovan producers on the European market, the access is still limited by the poor compliance to EU standards. As a result of this non-tariff barrier, many local agrifood sectors remained uncompetitive.

Table 3. – Competitiveness of the Moldovan Agrifood Products on the EU Market, RCA Indexes in Figures (year 2010)

	2005	2006	2007	2008	2009	2010
Cereals	19.19	15.76	1.79	5.39	21.09	28.60
Hides, skins, furskins	458.17	14.80	13.31	7.98	7.73	13.65
Oilseed, oleag. fruit	7.61	7.50	7.67	8.50	10.78	12.15
Veg. fats and oils	7.13	11.70	12.50	9.10	8.67	11.61
Beverages	7.56	23.12	9.46	10.99	10.91	10.25
Vegetables and fruit	8.58	8.32	10.47	5.39	6.05	7.38
Sugar, sugr. prep, honey	7.79	11.70	2.69	11.52	13.09	3.04
Tobacco, Tobacco Manufact.	1.17	3.06	1.97	3.69	1.98	1.62
Animal feed	1.50	1.20	0.45	0.49	0.33	0.81
Cork and wood	0.31	0.54	0.59	0.53	0.62	0.53
Crude animal, veg. mater	1.27	0.40	0.68	0.35	0.44	0.48
Misc. edible products	0.47	0,33	3.43	1.52	0.35	0.46
Animal, veg. fats, oils, nes	0.48	0.75	2.71	0.86	0.68	0.43

	2005	2006	2007	2008	2009	2010
Coffee, tea, cocoa, spices	0.80	0.65	0.47	0.50	0.47	0.41
Textile fibres	0.36	0.14	1.36	0.15	0.04	0.37
Pulp and waste paper	0.18	0.04	0.09	0.10	0.25	0.13
Meat, meat preparations	0.13	0.07	0.15	0.05	0.04	0.04
Dairy products, eggs	23.41	25.10	0.07	0.00	0.00	0.03
Crude rubber	0.00	0.00	0.01	0.00	0.11	0.01
Fish, crustaceans	0.01	0.00	0.00	0.00	0.00	0.00
Live animals	0.02	0.09	0.00	0.01	0.00	0.00
Animal oils and fats	0.00	0.00	0.00	0.00	0.00	0.00

Note: Sectors with revealed comparative advantages are marked with bold  
Source: Author's computation based on UN COMTRADE

As revealed by table 3, not all agrifood products are not competitive and are vulnerable to trade liberalisation. A number of important sectors can compete and even outpace the European ones, meaning that these products will benefit the most as a result of DCFTA. These sectors are market with bold in table 3 are the drivers of the domestic agrifood sector. More specifically, these are maize seed, grapes, fresh or dried, edible nuts fresh or dried, fruits fresh or dried, juices, molasses, sunflower seed and sunflower oil.

## Industrial sector

The industrial sector is much more integrated into the trade flows with EU in comparison with the agrifood one. Given higher inflows of FDI, paralleled with less stringent standards than for products destined for human consumption and favourable external environment, the industrial firms proved to be more competitive on the European market in comparison with the agrifood producers. Hence, the share of these exports over the last years accounted for about 2/3 of total Moldovan exports to EU-27<sup>6</sup>.

The most competitive industrial sectors are clothing and clothing accessories, footwear and furniture, bedding and mattresses. Im-

<sup>6</sup> NHDR 2012 "European Aspirations and Human Development of the Republic of Moldova", UNDP Moldova, 2012

portantly, since 2008 strongly increased the competitiveness of electrical machinery, which is the direct result of the large FDI that were set up in 2007 and 2008 in this sector (*table 4*).

Table 4.  
Revealed Comparative Advantage Index for Moldovan Industrial Products

	2005	2006	2007	2008	2009	2010
Clothing and clothing accessories	11.97	14.34	13.89	13.42	11.54	11.81
Footwear	12.60	12.48	12.86	13.00	7.11	7.44
Furniture, bedding, mattresses	1.06	1.44	2.23	3.11	2.67	5.90
Travel goods, handbags and similar goods	7.25	7.45	8.02	8.56	5.23	4.90
Electrical machinery	0.20	0.27	1.05	4.32	5.19	3.93
Essential oils and perfume materials	3.70	2.60	2.41	2.63	2.59	2.85
Textile yarn, fabrics and related products	1.26	2.43	2.14	2.59	2.28	1.96
Machinery specialized for particular industries	0.66	0.57	1.30	0.64	0.79	1.90
Paper, paperboard and articles thereof	1.28	2.02	3.55	1.76	0.95	1.86
Leather manufactures and dressed furskins	4.44	3.75	2.53	4.84	9.64	1.46
Non-metallic mineral manufactures	0.99	1.39	2.24	2.26	1.38	1.42
Miscellaneous manufactured articles	0.58	1.10	1.17	0.74	0.95	0.92
Cork and wood manufactures (excluding furniture)	0.29	0.23	0.39	0.77	1.00	0.86
Manufactures of metals	1.94	1.28	1.10	1.00	1.41	0.78
Prefabricated buildings, sanitary, heating, lighting	1.57	1.73	1.39	1.23	0.86	0.63
General industry machinery and equipment	0.15	0.21	0.18	0.26	0.30	0.46

	2005	2006	2007	2008	2009	2010
Road vehicles	0.14	0.23	0.20	0.30	0.45	0.46
Metalworking machinery	0.13	0.28	0.44	0.47	0.27	0.44
Professional, scientific and controlling instruments and apparatus	0.15	0.35	0.67	0.72	0.36	0.26
Medicinal and pharmaceutical products	0.06	0.06	0.05	0.05	0.16	0.18
Plastics in primary forms	0.05	0.04	0.17	0.18	0.14	0.16
Rubber manufactures	1.40	1.17	0.13	0.20	1.52	0.16
Photographic apparatus and optical goods, clocks	0.08	0.16	0.11	0.08	0.03	0.13
Telecommunication, TV, sound, video	0.07	0.05	0.03	0.02	0.05	0.13
Plastics in non-primary forms	0.53	0.34	0.17	0.14	0.27	0.12
Iron and steel	1.82	2.58	1.34	1.60	0.17	0.12
Power-generating machinery and equipment	0.63	0.14	0.09	0.13	0.12	0.08
Dyeing, tanning and coloring materials	0.26	0.10	0.16	0.18	0.24	0.07
Other transport equipment	0.03	0.05	0.01	0.02	0.03	0.06
Chemical materials and products	0.09	0.19	0.07	0.05	0.07	0.05
Non-metallic mineral manufactures	2.03	0.24	0.20	0.09	0.15	0.03
Office machines and computers	0.03	0.03	0.03	0.03	0.03	0.02
Inorganic chemicals	0.00	0.02	0.01	0.01	0.00	0.01
Non-ferrous metals	0.01	0.00	0.01	0.01	0.01	0.01
Organic chemicals	0.05	0.04	0.01	0.01	0.08	0.00

Source: Author computations based on UN COMTRADE database, 2010

Note: Sectors with revealed comparative advantages are marked with bold

Importantly, most industrial sectors where Moldova registers comparative disadvantages with the European producers are high-tech and very capital intensive, such as general industry machinery and equipment, photographic apparatus and optical goods, clocks, metalworking machinery, road vehicles or power-generating machinery and equipment. The fact that Moldova is a net importer of such products is a natural outcome of the peculiarities related to the production factors' endowment of the country. As a result, the protection level of these products is very low or even absent with 0% custom duties. Hence, trade liberalization with EU will not generate major competitive shock for these industrial sectors. Additionally, wiping out the remaining custom duties for these segments will decrease import and production costs with positive, though marginal, welfare effects<sup>7</sup>.

All in all, we may notice that the agrifood sector is the most vulnerable to trade liberalisation to EU. The biggest problem is related to a number of fragile branches that are likely to suffer after the import tariffs will be removed and the imported products will become less expensive. In some cases, it could generate a series of defaults among the least competitive enterprises, putting additional pressures on the domestic labor market and living standards, especially in small towns and villages. This problem becomes even more acute given the poor convergence to the EU quality sanitary and low access to capital necessary for implementing these standards and improving the overall quality infrastructure of the country.

A particular problem is related to the DCFTA implementation on the territory of Transnistria – a breakaway region of the Republic of Moldova. The Moldovan authorities do not have any control over this land, which complicates the process of rules of origin verification and convergence and adjustment to the EU norms and directives. This issue is even more acute taking into account the fact that the region's unrecognized authorities follow an opposite geopolitical vector, being strongly pro-Russian and against European integration. In fact, the DCFTA implementation in Transnistria is the largest unknown in this equation, because

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<sup>7</sup> NHDR 2012 "European Aspirations and Human Development of the Republic of Moldova", UNDP Moldova, 2012

the negotiations were conducted from the part of the Republic of Moldova, as a whole (Transnistria has been represented only formally and took a passive role in this process).

### **Short and Medium Term Policy Priorities**

Moldova has finalised the negotiations on the DCFTA with EU and is expecting to agree on these documents at the forthcoming Eastern Partnership Summit in Vilnius in November 2013. In this case, the Agreement is likely to be ratified by the EU member states in 2014 and entered into force in 2015. Therefore, in the immediate perspective, the Moldovan authorities will be focused on implementing the DCFTA requirements, for which the Government will receive a two-year technical assistance from the EU. Given the progress and challenges registered so far in the process of preparations for DCFTA negotiations, the main emphasis will be placed on the following issues:

- **technical barriers to trade (TBT)** – the broad adjustments of the national standards to the European ones, transposing the directives of the new approach, supporting the elimination of the national standards which are conflicting with the EU ones, supporting the implementation of the yearly National Standardisation Programs, capacity building of the National Accreditation Body and of the National Institute for Standardization and Metrology, ensuring traceability of the national standards, assisting in the implementation of the Program for the development of the National Standards Base for 2011-2015,
- **market access** – implementation and integration of the amended Combined Nomenclature of the Republic of Moldova, adjusting the customs' tariff to the DCFTA requirements,
- **trade facilitation** – full adjustment of the Customs' Code to the WTO and EU requirements, bringing the pricing system of custom services and procedures to the EU norms, improving the application of the Moldovan customs legislation throughout the entire territory of the country, including the Transnistrian region, assisting in implementation of EUBAM recommendations on trade facilitation, contributing to the capacity building of the Custom Service, ensuring a smooth dialog with the EC

- on the legal amendments, institutional adjustments and overall progress related to the trade facilitation issue,
- **market surveillance** – assisting in the implementation of the action plan for Development of the Infrastructure for Market Surveillance, assisting in drafting and implementation of the law on market surveillance harmonized to EC regulations,
  - **analysis of trade statistics** – elaboration and implementation of an optimal mechanism for collecting trade statistics for the whole territory of Moldova (including Transnistria), harmonizing the trade statistics with the EU Acquis,
  - **international trade in services** – implementation of transparency principles, following the EU requirements, in the domestic financial sector, strengthening the supervisory capacities of the National Bank of Moldova (NBM), capacity building of NBM, National Commission for Financial Market, Ministry of Transports and other institutions involved in the international trade in services, assisting in the implementation of the Strategy for the Development of the Non-Banking Financial Sector 2011-2014 and strengthening the crisis management tools,

## **Conclusions and Strategic Policy Recommendations**

Despite a series of short-term negative shocks associated to the DCFTA implementation, the empirical estimates confirm the net beneficial effect of deeper trade integration with EU. Hence, the Moldovan Government should continue following its European integration agenda. Moreover, in order to rip all benefits of the DCFTA and minimize its costs, the Moldovan economy should be modernized and become more competitive. In order to achieve this, it is necessary to enhance the investment attractiveness of the country by three core policy directions: (i) more liberalized regulatory framework for the entrepreneurial activity; (ii) more robust, transparent and efficient public institutions, and (iii) a better judicial system that can ensure a proper protection of private property. It will boost the competitiveness of the Moldovan economy and ease the reorientation of the labor force from some companies that will suffer the most to those that will benefit as a result of the DCFTA.

Taking into account the expected competitiveness shock on a number of vulnerable agrifood sectors, the trade liberalisation should occur gradually, with a comfortable transition period that will ensure enough time for the Moldovan companies to comply to the EU standards. This is particularly important for milk and other dairy products, bakery, sugar, products of animal origin, fruits and vegetables and other food preparations that are least competitive and, at the same time, are strongly protected through import tariff.

The DCFTA implementation will require substantial human and financial resources, as it will imply a broad institutional and legal adjustment and standards' implementation. Therefore, technical assistance projects, coupled with budgetary support are of crucial importance. In order to ensure this, the Government needs a stable and predictive collaboration framework with the EU, which can be ensured by a lucrative memorandum with the IMF, keeping the pace of reforms and preserving the political stability within the country.

Transnistria should be well integrated into the DCFTA implementation processes through creating the right incentives for the regional authorities and companies to cooperate. It can be done by promoting an appropriate communication strategy in this region in order to ensure the local elites and the population that DCFTA means first of all more and better paid jobs, more investments and more business, and that this process does not involve politics. The empirical estimates show that if Transnistria adhered to DCFTA, the net effect would be beneficial, the investment attractiveness of the region would improve, while the exports would increase. At the same time, if DCFTA is implemented on the territory of Moldova, except for Transnistria, EU will replace the current preferential trade regime with MFN tariffs, making the region's exports less competitive. Given the fact that EU attracts about 40% of Transnistria's export, more restrictive trade regime will imply significant economic costs for the region.

All in all, the European integration objective is the single strategic direction which is compatible with the modernisation of the Republic of Moldova. However, in order to minimize the costs of this process and maximize its benefits, it is necessary to improve

the business climate, ensure a functional and credible judiciary system and an effective communication strategy with all regions of the country.

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# GEORGIA'S EXPERIENCES ON DEVELOPING TRADE AND TRADE POLICY RELATIONS WITH THE EUROPEAN UNION

*Merab Kakulia*

## **Eastern Partnership: Actual State**

The Eastern Partnership (EaP) Initiative is a format in which Eastern post-Communist countries, including Georgia, which have made the European choice, can accelerate political association and deepen economic integration with the European Union (EU). That is why, from the very beginning (May 2009), Georgia has been actively involved in both bilateral and multilateral dimensions of the EaP and successfully implementing the Eastern Partnership roadmaps adopted on 15 May 2012. The Association Agreement (AA) between the EU and Georgia, including the establishment of a Deep and Comprehensive Free Trade Area (DCFTA), is the cornerstone of bilateral relations in the EaP framework. After three years of hard work (negotiations started in July 2010), the parties have substantively completed the negotiations on the AA.<sup>1</sup> This was preceded by the successfully concluded talks on the DCFTA.<sup>2</sup>

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<sup>1</sup> European Union. *Statement by EU High Representative Catherine Ashton and Commissioner Štefan Füle on completion of negotiations on the future Association Agreement with Georgia*. Brussels. 24 July 2013. A 400/13. [http://europa.eu/rapid/press-release\\_MEMO-13-727\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-13-727_en.htm?locale=en)

<sup>2</sup> European Commission. *EU and Georgia conclude talks on Deep and Comprehensive Free Trade Area*. Press release, Brussels. 22 July 2013. [http://europa.eu/rapid/press-release\\_IP-13-721\\_en.htm](http://europa.eu/rapid/press-release_IP-13-721_en.htm)

Currently, the EU and Georgia look forward to the initiating of the Association Agreement at the next Eastern Partnership Summit in Vilnius (29 November 2013) and to the subsequent signing of the Agreement as soon as the technical procedures are completed.<sup>3</sup>

Entry into force of the EU-Georgia AA is “opening the way to comprehensive modernization and reform based upon shared values, political association and economic integration with the European Union. This Agreement will have a direct impact on daily life and bring Georgia and all its citizens closer to the European Union. It will build on existing strong cooperation between the EU and Georgia on international issues.”<sup>4</sup>

The EU and Georgia have already started consultations on the Association Agenda which should replace the ENP Action Plan (ENP AP). This document aims to prepare and facilitate the entry into force and implementation of the Association Agreement (including the DCFTA). During the Plenary Session on 30 January 2013 preliminary talks on the Association Agenda were held by the parties involved. The negotiations on the draft text of the Agenda are expected to start in the near future.

An important direction of bilateral cooperation in the EaP framework is the promotion of the legal movement of people with, as a long-term goal, full visa liberalization. Georgia has already been implementing the Agreements concluded with the EU on Facilitation of Issuance of Visas and, especially, the Readmission of Persons Residing without Authorization (are in force since 1 March 2011).

Within the framework of the Visa Dialogue, the Visa Liberalization Action Plan (VLAP) was handed over to Georgia. Georgia is committed to ensuring effective cooperation in legislative and operational phases of the VLAP, which focuses on four blocks: Document Security, Irregular Immigration including Readmission, Public Order and Security, External Relations and Fundamental Rights.<sup>5</sup>

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<sup>3</sup> European Union. *Statement by EU High Representative Catherine Ashton and Commissioner Štefan Füle on completion of negotiations on the future Association Agreement with Georgia*. Brussels. 24 July 2013. A 400/13.

<sup>4</sup> *Ibid.*

<sup>5</sup> Office of the State Minister of Georgia on European and Euro-Atlantic Integration. *Georgia's Progress Report on Implementation of the ENP Action Plan and the EaP Roadmaps October 2012 – June 2013*. (Not published.)

In accordance with the EU-Georgia visa facilitation and readmission agreements, Joint Committees on Readmission and Visa Facilitation were established to discuss the procedures of implementation and monitoring of the above-mentioned agreements and exchange relevant information.

Georgia has been actively involved in the preparations and work of all the four platforms, flagship initiatives, panels and related events of the Eastern Partnership. The country became the venue for hosting important events organized within the EaP framework such as the second meeting of the Eastern Partnership Dialogue (Tbilisi, 12-13 February 2013). For the first time, the agenda of this meeting included the new element of sectoral cooperation focusing on issues of transport and the dimension of cooperation with civil society.

Among the other EaP events recently carried out in Georgia, of note are the third meeting of the Panel on SME Policy [EaP Platform II] (Batumi, 30-31 October 2012); a seminar on Information Protection and Security [EaP Platform I, Panel on Public Administration Reform] (Tbilisi 30 January-1 February 2013); the fourth meeting of the Panel on Migration and Asylum [EaP Platform I] (Tbilisi, 20-21 March 2013); the second workshop on Regulatory Convergence organized in cooperation with the EU Energy Regulators [EaP Platform III] (Tbilisi, 18-19 June 2013) and the Eastern Partnership Ministerial Conference on Culture (Tbilisi, 27-28 June 2013).

The new Georgian government expects that cooperation in the multilateral format has to be further intensified in order to reach tangible results on issues such as tackling the consequences of the economic and financial crisis, promoting legal migration and assisting the partner states in coping with the respective commitments. In this regard, Georgia stands ready to contribute by sharing its success and positive experience in areas such as the fight against corruption and organized crime, integrated border management, money laundering, etc.<sup>6</sup>

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<sup>6</sup> *Ibid.*

## Georgia-EU Trade

The European Union is Georgia's largest trading partner. In 2012, Georgia's trade with EU countries\* comprised USD 2.8 billion, accounting for 27% of the country's total trade turnover. Three EU Member States are among Georgia's top ten trading partner countries: Germany (5<sup>th</sup> place), Bulgaria (8<sup>th</sup> place) and Italy (10<sup>th</sup> place).

The share of imports in the trade turnover with the EU accounted for 87% – almost seven times greater than the share of exports. Consequently, Georgia's trade deficit with the EU reached USD 2.1 billion – 38% of the country's total trade deficit in 2012.

Table 1.  
Summary of Georgia-EU Trade (Mln. USD)

	2007	2008	2009	2010	2011	2012
Exports	269	335	238	310	424	353
% to Total exports	22	22	21	18	19	15
Imports	1539	1756	1336	1467	2053	2427
% to Total imports	29	28	30	28	29	31
Trade turnover with the EU	1808	2091	1574	1777	2477	2780
% to Total trade turnover	28	27	28	26	27	27
Trade deficit with the EU	-1270	- 1421	- 1098	- 1157	-1629	- 2074

Source: National Statistics Office of Georgia (Geostat)

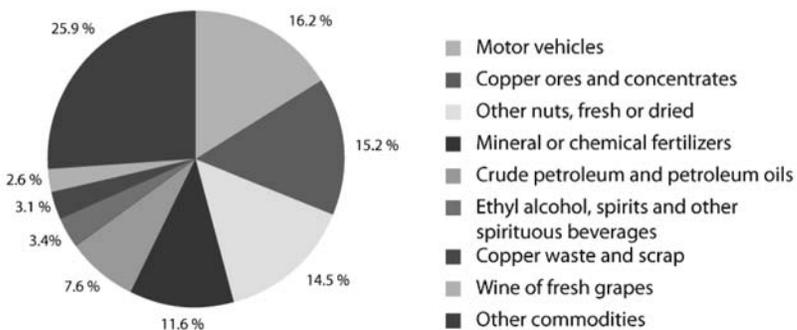
The table data (*see table 1*) show that the share of Georgia's exports to the EU in total exports of the country decreased substantially after the global financial crisis whereas the share of imports increased to the same extent. This is due to the fact that after re-

\* Data of Georgia's trade statistics significantly differ from those of Eurostat data especially on the export side. This is caused by the fact that the transit of some commodities through Georgia is erroneously reported in the customs declarations as export from Georgia. (See: Volkhart Vincentz. "Trade Policy and Georgian Exports," *Georgian Economic Trends*, September 2008, p. 59.)

covery in 2010-2011, the volume of exports to EU countries fell again in 2012. As for imports, its volume continued recovery and in 2011 significantly exceeded the pre-crisis level. Thus bilateral trade turnover has kept an upward trend thanks to the substantial increase in imports and the deterioration of Georgia's trade balance.

Georgia's exports to the EU (2012) are less diversified and dominated by crude materials and mineral products (see diagram below). It is noteworthy that motor vehicles comprise the largest commodity group of Georgia's exports to the EU even though they are not produced by the country. Due to the favorable regime of re-export, however, Georgia has become an entrepot of international trade in this kind of product. If we compare the list of the 20 leading commodity groups of Georgian exports to the EU (except motor vehicles) in 2012 and 2007, we find that it has practically not modified; only the proportion of selected products has changed.

### Georgia's Exports to the EU 2012



Source: National Statistics Office of Georgia (Geostat)

It should be noted that since 2005 Georgia enjoys the Generalized System of Preferences – (GSP+) granted by the EU, which aims to increase exports to the EU and its diversification. However, the analysis of data on trade in this format indicates that the Georgian exports under the GSP+ increased little and its product structure has not undergone significant changes. More than 70%

of exports represent two commodity groups – nuts and fertilizers. The dynamics of export of these goods determines the overall dynamics of the Georgian exports under this scheme (*see table 2*).

Table 2.  
Georgia's Exports under GSP+ (Mln. USD)

	2007	2008	2009	2010	2011	2012
Exports under GSP+	127	118	112	123	214	133
% to Total exports to the EU	47	35	47	40	50	38
Exports of Nuts and Fertilizers	77	87	91	87	179	95
% to exports under GSP+	61	74	81	71	84	71

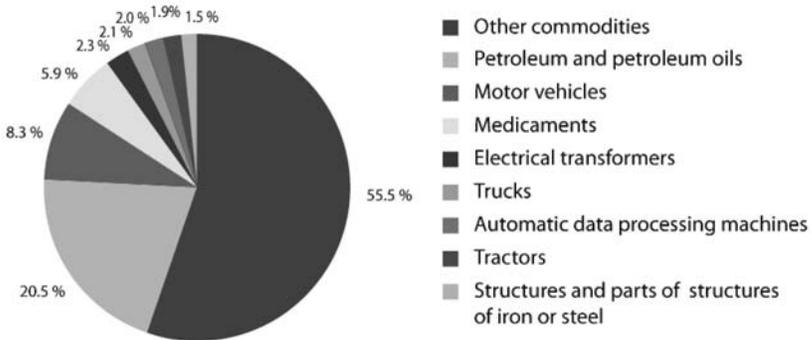
Source: Ministry of Economic Development of Georgia

Inefficient use of GSP+ indicates that the main obstacles of the Georgian exports to the EU are not so much the tariff as non-tariff barriers whose overcoming requires further institutional reforms and active export promotion policy.

The increasing of Georgia's agrarian exports to the EU can be facilitated by the Agreement on the Protection of Geographical Indications for Agricultural Products and Foodstuffs, which entered into force in 2012. An annex to the Agreement provides a list of 18 geographical indications of Georgian wine products, which have already been recognized by the EU. Negotiations are continuing on the registration of an additional 19 geographical indications of products including 14 types of dairy products – mainly cheeses as well as mineral waters, Chacha vodka and Churchkhela. Registered geographical indications will be protected against misuse, imitation or evocation which may mislead the origin of the product.

Imports from the EU to Georgia (2012) consist mainly of mineral fuels, machinery, mechanical appliances and transport equipment, chemicals, pharmaceutical products and other manufactured goods (*see diagram below*). If we compare the list of the 20 leading

## Georgia's Imports from the EU 2012



Source: National Statistics Office of Georgia (Geostat)

commodity groups of Georgia's imports from the EU in 2012 and 2007, we find that it has not sufficiently modified; only the proportion of selected products, as in the case of exports, has changed.

### FDI from the EU

The EU as a whole is Georgia's largest foreign investor: its share in total FDI flow accounted for 47% in 2012. There were five EU Member States among Georgia's top ten major foreign investors (2012): Germany (1<sup>st</sup> place), Netherlands (2<sup>nd</sup> place), UK (5<sup>th</sup> place), Luxembourg (7<sup>th</sup> place) and Cyprus (8<sup>th</sup> place).<sup>7</sup>

Against the background of the Russian-Georgian war in August 2008 and the deepening of the global financial crisis (2009) FDI from the EU to Georgia declined substantially (*see table 3*). However, as a result of the government's efforts to improve the country's attractiveness for foreign investors, their confidence started to be restored. Despite this, after some recovery, the FDI from the EU countries again fell sharply in 2012 due to the uncertainties related to the start of the active phase of the electoral cycle in Georgia. Among the EU countries as direct investors of Georgia,

<sup>7</sup> National Statistics Office of Georgia (Geostat). *FDI in 2012 (Preliminary)*. [http://www.geostat.ge/cms/site\\_images/\\_files/english/bop/FDI\\_2012-Eng.pdf](http://www.geostat.ge/cms/site_images/_files/english/bop/FDI_2012-Eng.pdf)

Table 3.  
FDI from the EU to Georgia (Mln. USD)

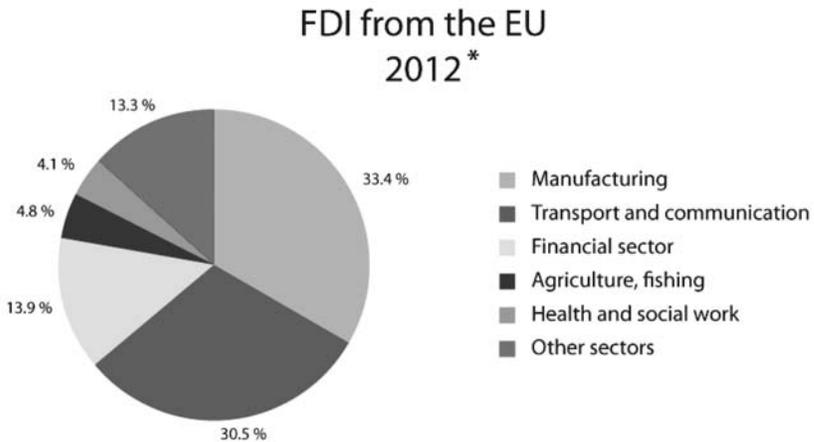
	2007	2008	2009	2010	2011	2012*
FDI from the EU	1133	477	225	248	554	402
% to Total FDI to Georgia	56	30	34	30	50	47
Germany	57	41	21	13	26	142
Netherlands	299	136	33	73	242	88
UK	145	149	72	59	55	67
% of top 3 EU investors to FDI from the EU	44	68	56	58	58	74

Source: National Statistics Office of Georgia (Geostat)

Note:\*Preliminary data

the Netherlands draws particular attention. During the last six years it invested USD 871 million in the country's economy. As can be seen from the table above, the dynamics of Dutch FDI has a significant impact on the overall dynamics of the EU FDI to Georgia. Investment activity of the Netherlands is largely caused by the presence in this country of the liberal and similar to offshore investment regime that allows residents of Georgia to invest in their own country via the Netherlands. Together with the Netherlands investments from Cyprus and Luxembourg are also noticeable in Georgia, although not as consistently, which can be explained by the same above-mentioned reason.

The main sectors of European FDIs to Georgia are manufacturing, transport, communications and financial intermediation, which account for almost 80% of their total volume (2012). Germany, Luxembourg and Cyprus were the main investors of the manufacturing industry. Dutch and British investments have been significant in the sector of transport and communication. British and French investments should be noted in the financial sector. Over the last few years, a significant amount of the EU investments were also made in the energy, construction, trade, hotel and restaurant sectors of the Georgian economy.



Source: National Statistics Office of Georgia (Geostat)

Note: \*Preliminary data

### **EU-Georgia DCFTA: Actual Status**

On 22 July 2013 the European Union and Georgia successfully concluded negotiations for a Deep and Comprehensive Free Trade Area (DCFTA) as part of the Association Agreement between them. The DCFTA will be included in the Association Agreement and signed as soon as internal EU and Georgia procedures are completed.<sup>8</sup>

DCFTA negotiations between the EU and Georgia lasted a relatively short time – 17 months. The talks were carried out in a constructive atmosphere with many of the issues agreed between the parties through video conferencing. The success of the negotiations contributed largely to the informal preparatory phase, which continued for almost three years.

The EU's readiness to cooperate with Georgia with the aim to conclude the Free Trade Agreement was expressed in the European Council Conclusions of 1 September 2008.<sup>9</sup> The European

<sup>8</sup> European Commission. *EU and Georgia conclude talks on Deep and Comprehensive Free Trade Area*. Press release. Brussels, 22 July 2013.

<sup>9</sup> Presidency Conclusions, Extraordinary European Council, Brussels, 1 September 2008. [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/cc/102545.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/cc/102545.pdf)

Commission (EC) was tasked with assessing Georgia's degree of preparedness regarding DCFTA negotiations. In March 2009, the EC unveiled to Tbilisi the official document evaluating Georgia's preparedness to start negotiations on the DCFTA together with a package of recommendations. The fulfillment of these recommendations was actually set as a precondition for starting negotiations. Four key areas deemed crucial by the EC for starting negotiations were: Technical Barriers to Trade (TBTs), Sanitary and Phytosanitary (SPS) Measures, Intellectual Property Rights (IPR) and Competition Policy.<sup>10</sup>

Performing the above-named EU recommendations proved difficult as the policy based on the principals of minimal state and maximum deregulation pursued by the Georgian government differed from the EU's approach.<sup>11</sup> However, the Georgian side, after a rather lengthy discussion with the relevant EC services, reached a compromise: with the consent of the EC the Georgian government approved the comprehensive strategies in three priority areas in 2010 (TBTs, SPS and Competition Policy)<sup>12</sup> and started their implementation. Significant measures have also been taken in the fourth priority area (IPR) to implement the EU recommendations.<sup>13</sup>

At the end of 2011 the EU decided to launch negotiations with Georgia on the DCFTA. According to the EC this decision was

<sup>10</sup> Implementation of European Neighborhood Policy Action Plan for Georgia in Trade and some Trade Related Areas in 2010. (Report summary). Eurasia Partnership Foundation (EPF). Tbilisi. January 2011, p. 7. [http://www.epfound.ge/files/report\\_enp-epf\\_summary\\_03.22.11\\_eng\\_1.pdf](http://www.epfound.ge/files/report_enp-epf_summary_03.22.11_eng_1.pdf)

<sup>11</sup> See: Merab Kakulia. "Economic Integration and Regulatory Convergence with EU Polices: A View from Georgia" in *Eastern Partnership for the South Caucasus*. Georgian Biographical Centre. Tbilisi. 2011. [http://gfsis.org/media/download/library/articles/kakulia/Economic\\_Integration\\_and\\_Regulatory\\_Convergence\\_with\\_the\\_EU\\_Policies.pdf](http://gfsis.org/media/download/library/articles/kakulia/Economic_Integration_and_Regulatory_Convergence_with_the_EU_Policies.pdf); Tamar Khuntsaria. *Prospect of Deep and Comprehensive Free Trade Area (DCFTA) – Is there a European Way for Georgia?* Center for Social Sciences. September 2012. [http://css.ge/files/books/papers/Tamar\\_Khuntsaria\\_Final\\_CSS\\_Journal\\_ENG.pdf](http://css.ge/files/books/papers/Tamar_Khuntsaria_Final_CSS_Journal_ENG.pdf)

<sup>12</sup> Decree N1140 of the Government of Georgia, dated 25 August 2010. *On the Approval of the Governmental Programme on Legislative Reform and Adoption of Technical Regulations in the area of Standardization, Accreditation, Conformity Assessment, Technical Regulation and Metrology*;

Decree N1756 of the Government of Georgia, dated 28 December 2010. *On the Approval of the Comprehensive Strategy and Legislative Approximation Programme in Food Safety*;

Decree N1551 of the Government of Georgia, dated 3 December 2010. *On the Approval of the Comprehensive Strategy in Competition Policy*.

<sup>13</sup> Decree N912 of the President of Georgia, dated 12 November 2010. *On the Establishment of Interagency Coordination Council on Copyright Protection and Approval of its Charter*.

conditioned upon Georgia fulfilling a set of "key recommendations." These were issued in March 2009 and covered necessary reforms in key regulatory areas related to trade and investment in order to prepare Georgia for further negotiations.<sup>14</sup>

During the DCFTA talks, which started in February 2012, seven rounds were arranged. The negotiations were held behind closed doors; therefore, information about them was scarce. According to the available data, it became clear by the fifth round (29-31 January 2013) that negotiations on the main chapters were already close to completion.<sup>15</sup> During the sixth round (19-21 March) the parties made major progress in provisionally closing a number of chapters such as Sanitary and Phytosanitary Measures, Intellectual Property Rights and Trade Related Energy. At that stage talks could be also considered as completed on areas such as Technical Barriers to Trade, Sustainable Development, Customs and Trade Facilitation and a schedule for the elimination of import duties for goods where an agreement in principle had been reached. The main areas which remained under discussion after the sixth round were Services (covering establishment, cross-border provision of services and movement of natural persons for business purposes) and Dispute Settlement.<sup>16</sup> The completion of DCFTA negotiations indicates that the parties successfully agreed on these issues.

## **DCFTA: Main Expectations and Problems**

Despite the fact that DCFTA negotiations between the EU and Georgia have successfully been completed, the question of the potential benefits that the Deep and Comprehensive Free Trade Area with the EU may bring to Georgia's economy is still relevant.

The main objective of the DCFTA is to strengthen Georgia's export performance and facilitate its deeper integration with the EU economy of 500 million consumers. With this aim, the parties

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<sup>14</sup> European Commission. *EU launches trade negotiations with Georgia and Moldova*. Press release. 5 December 2011. [http://europa.eu/rapid/press-release\\_IP-11-1504\\_en.htm](http://europa.eu/rapid/press-release_IP-11-1504_en.htm)

<sup>15</sup> EU-Georgia Trade Insight. Issue 2. February 2013. [http://ec.europa.eu/delegations/georgia/documents/newsletters/20130222\\_trade2\\_en.pdf](http://ec.europa.eu/delegations/georgia/documents/newsletters/20130222_trade2_en.pdf)

<sup>16</sup> EU-Georgia Trade Insight. Issue 3. June 2013. [http://ec.europa.eu/delegations/georgia/documents/newsletters/20130619\\_trade3\\_en.pdf](http://ec.europa.eu/delegations/georgia/documents/newsletters/20130619_trade3_en.pdf)

agreed on a further and quite ambitious liberalization of tariffs.<sup>17</sup> It should be noted that Georgia unilaterally liberalized 90% of import duties in 2006.\* The previous year, Georgia received GSP+ from the EU covering 7200 kinds of goods with additional benefits for good governance. The DCFTA replaces the GSP and tariffs will be abolished for almost all products.

However, the liberalization of tariffs cannot remove non-tariff barriers to Georgia's trade with the EU such as, for example, the issues of quality standards or weak competitiveness. That is why the DCFTA is intended to correct this deficiency through institutional reforms. In order to modernize its export capacity in agricultural and industrial goods Georgia committed to bring its legislation closer to that of the EU. Approximations with the EU acquis would significantly improve competitiveness of Georgia's products; in particular:

- convergence of legislation in the area of free movement of goods and technical regulations will increase the access of Georgian manufactured goods to the EU markets. At the same time it will ensure domestic safety and consumer protection.
- introduction of food safety standards compatible with those of the EU would facilitate the growth of Georgia's agrarian exports to the EU countries and the countries which also use the same standards (for example, Turkey<sup>18</sup>). Simultaneously, new SPS standards will secure the Georgian market from cheap but low-quality goods from third countries.
- compliance with the EU trade related regulatory standards will bring regulatory disciplines that aim to ensure a stable policy framework including competition and transparency provisions as well as intellectual property rights.

Thus, the DCFTA will lead to the reduction of barriers to trade

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<sup>17</sup> European Commission. *EU-Georgia Deep and Comprehensive Free Trade Area*. Memo. Brussels. 22 July 2013.

\* Until 2011, tariffs were abolished for 90% of imported product types. After the increase of tariff rates on several types of industrial products, tariffs are zero rated on 84% of imported product types.

<sup>18</sup> ECORYS/CASE. *Trade Sustainability Impact Assessment in support of negotiations of a DCFTA between the EU and Georgia and the Republic of Moldova*. Final Report. Final version. Rotterdam. 27 October 2012, p. 38. [http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc\\_150105.pdf](http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150105.pdf)

and enhanced access to the EU market. According to the DCFTA latest Trade Sustainability Impact Assessment (TSIA) the reduction of SPS and TBT types of Non Tariff Barriers (NTB) will bring Georgia an additional EUR 88 million and 257 million over the short and long runs, respectively.<sup>19</sup>

In addition, the DCFTA envisages an ambitious liberalization of services. Georgia has already had a very liberal set of commitments for services in the WTO GATS which is further extended under the DCFTA. The EU, in turn, also provides for a broad set of commitments that go significantly beyond its GATS schedule. In addition, the mutual offers cover establishment provisions more widely, beyond the WTO GATS schedules.<sup>20</sup>

The stable and growth-oriented policy framework initiated and strengthened by the DCFTA will promote the rebranding of Georgia as a new investment destination.<sup>21</sup> Some modeling simulations made in 2008 suggest that the FDI stock in Georgia could increase up to five-fold until 2020 although this has been considered as a rather optimistic figure since it assumes that Georgia succeeds in its transition reforms.<sup>22</sup>

A harmonization of national legislation and the restructuring of institutions in accordance with EU standards within the DCFTA framework could significantly enhance Georgia's investment attractiveness. Business-to-business contacts and FDIs will be facilitated by the commitment of both parties to allow setting up a business in Georgia or in the EU on equal terms in a wide variety of economic sectors. These commitments are supported by so-called 'mode 4 provisions' which include mobility of natural persons for business purposes within clearly defined and limited timeframes covering *inter alia* categories such as intra-corporate transferees or independent professionals.<sup>23</sup>

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<sup>19</sup> *Ibid.*

<sup>20</sup> European Commission. *EU-Georgia Deep and Comprehensive Free Trade Area*. Memo. Brussels. 22 July 2013. [http://europa.eu/rapid/press-release\\_IP-13-721\\_en.htm](http://europa.eu/rapid/press-release_IP-13-721_en.htm)

<sup>21</sup> CASE/Global Insight. *Economic Feasibility, General Economic Impact and Implications of a Free Trade Agreement between the European Union and Georgia*. Final Report. 8 May 2008, pp. 109-110. [http://trade.ec.europa.eu/doclib/docs/2008/october/tradoc\\_141169.pdf](http://trade.ec.europa.eu/doclib/docs/2008/october/tradoc_141169.pdf)

<sup>22</sup> *Ibid.*, p. 183.

<sup>23</sup> European Commission. *EU-Georgia Deep and Comprehensive Free Trade Area*. Memo. Brussels. 22 July 2013. [http://europa.eu/rapid/press-release\\_IP-13-721\\_en.htm](http://europa.eu/rapid/press-release_IP-13-721_en.htm)

Regulatory convergence with the EU facilitated by the DCFTA would increase the regulatory burden on domestic producers. Some analysts predict that the introduction of TBT standards similar to the EU amounts "to a tax on Georgian industrial production" which would "distort Georgia's process of industrialization." Adoption of SPS measures "would trigger an average price increase of 90% for the key food products purchased by the one-third of the Georgian population who lives in poverty."<sup>24</sup> Approximating with the EU *acquis* would require some short-term costs but bring long-term benefits in terms of increased competitiveness on both domestic and foreign markets and improved foreign and local investment opportunities. Additionally, regulatory convergence with the EU is a gradual process which takes into account the interests of local stakeholders. The DCFTA envisages the inclusive policy-making process focusing more systematically on the needs of consumers and ensuring stakeholder participation in law-making.<sup>25</sup>

## DCFTA: Short and Long-Term Prospects

The latest Trade Sustainability Impact Assessment (TSIA) ordered by the EC DG Trade confirms that the macroeconomic consequences of the DCFTA for Georgia will be sufficiently positive. The DCFTA would have a significant impact on the country's economy in the long run when dynamic investment effects kick in:<sup>\*</sup> Georgia would get 2.5 times more increase in national income in the longer run than in the short run which means that GDP growth in the long run will be more than twice as much as compared to the short term and reach 4.3% (*see Table 4*).

<sup>24</sup> Patrick Messerlin, Michael Emerson, Gia Jandieri and Alexandre Le Vernoy. "An Appraisal of the EU's Trade Policy towards its Eastern Neighbours: The Case of Georgia." Groupe D'Économie Mondiale Sciences Po, Paris; Centre for European Policy Studies, Brussels. 2011. <http://www.ceps.be/ceps/dld/4252/pdf>

<sup>25</sup> European Commission. *EU-Georgia Deep and Comprehensive Free Trade Area*. Memo. Brussels. 22 July 2013.

<sup>\*</sup> The short and long run in the TSIA does not refer to a specific time period but to the time it takes for economic effects to adjust. The long run effect is generally expected to take place over a period beyond five to ten years from the moment of implementation of the DCFTA. (*See: Trade Sustainability Impact Assessment in Support of Negotiations of a DCFTA between the EU and Georgia and the Republic of Moldova. Final Report*. Final version. ECORYS/CASE. Rotterdam, 27 October 2012, p. 26.)

The increase of Georgia's national income under the DCFTA will be due mainly to the lowering of non-tariff measures which will have a three-times-greater national income effect in the long run than in the short run. The second most important contributor to the national income growth will be the liberalization of services which will have a slightly lesser effect in the long run than in the short run. As for tariff reduction, the short run effect of this factor in terms of national income increase will be negative although sufficiently positive in the long run.<sup>26</sup>

Table 4.

DCFTA: Macroeconomic Results (CGE modeling calculation, % change)

	Short run		Long run	
	EU	Georgia	EU	Georgia
National Income, mln €	79.1	114.4	- 47.0	291.9
GDP	0.0	1.7	0.0	4.3
Consumer prices	0.0	-1.0	0.0	-0.6
Wages, less skilled	0.0	1.5	0.0	3.6
Wages, more skilled	0.0	1.5	0.0	3.6
Total imports	0.0	4.4	0.0	7.5
Total exports	0.0	8.9	0.0	12.4

Source: ECORYS/CASE. Trade Sustainability Impact Assessment. 2012.

Modeling calculations show that consumer prices are expected to decrease slightly in both the short and long runs after the entry into force of the DCFTA although foodstuffs could rise in price. Rising prices of most food products leads to welfare deterioration for households from the lowest quintile although this is partly compensated for by a reduction of non-food prices. The above-mentioned negative price effects will be offset by income growth as a result of relative wage changes in the economy.<sup>27</sup>

<sup>26</sup> ECORYS/CASE. *Trade Sustainability Impact Assessment in support of negotiations of a DCF-TA between the EU and Georgia and the Republic of Moldova*. Final Report. Final version. Rotterdam. 27 October 2012, p. 38. [http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc\\_150105.pdf](http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150105.pdf)

<sup>27</sup> *Ibid.*, p. 48.

According to the TSIA, the DCFTA will have significant positive impact on Georgia's external trade: total exports including goods and services would be enhanced twice as fast as total imports in the short run and 1.7 times faster in the longer run (see table 4). This means that the DCFTA is expected to somewhat improve the trade balance for Georgia although given that imports currently much exceed exports, the trade deficit may still increase.<sup>28</sup>

Judging by the results of the TSIA, the implementation of the DCFTA with the EU might result in the increase of total Georgian exports by 9% in the short run and 12.4% in the long run which would presumably be achieved due to the removal of non-tariff barriers and increased FDIs to the export sectors. It is noteworthy that as a result of the DCFTA, Georgia's exports specifically to the EU will grow at a much higher rate – by 43% in the longer run than the total export of Georgia.<sup>29</sup>

Among the traditional export categories, the modeling calculation revealed the high growth potential in the sector of chemicals, rubber and plastics which includes nitrogen fertilizer as one of the leading Georgian export goods. The exports in this commodity group might increase by almost 65% in the long run (see table 5) which is unlikely to happen due to the increase in fertilizer exports alone. The growth of pharmaceuticals (which is included in the same sector) exports may also contribute to the forecast increase. It is not surprising that the TSIA also predicts a significant increase in the output in this commodity group.

The model simulation showed a sufficient prospect of export growth – 22% in the commodity group of vegetables, fruits, nuts and oilseeds. It seems that the export potential of fruits and vegetables will be considerable after the removal of non-tariff barriers whereas the overcoming of these barriers will have little effect on the volume of the exports of hazelnuts which have special (rather easy to comply with) arrangements for the SPS conformity certificate. It should be noted that high rates of growth of output are not expected in this sector. As for the other leading commodity groups of Georgian exports, the DCFTA would have a relatively

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<sup>28</sup> *Ibid.*, p. 37.

<sup>29</sup> *Ibid.*, p. 41.

little effect on the dynamics of their exports according to the TSIA; for example, the export of primary metals will be increased by 8.5%, motor vehicles – 8.3% and beverages and tobacco – 2.5%.

On the other hand, the latest modeling calculations have shown good prospects for increasing exports of other commodities that do not currently belong to Georgia's main export categories. Among them, it is necessary to emphasize livestock and meat products whose exports may increase by 170%. Such an impressive result can be attributed to the base effect – the export volume of these types of goods to date is relatively small and the elimination of SPS NTBs presumably will have a positive impact on it. At the same time, the TSIA predicts a significant reduction in the output of this sector presumably due to the removal of Georgian tariffs on imports from the EU under the DCFTA.

Table 5.  
DCFTA: Georgia's Sector-Specific Changes in Trade (Goods)  
(CGE modeling calculation, % change)

	Output long run	Exports long run	Imports long run
Vegetables, fruits, nuts	3.4	21.9	19.1
Livestock and meat products	-14.8	169.9	17.8
Chemicals, rubber, plastics	62.2	64.5	-2.7
Other machinery and equipment	23.7	48.1	4.1
Petrochemicals	-1.0	16.5	1.8
Electronics, computers	-9.3	16.3	8.8
Other processed foods	-8.8	14.5	13.0
Other manufacturing	-24.0	13.8	14.3
Primary metals	7.9	8.5	4.9
Motor vehicles	-3.5	8.3	5.9
Fabricated metals	-3.2	6.6	6.1
Animal products	3.1	5.7	19.8
Other crops	-2.0	3.0	15.1
Beverages and tobacco	-4.0	2.5	22.5

Source: ECORYS/CASE. Trade Sustainability Impact Assessment. 2012.

Another sector, whose total export is expected to significantly increase according to the TSIA, is other machinery and equipment – by 48%. Reductions in TBT NTBs can be considered as a main driver for export promotion of this product.

Overcoming of non-tariff barriers based on the DCFTA will also facilitate relatively modest growth of export in the sectors of petrochemicals (by 16.5%), electronics and computers (by 16.3%) and other processed foods (14.5%).<sup>30</sup>

The TSIA confirmed, therefore, that the DCFTA may have a sufficiently positive influence not only on the dynamics of the Georgian exports of goods but also on its diversification.

As for the structure of Georgia's exports specifically to the EU, the largest expected trade impacts of the DCFTA for Georgia according to the modeling calculations are found in primary metals (26.2% of the total increase in the value of EU imports from Georgia) followed by chemicals, rubber and plastics (25.7%) and other machinery and equipment (almost 20%).<sup>31</sup> From these data we can say that metals will continue to play an important role in the structure of Georgian exports to the EU after the entry into force of the DCFTA.

Modeling calculations have shown that the DCFTA will cause a relatively small increase in total imports to Georgia – 4.4% in the short run and 7.5% in the longer run (see table 4) although Georgia's imports from the EU are expected to increase much more than total imports to Georgia – by 23% (from EUR 1.7 billion to EUR 2.05 billion).<sup>32</sup>

It is noteworthy that according to the TSIA, none of the major categories of Georgian imports of goods has experienced a significant impact as a result of the DCFTA; for example, the import of petrochemicals in the long run will be increased only by 2%, motor vehicles – by 6%, primary metals – by 5% and chemicals, rubber and plastics which includes pharmaceuticals – will even decline by about 3% (see table 5). On the other hand, the import of goods which actually do not play a key role in the total Georgian imports

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<sup>30</sup> *Ibid.*

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*, p. 40.

will be significantly increased; for example, dairy products – by 27%,<sup>33</sup> beverages and tobacco – by 22%, animal products – by 20% and vegetables, fruits and nuts – by 19% (*see table 5*). Presumably, removal of non-tariff barriers and large-scale liberalization of tariffs will facilitate the increase in imports of agricultural and food processing products to Georgia.

It should be noted that the results of the modeling calculations do not suggest any significant impact of the DCFTA on the import of capital goods: the growth in other machinery and equipment may comprise 4%. This conclusion does not correspond to the expectations of the strengthening of FDI inflow under the DCFTA.

As for the structure of Georgia's imports specifically from the EU, livestock and meat products count for 16% of the total increase in Georgian import value according to the TSIA followed by other machinery and equipment (12%), beverages and tobacco (7%) and motor vehicles (7%).<sup>34</sup>

Table 6.  
DCFTA: Georgia's Sector-Specific Changes in Trade (Services)  
(CGE modeling calculation, % change)

	Output long run	Exports long run	Imports long run
Air transport	-4.4	21.0	7.9
Business and ICT	0.4	12.0	4.2
Trade	3.1	8.2	14.0
Construction	4.5	7.7	6.6
Communications	3.6	4.8	5.4
Water transport	4.1	2.9	2.5
Public and other services	1.7	1.8	20.6

Source: ECORYS/CASE. Trade Sustainability Impact Assessment. 2012.

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*, p. 42

Modeling calculations show that export of services will also be increased after the entry into force of the DCFTA but not in such a scale as in the case of the export of goods (see table 6). The export of air transport would grow at the highest rate (21%) in the services sector followed by business services (12%), trade (8%) and construction (almost 8%). Exports of other types of transport and communications will grow at rather modest rates. As for the hotel and restaurant services related to the tourism industry, the DCFTA would not sufficiently impact their export according to modeling calculations.

Concerning the import of services to Georgia, the DCFTA will have the greatest impact on public and other services whose import will increase by nearly 21% followed by trade (14%) and air transport (8%). The scale of influence of the DCFTA on the imports of the other services is much less.

It is noteworthy that different types of services would play a noticeable role in Georgia's import from the EU according to the modeling calculations: other transport in the overall growth of import may amount to almost 8%, air transport – 4%, business and ICT – 4.1%, financial services – nearly 4% and public services – more than 3%.<sup>35</sup>

### **DCFTA: How the EU Could Do a Better Job within the EaP Framework**

The European Union and Georgia successfully concluded talks on the DCFTA as part of the Association Agreement between them. The parties have substantively completed the negotiations on the AA as well. The main task of the sides at this stage is to initial the Association Agreement with the DCFTA during the next Eastern Partnership Summit in Vilnius. This is not an easy task given the fact that only three months remain until the Summit takes place. Despite this, the parties, mainly the EU, have to mobilize all administrative resources to finalize necessary procedures.

The next task of the parties is to facilitate the entry into force and implementation of the AA including the Deep and Compre-

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<sup>35</sup> *Ibid.*

hensive Free Trade Area. The framework of the Eastern Partnership can play an important role in the achievement of this goal.

After the completion of the negotiations on the Association Agreement with the DCFTA the parties must agree on the Association Agenda which becomes the main basis of the bilateral cooperation under the EaP. The Association Agenda between the EU and Georgia should provide the format which will allow the sides to identify bottlenecks in achieving their shared goals and give the opportunity for these to be effectively addressed.

The Association Agenda should identify a limited number of priorities accompanied by measurable benchmarks which require urgent actions. It is crucial to provide a consistency of the Association Agenda with the Eastern Partnership roadmaps with clear descriptions of short-term priorities against which progress can be assessed. Priorities associated with the implementation of the DCFTA should be adequately reflected in this document.

A prior consultation on the Association Agenda between the EU and Georgia took place in January 2013 but concrete steps have not followed. The work on the document has to be completed in July of this year but by the end of August the draft Association Agenda had still not been received by the Georgian side. Based on the fact that the negotiations on the Association Agreement with the DCFTA have been completed, the development of this document is imperative. Thus, the relevant services of the EC should take urgent steps to convey the draft Agenda to the Georgian side and finalize the consultations within a timely manner.

The EU could support Georgia in the realization of the objectives and priorities set out in the Association Agenda by means of the bilateral format of the EaP. The following objectives could be defined in this dimension:

- Rapid fulfillment of legal procedures necessary for entry into force of the Association Agreement with the DCFTA.
- Intensive dialogue on the reform agenda related to the DCFTA between Georgia and the EU (within cooperation institutions established by the agreement).
- Careful assessment of the process of regulatory convergence undertaken by Georgia in accordance to DCFTA provisions taking

into account local context.

- Exchange of technical expertise and advice, best practices and know-how.
- Establishing sectoral dialogues where necessary.
- Strengthening the administrative capacity of Georgia's civil service via the increased effectiveness of the Comprehensive Institution Building (CIB) program.
- Intensifying communication with Georgia's civil society and interest groups with the aim to strengthen their engagement in the regulatory reforms targeted at approximation to EU standards.

The instruments of the multilateral format of the Eastern Partnership could also be helpful in the implementation of the Association Agenda related to the DCFTA. The following goals could be set in this dimension:

- Strengthening the role of the EaP thematic platform II – Economic integration and convergence with EU policies in exchange of experience on EaP reforms undertaken in the framework of the DCFTA.
- Facilitating the cooperation between Georgia's and other partners' regulatory and enforcement authorities.
- Organization of thematic workshops to assist Georgia and other partners in their efforts concerning trade and trade-related approximation and administrative capacity development.
- Supporting the partners, including Georgia, in the creation of a network of bilateral Deep and Comprehensive Free Trade Areas (DCFTA) among the partner countries.
- Supporting Georgian NGOs to monitor the implementation of commitments related to the DCFTA and the National Platforms of the Eastern Partnership Civil Society Forum in this direction.

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## AZERBAIJAN'S EXPERIENCES ON DEVELOPING TRADE AND TRADE POLICY RELATIONS WITH THE EUROPEAN UNION

*Vugar Bayramov*

The overall goal of this paper is to understand how Azerbaijan can converge its Trade and Customs Policy with the European Union to meet the economic integration goals set in the EU Eastern Partnership Initiative in Azerbaijan. More specifically, the paper is interested in harmonizing standardization, technical barriers to trade, and customs legislation with the European Union. This goal is met by developing the following issues:

- policy landscape map in standardization, TBT and customs in EU and Azerbaijan,
- analysis of facilitation of and assistance in the accession of Azerbaijan to the World Trade Organisation (WTO), and promotion of overall European integration in the context of the subject areas,
- policy gap analysis and regulatory needs assessment for sector policy convergences in the above listed areas,
- relevant policy recommendations.

It is found that current Customs and Standardization Codes are not in line with EU standards. With foreign assistance from the UNDP and co-financing by the European Commission, Azerbaijan has developed a modern draft Customs legislation that meets EU and international standards. However, it has not been adopted by the Parliament and needs executive approval. As far as standardization, Azerbaijan is currently in negotiations to accede to the

World Trade Organization. This is necessary for complying with the TBT Agreement, which ensures that standards do not create unnecessary obstacles to trade.

Therefore, it is recommended that Azerbaijan diligently and efficiently continue the WTO negotiations process, as accession would serve as a great leap in encouraging European integration and future further access to the EU Single Market. Apart from the direct impact on EaP priority areas listed above, these reforms are also expected to provide an easier and more effective framework for facilitating the movement of goods, services, information and people, and will therefore demonstrate positive side effects in promotion of other components of EU strategy in the region, and in socio-economic integration and development of the neighbouring countries. Timely intervention with clear policy and advocacy goals is therefore highly efficient and politically important for regional countries, including Azerbaijan, and for promotion of EaP and overall EU principles and priorities.

## **Introduction**

The EU single market with about 500 million consumers is the largest in the industrialised world, making it specifically attractive for neighbouring countries to harmonise their laws and regulations for better trade relations and economic integration. There is a huge economic, social and geopolitical reason and interest on governmental and societal levels in Azerbaijan towards effective European integration. Moreover, the EU expressed its interest in sectoral convergences with EU policies and policy reforms in Azerbaijan via the Partnership and Cooperation Agreement (PCA) between EU and Azerbaijan, and European Neighbourhood Policy (ENP). The EU's recent widening towards South-East provided the EU with growing responsibility to help the neighbouring countries address the socio-economic challenges, and with closer political ties and energy security strategies with more involvement of the neighbouring countries.

The Eastern Partnership (EaP) endorsed by the European Council in May 2009 aims at the development of a specific Eastern di-

mension of ENP. EaP emphasizes several priority areas and growing cooperation, including a border management program, the Southern corridor, integration of economies, improved mobility and contacts among people and businesses. All these make convergence of policies of EaP countries in the field of *trade and cross-border cooperation* with respective policies of EU very important to facilitate the implementation of EaP priorities and overall EU policy and goals in Azerbaijan and the region.

The Centre for Economic and Social Development (CESD), therefore leads the initiative along with two foreign and seven local partner organizations to conduct research, advocacy and capacity-building on policy convergence in the above identified priority sector in Azerbaijan. CESD has deployed its full administrative capacity to carry activities in the above areas and has involved two (local and international) experts. The international expert has conducted capacity building among local counterparts, whereas the CESD local expert has developed this paper. The paper aims at convergence of Azeri policies in trade and cross-border cooperation with respective EU policies and consequently addresses two areas: 1) (removing, lessening and smoothing the) technical barriers to trade (TBT), and 2) customs. The work on TBT in this paper is based on technical rules and standards in trade, whereas the work in the second area is based on analyzing the Azeri and EU laws in customs.

CESD has been set up to promote research and analysis into domestic economic and social issues for the purpose to positively influence public policy decision-making processes. The Centre is a leading Azerbaijani think-tank specialized in economic and social policy issues working with and establishing a bridge between the government and the various representatives of civil society. While collaborating with other think-tanks, CESD has principal and conceptual differences in its main focus area and functions, and this is reflected in its mission, strategy, and daily activities. As a leading economic think-tank, CESD is trying to promote good governance in Azerbaijan. The Centre has extensive expertise in EU sectoral projects, capacity building, legal and policy harmonization. CESD has also extensively worked on policy development in trade and cross-border communication with international donors in

Azerbaijan, as well as with neighbouring countries as strategic partners (Kazakhstan, Georgia, etc.). CESD, therefore, on the one hand produces studies focused on enhancing civic participation, an important engine for rule of law and government accountability, building the “bridge” between the two important actors – the government and the civil society – and on the other hand, provides necessary advocacy along with other stakeholders to strengthen these activities. The Centre has extensive relationships with civil society members in Azerbaijan, including NGOs dealing in legal, economic and social reforms, and media (CESD experts are daily invited to interviews).

The paper analyses and proposes necessary modifications in TBT and customs law in Azerbaijan. Apart from the direct impact on EaP priority areas listed above, these reforms are also expected to provide an easier and more effective framework for facilitating the movement of goods, services, information and people, and will therefore demonstrate positive side effects in promotion of other components of EU strategy in the region, and in socio-economic integration and development of the neighbouring countries. Timely intervention with clear policy and advocacy goals is therefore highly efficient and politically important for regional countries, including Azerbaijan, and for promotion of EaP and overall EU principles and priorities.

## **Goals and Objectives**

The paper is developed within and is part of the CESD project of ‘Sector Policy Convergences in Trade and Cross-Border Cooperation in Azerbaijan – to support EU Eastern Partnership Initiative’ and aims to complement the project and provide analysis and promote reforms in the priority areas. The project seeks the policy analysis and advocacy towards the EaP principles and priorities of better economic integration with the EU and increased mobility and contacts between people and the identified priority areas technical barriers to trade (TBT) and customs.

The overall project is implemented within the context of the broad objective of promoting EU values, Azerbaijan’s socio-eco-

conomic integration with EU, and the economic, political and social development of Azerbaijan in line with the priorities set out in the EU Eastern Partnership initiative (EaP). Specifically, the project seeks to provide (1) policy analysis, (2) advocacy and (3) capacity building in Azerbaijan towards EaP principles and priorities of better economic integration with the EU and increased mobility and contacts between people through sectoral policy convergence with the EU in trade and cross-border cooperation. This paper fulfils the first objective (policy analysis) of the project and also serves as a tool for the second and third objectives (advocacy and capacity building).

Specifically the paper seeks the development of:

- policy landscape map in TBT and customs in Azerbaijan
- analysis of facilitation of and assistance in the accession of Azerbaijan to the World Trade Organisation (WTO), and promotion of overall European integration in the context of the subject areas,
- policy gap analysis and regulatory needs assessment for sector policy convergences in the above areas,
- relevant policy recommendations,
- strategy including the role of state and civil society actors for promoting EU values and awareness and EaP priorities and principles in above areas to develop rapport between EU and Azerbaijan.

There is a big gap in the policy analysis as well as awareness and effective involvement in the areas of TBT and customs in Azerbaijan to effectively facilitate the sector policy convergence and European integration. Timely intervention with clear policy and advocacy goals is therefore highly efficient and politically important for the promotion of EaP and overall EU principles and priorities. The policy convergences in these areas will have direct impact on each EaP priority listed above; in addition, some positive indirect and side effects are expected in other EaP priorities and overall EU policy and goals in the region and Azerbaijan. Moreover, these are the areas that have the most importance and demonstrate bottlenecks to be addressed towards EU-Azerbaijan cooperation first, as identified in the sector assessment in the next sections.

## Research Methodology

There exists a big gap in the research in the areas of TBT and customs in Azerbaijan to effectively facilitate sector policy convergence and European integration. The research, with the main focus on this, starts with the meetings and discussions with relevant stakeholders to identify possible and desired areas of cooperation in TBT and customs, and to assess and incorporate the efforts made by both parties in this area. These initial activities are followed by the study and comparison of existing legislation and policies in the EU and Azerbaijan to identify possible and desired areas of policy convergence to develop regulatory needs analysis. These will comprise the preliminary background to develop policy in each area that also includes the sector diagnostic work with concentration on needs (staff, training and regulatory) analyses towards the objectives outlined in the earlier section.

Then, further analyses are conducted to explore the convergence possibilities and expected outcomes. Recommendations on sector policy convergence are developed to be communicated with the consideration of socio-economic development goals, EU strategic interests, and analysis of possible impacts on the economy (including ongoing activities and strategy) and other areas important to develop regulatory impact analyses. The outline of the selected priority sectors (TBT and customs) also maps the policy landscape identifying the gaps for convergences and harmonization, and contains information on existing legislations and policies to be adopted or amended. Any convergence of sector policies with EC technical rules is carried with the consideration of national and sector strategies elaborated by the Azeri government. In particular, the emphasis is placed on the adaptation with the directives that are the most likely to facilitate trade between the EU and Azerbaijan.

Finally, though the research is conducted solely by the CESD expert, the overall project involves and uses the experience of 2 foreign partners (one from an EU member state and another from an EaP country) in addition to 7 associate partners from Azerbaijan. The foreign partners have broad experience in EU funded policy analyses and structural reforms in the region. Both organizations have conducted EU sectoral programs in the region and are

familiar with the situation in Azerbaijan, and have wide experience in priority sectors addressed in this paper and therefore, their contribution – including the lessons learned – has been very valuable for the successful implementation of the project.

## **Policy Landscape In Priority Areas**

The analysis below indicates that the priority areas of TBT and customs in this paper have a larger importance and demonstrate bottlenecks to be addressed towards EU-Azerbaijan cooperation first, and EaP policy convergences in these areas will also have indirect impact on every EaP priority, including border management programme, the Southern corridor, integration of economies, improved mobility and contacts among people and business.

Below is the analysis of TBT and customs, including the mapping of the policy landscape and analysis of facilitation of and assistance in the accession of Azerbaijan to WTO, and promotion of overall European integration in the context of the subject areas.

### **EU Customs Policy**

For EU businesses, the starting point is the bilateral EU-Azerbaijan relationship and the Partnership and Cooperation Agreement (PCA), especially its trade and investment provisions. As the PCA's trade and investment provisions are largely based on WTO principles, Azerbaijan's accession will reinforce at an international level those principles and protections existing at bilateral level and establishing this added degree of legal certainty is absolutely key to ensure greater trade and investment by EU businesses to the benefit of Azerbaijan's economy beyond just the energy sector.

The added transparency imposed by the WTO is a prerequisite for trade and investment in the majority of the areas of greatest interest to EU businesses, besides oil and gas and hydrocarbon transit:

- financial services,
- consumer goods,
- agriculture and food,
- information technology,
- telecommunications,
- state procurement.

WTO accession commitments in these areas are guarantees for EU businesses that, regardless of the levels of practical implementation, Azerbaijan is bound and potentially subject to that discipline. The Customs law is an essential element of the EU single market and has huge implications for its four basic freedoms (free circulation of goods, persons, services and capital). With no internal economic frontiers it is the catalyst for the economic integration of the European Union. Thus the effects of the Community's Customs Union (CU) are far reaching. To set up, develop and run a single common market, wherein goods circulate freely, can only be achieved within the framework of a CU where common rules are applied at external borders. CU is a secure basis for highly developed integration.

Without the Community's CU, the EU common commercial and development policy, its common agricultural market and an effective coordination of economic and monetary policies would not be possible.

The basic principles of CU are:

- to establish universally accepted rules and principles that have proved their efficiency,
- to abolish gradually the customs duties that applied in trade between the original six member states and to introduce a Common Customs Tariff (CCT) applicable to goods imported from third countries. On 1st July 1968, the tariff union was accomplished. Since then any new Member State joining the Community has undergone the process of abolishing duties on intra-Community trade and aligning its external tariff to the CCT,
- a growing harmonisation and further simplification of customs procedures resulting from the necessity to facilitate trade, e.g. the Single administrative document and the Combined nomen-

clature were introduced. In parallel, the EEC-EFTA Convention on a Common transit procedure was signed on 20 May 1987, and

- the consolidation of virtually all the Community customs provisions into a single coherent text, the Community customs code and its implementing provisions, which entered into force on 1 January 1994.

CU was one of the EU's earliest milestones. It abolished customs duties at internal borders and put in place a uniform system for taxing imports into the EU from third countries. As a result, internal border controls subsequently disappeared and today customs officers are found only at the EU's external borders.

The main objectives of the Common Customs Policy of the EU are:

- to foster world trade,
- to promote fair trade relations; to increase the attractiveness of the EU as a location for industry and trade and contribute to the creation of new jobs,
- to promote development elsewhere,
- to assist the candidates for accession in their future role,
- to ensure protection for the Community's citizens and business in all areas involving imports or exports in a clear, uniform, simple way as efficiently as possible,
- to 'ring fence' the single market, securing the maximum benefit from it for everybody,
- to facilitate a practical system to collect revenues, customs duties, VAT and excise duties, and
- to collect essential statistics on trade.<sup>1</sup>

## **Azerbaijan's Customs Policy**

The State Customs Committee of Azerbaijan Republic (SCC), which is the main State authority in the field of customs, was established by the Nr. 561 Presidential Decree on 30 January 1992. SSC adopts decrees, regulations and instructions in the field of

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<sup>1</sup> Jafar Alakbarov, Ulviya Abdullayeva, and David Parsons, *Scoreboard Report On Customs Law*, [http://pca.az/uploads/Customs\\_final.doc](http://pca.az/uploads/Customs_final.doc) (accessed November 1, 2010).

customs legislation. Since 1995, these acts are regularly published in the Committee's official newspaper "Gömrük xəbərləri" (Customs news). The list of normative acts is presented in Annex 1.

According to the Statue of SSC approved by the Nr. 7 Decree of the President from 27 October 1998, the Committee is the central executive authority, which implements state customs policy and has the following functions:

- realisation of single customs policy,
- provision of unity of the customs territory,
- organisation and improvement of customs,
- securing economic interests and economic safety of Azerbaijan Republic,
- use of progressive methods of customs regulation,
- control after execution of which was obligated on it;
- securing compliance with customs and other legislation.

The Committee bears responsibility for:

- fighting customs crimes and preventing illegal trafficking of narcotic drugs, weapons, articles of artistic, and items of historical and archaeological importance,
- collecting taxes, customs duties, excise duties and other customs payments on goods transferring customs border,
- controlling the accuracy of defining customs value of goods,
- issuing licenses and keeping records,
- providing efficient use of equivalent customs procedures,
- keeping customs statistics on foreign trade and specific customs statistics,
- organizing forming goods nomenclature of foreign economic activity,
- establishing the system of information and consultation,
- creating conditions for realisation of rights to appeal to physical and legal persons,
- representing the interests of the State in international organizations and implementing international obligations.

Many aspects of organisation of customs activity are also reflected in the Law on approval of the Statue of "The service of the Customs Authorities" from 7 December 1999.<sup>2</sup>

The Government of Azerbaijan has taken the following legislative steps to promote foreign investment :

- Law on the Protection of Foreign Investments, 1992,
- Law on Foreign Investment Activity, 1992,
- Bilateral Investment Treaties,
- Azerbaijan Investment Company,
- Law on the Special Economic Regime for Export Oil and Gas Activity (2 February 2009)
- Law on Special Economic Zones (14 April 2009).

More recently, the GoA has made improvements with its Customs policy. As part of a \$1,694,320 reform project co-financed by the European Commission and implemented by the United Nations Development Programme in 2006-2007, steps were successfully made to prepare Azerbaijan Customs draft legislation in line with EU and international standards. Improvements were also made specifically in modernizing information technologies for customs processing.<sup>3</sup> Separately, Azerbaijan introduced the Single Window system in 2009. "In a theoretical sense, a Single Window can be described as a system that allows traders to lodge information with a single body to fulfill all import- or export-related regulatory requirements."<sup>4</sup> Therefore, the Single Window environment aims to accelerate and simplify the flow of information between traders and the government. This will help to increase the flow of trade by streamlining the process and decreasing the transit time of goods going across the borders.

## **EU Policy on Standardization and Technical Barriers to Trade**

Before the harmonization of technical rules or standards of trade in the EU, irregularities between national standards created Tech-

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<sup>2</sup> Ibid.

<sup>3</sup> United Nations Development Programme, "Azerbaijan: Modernization of Customs Services in Azerbaijan," Public administration reform and anti-corruption in Europe & CIS, <http://europeandcis.undp.org/governance/parac/show/80FB8FE5-F203-1EE9-B27BFEEA6C9CE783> (accessed November 1, 2010).

<sup>4</sup> United Nations. *The Single Window Concept*. Geneva, 2003. <http://unpan1.un.org/intradoc/groups/public/documents/UNECE/UNPAN019892.pdf> (accessed November 1, 2010).

nical Barriers to Trade (TBT) that negatively impacted the flow of goods between EU countries. Currently, the three main governing standards organizations in Europe include European Committee for Standardization (CEN), the European Committee for Electrotechnical Standardization (CENELEC), and the European Telecommunications Standards Institute (ETSI). These organizations play a central role in limiting TBT in the European Union and enhancing the ability of trade to flow freely throughout the region. CEN and CENELEC both have one voting member representing the national standards body of each of the 30 member countries, which include the 27 28 European Union member states, and the 3 countries of the European Free Trade Association. All ratified European standards are then voluntarily adopted as national standards in each country. Moreover, the European Council created the “New Approach” in 1985 that sets essential requirements that products must meet before they can be distributed on the European Market. As long as manufacturers provide a ‘technical file’, they can choose any technical way to meet these requirements. However, by far the easiest way is to follow the relevant ‘European Standard’, which will gain them access to the European Single Market.

A main TBT that presents problems for international trade is when a country changes technical regulations required for all products without giving manufacturers or governments of other countries time to review the changes. In addition to the 98/34 notification procedure that requires member states to go through a three-month examination period by other member states when adopting a new draft. The European Commission has also adopted the WTO TBT notification procedure. Both of these procedures limit barriers and enable competitive and open trade for the Internal European Market. More specifically, the TBT Agreement of the WTO requires all members “to notify their draft technical regulations and conformity assessment procedures and to respect the principles of non-discrimination between national and imported products, proportionality and equivalence.”<sup>5</sup> This procedure

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<sup>5</sup> European Commission. "Single market for goods Prevention of technical barriers to trade." Enterprise and Industry. [http://ec.europa.eu/enterprise/policies/single-market-goods/prevention-technical-barriers-trade/index\\_en.htm](http://ec.europa.eu/enterprise/policies/single-market-goods/prevention-technical-barriers-trade/index_en.htm) (accessed November 1, 2010).

gives WTO members and producers to have the chance to review all changes to product requirements. The access to open information allows manufacturers to make the necessary changes to their products in order to compete in the international market.

The current State Agency on Standardization, Metrology, and Patents of the Republic of Azerbaijan (AZSTAND) was established by Decree No. 623 on December 27, 2001 to become the main authority for creating and enforcing standardization policy in Azerbaijan. It is backed by the following 6 State standards of law "On Standardization": (AZS 1.0-96, AZS 1.2-96, AZS 1.3-96, AZS 1.4-96, AZS 1.5-96, AZS 1.6-96). AZSTAND is officially a member of the International Standards Organization.

These are the following duties of the Agency as stated on a state website<sup>6</sup>:

- to implement the state policy in the field of standardization, metrology, certification and protection of objects of the industrial property,
- to form the basic directions of a state policy, prepare and provide implementation of target programs, coordinate activities of other state bodies and institutions of local governing, economic subjects in the above-mentioned fields,
- for the purpose of observance of requirements of standardization and metrology, to take measures of the state control,
- to provide unity of the means of measurements,
- to organize works on protection of objects of the industrial property,
- in order to increase the competitiveness and quality of the goods (works, services) made in the territory of the Republic of Azerbaijan, to update normative documents in the field of standardization, metrology, certification and protection of objects of the industrial property, uniting in themselves modern scientific and technical potential and the advanced international practice, and take measures on providing their conformity to modern international practice,

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<sup>6</sup> Heydar Aliyev Foundation. State Committee On Standardization, Meteorology, and Patents of Azerbaijan (accessed November 1, 2010)

- in accordance with the procedure provided for in the legislation, to implement the state control over the conformity of imported (put into free circulation) and exported goods (works, services) to the requirements of standards, metrological rules and norms, rules of certification and protection of industrial property objects,
- to implement the necessary measures in the sphere of application of appropriate international standards in the Republic of Azerbaijan,
- to implement the other duties provided for in the legislation of the Republic of Azerbaijan.

Notably, Enquiry Point of the Republic of Azerbaijan was established in September 2010 under the State Agency on Standardization, Metrology and Patents of the Republic of Azerbaijan in accordance with the requirements of Agreement on Technical Barriers to Trade of World Trade Organization. The Azerbaijan Enquiry Point's duties were stated on the official website<sup>7</sup>. It aims to ensure the global trade without any barrier and there are some agreements of members that were taken into account. One of these duties is to prepare and implement the standard based activities that influence the trade. These activities are the agreements on Technical Barriers to Trade that contain WTO members' rights and responsibilities. TBT agreement requires every member country to establish the national Enquiry Point in order to remove the lack of information and to give information service to stakeholders.

The services that Enquiry Point delivers are followings:

- notifying WTO partners of Azerbaijan about new or modified technical regulation and conformity assessment procedures with the possible impact on trade and providing them with related documents,
- sending the comments received in connection with the local and foreign measures to the relevant regulating authority for consideration,

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<sup>7</sup> [http://www.azstand.gov.az/index.php?lang=3&id=17&sub\\_id=176](http://www.azstand.gov.az/index.php?lang=3&id=17&sub_id=176)

- obtaining strategic information about design, production, marketing, import and export of products and services,
- replying technical enquires about different issues including national, foreign and international standards, technical regulation and conformity assessment procedures of Azerbaijan and other foreign countries.

### **Azerbaijan WTO Accession Process**

Notably, Azerbaijan's WTO accession is EaP's goal . Thus EaP has set the goals for Azerbaijan in order to increase competitiveness, develop non-oil sector and enhance share of non-oil sector in GDP, develop business environment, be a member of WTO. These goals were set in order to support the economic, social and political reforms and to align them with the standards of the European Union and Council of Europe.

Eastern Partnership works in the framework of European Neighbour and Association Agreement (AA). There are four parts of AAs: 1) Political Dialogue and Foreign and Security Policy, 2) Justice, Freedom and Security, 3) Economic and sectoral cooperation, 4) Deep and Comprehensive Free Trade Agreements (DCFTA).

Every country negotiates the DCFTA separately. The DCFTA is an adaptation of the partner countries trade related legislation with the EU standards. As Azerbaijan is not a WTO member, she cannot negotiate over DCFTA with the EU. The government of Azerbaijan (GoA) officially applied to the WTO Secretariat to become a WTO member in 1997, thus resulting from the establishment of Azerbaijan's Working Party in the same year. A group by GoA had been established, with a view to tackle problems before the country gets into the accession period. GoA submitted a Memorandum on its Foreign Trade Regime on 22 April 1999. Later on, the Permanent Mission of the Republic of Azerbaijan had provided replies to additional questions submitted by Members on the Memorandum on the Foreign Trade Regime - Australia, Japan, the European Union states, and the United States.

Azerbaijan has reached agreement with Georgia and Moldova on bilateral negotiations meanwhile negotiating with other selected countries including US and EC continues. In order to continue

negotiations over fair trade principles in the wake of joining the WTO and to develop the documents to be submitted to the WTO by the coordination from related structures, as well as to provide a single economic policy in WTO negotiations, an appropriate Commission, consisting of high-rank government officials according to the 22 August 2003 order by the Cabinet of Ministers, had been established. To deal with these items, the Commission/Committee had designed nine Work Groups.

## Policy Convergence Discussion

Trade is an essential element of the EU single market with its four basic freedoms: circulation of goods, persons, services and capital. With no internal economic frontiers it is the catalyst of the EU economic integration.<sup>8</sup> Policy convergence of varying requirements for products of the different trading nations is considered as an essential task to reduce production costs and to increase transparency for traders. Therefore, the convergence of technical requirements for products to those provided by the EU-Acquis reduces barriers to trade and gives positive incentives to international trade. Transition to the market economy is characterised by competition necessarily implies the maintenance of coherent, efficient and transparent standardisation and certification rules in order to achieve high quality and safety of products as well as services.

TBT and cross-border cooperation (customs) are consequently important fields to analyse development of mutual relationships and convergence of policies in these areas directly serves the purpose of EaP, emphasizing increased mobility, better economic integration and contacts between people. These are also totally in line with the overall EU policy and goals in the region and Azerbaijan, including ENP and PCA with the latter establishing a framework for the development of closer cooperation between the parties in the areas of trade, investment, economics, legislation and culture. TBT and customs (cross-border cooperation) are there-

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<sup>8</sup> Jafar Alakbarov, Ulviya Abdullayeva, and David Parsons, *Scoreboard Report On Customs Law*, [http://pca.az/uploads/Customs\\_final.doc](http://pca.az/uploads/Customs_final.doc) (accessed November 1, 2010).

fore selected as priority sectors that explicitly reflect EaP priorities (such as economic integration) and implicitly serve to others (such as mobility and border management programme).

The implementation of such a system also ensures a higher level of legal certainty for all economic operators and thus contributes to further stimulate the modernisation of the economy. In a global economy and increase of world trade, technical rules and standards, which are necessary for safety reasons and consumer and environment protection, should not be applied as a tool to impede trade. In such a case, technical rules and standards would indeed become an instrument of protectionist policy, which is forbidden according to the principles of the GATT. The aim of the ISO is to harmonise the development of standards, the establishment of uniform testing methods, label requirements and terminology.

When Azerbaijan becomes a WTO member, it will also have to comply with the most favoured nations clause and, as far as technical regulations are concerned, to treat imported goods from CIS and from other parts of the world on an equal footing. Technical regulations should furthermore not be more restrictive than necessary in order to fulfil legitimate objectives such as the protection of human health and safety, life and health of animals and plants, and protection of the environment. Enhancing Azerbaijan's Accession is important because DCFTA and Association Agreement will be offered only once these countries have joined the WTO. Since Deep and Comprehensive Free Trade Area (DCFTA) and Association Agreement will cover substantially all trade, including energy, and aim at the highest possible degree of liberalisation (with the asymmetry in the pace of liberalisation appropriate to the partners' economies, WTO Accession is becoming one of priorities in Azerbaijan.<sup>9</sup>

A quick look at the Azerbaijan's standardisation and conformity assessment procedures system reveals that relevant laws, decrees and resolutions include in some cases characteristics that are not compliant with international and European rules in the area. Convergences as close as possible to relevant EU sectoral policy rules is the best way of ensuring that Azeri policies and system comply

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<sup>9</sup> Ibid.

with the WTO Agreement on Technical Barriers to Trade , while providing the most favourable conditions in order to foster trade between Azerbaijan and the EU. Policy convergences are to be made in the more general context of legislative adaptations currently taking place in other CIS countries in respect of technical barriers to trade and standardisation.

In recent years, some of these countries, such as, for instance Moldova, Georgia and Kyrgyzstan, have joined the WTO and are in the process of reforming their standardisation and certification systems in order to comply with the requirements of the TBT Agreement. Similar reforms are underway in Russia, Ukraine, Kazakhstan, the countries struggling to accede to the WTO. As a consequence, the majority of CIS Member States is moving from the former soviet standardisation system based on the GOST standards towards a legal framework consistent with WTO principles. Since Azerbaijan has had trade relationships with all these countries, the adaptation of its rules, structures and procedures therefore also helps to ensure that its trade patterns within the CIS will not be impeded in the future due to diverging technical rules.

As mentioned in the Concept Note for the EaP, there are priorities under both the EaP and Partnership and Cooperation Agreement (PCA) and the ENP Action Plan, which need special attention in the 2011-2013 programming period to support the efforts of Azerbaijan to accede to WTO. The Eastern Partnership offers a long term prospect of Association Agreement including a DCF-TA and further integration into EU economy and a stronger focus on regional and cohesion policy. The document mentioned that EaP will facilitate trade between Azerbaijan and the EU, to assist Azerbaijan in its preparations for the WTO accession as well as to support Azerbaijan's gradual alignment with the EU's internal market as a result of increased regulatory convergence with the EU.

Azeri government has signed the Partnership and Cooperation Agreement with EU, and is included in EU European Neighbourhood Policy (ENP) and Eastern Partnership programs. PCA establishes a framework for the development of closer cooperation between the parties in the areas of trade, investment, economics, legislation and culture; all with big implications for TBT and cross-

border cooperation. These provide high opportunities for integration into European market, and require WTO accession discussed below. The EU programs could bring substantial efficiency and welfare gains to neighbouring countries, via liberalized access to the EU's single market. Legal changes in the areas of customs and financial services should promote trade facilitation and business creation. Convergence toward EU regulatory standards may not matter much if the ENP does not significantly improve the new neighbours' access to the single market.

Under Article 43 of the PCA, Azerbaijan shall endeavour to ensure that its legislation will, gradually, be made compatible with that of the Community. One of the key areas of the legislative cooperation that are stipulated in paragraph 2 of Article 43 is the Customs law. This is reinforced by Article 45 of the PCA that is concerned with cooperation of the Parties with a view to ensuring that Azerbaijan's international trade is conducted in conformity with the rules of the WTO.<sup>10</sup>

Complying with WTO provisions is important in this context. EaP expects Azerbaijan to become a WTO member or at least associate member soon to extend the duration of the program in the country. Now Azerbaijan is negotiating with WTO for getting accession. The local entrepreneurs (especially rural) do not necessary receive information regularly. This now hinders the accession.

Therefore there is a demand for publishing information on Principles and guidelines of WTO, brochures, the bilateral relations and the negotiations between GoA and WTO and its possible effects on the economic atmosphere, the advantages and disadvantages of accession to WTO for local entrepreneurs. The provisions on TBT and customs regulation are mainly reflected in General Agreement on Tariffs and Trade (GATT) from 1947. Article I of GATT sets the general principle of most favoured nation treatment, which means that "any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded to the like product originating in or destined for the territories of all other contracting parties".

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<sup>10</sup> Ibid.

Another important issue is regulation of transit procedure in Article V of GATT. According to this Article parties shall provide "freedom of transit through their territory, via the routes most convenient for international transit, for traffic in transit to or from the territory of other contracting party". "No distinction shall be made which is based on the flag of vessels, the place of origin, departure, entry, exit or destination, or on any circumstances relating to the ownership of goods, of vessels or of other means of transport". Each country is obliged to accord to traffic in transit to or from the territory of any other contracting party treatment no less favourable than the treatment accorded to traffic in transit to or from any other third country.

Article VI prohibits dumping by which products of one country are introduced into the commerce of another country at less than the normal value of the products and countervailing duties to the export or import of products. GATT regulates in detail the conditions of valuation of goods for customs purposes (Article VII), fees and formalities which are connected with importation and exportation (Article VI), marks of origin (Article IX) and elimination of quantitative restrictions (Article XI).

Several provisions concerning customs regulation are reflected in the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). In particular, Section 4 of the Agreement contains special requirement related to border measures of the member-states which are directed to the enforcement of intellectual property rights. They enable a right holder to apply for the suspension by the customs authorities of the release into free circulation of goods, which are suspected to be counterfeit trademark or pirated copyright goods.

## **Recommendations and Conclusion**

The Government of Azerbaijan has shown slow but promising steps towards modernizing its Customs and Trade sectors to facilitate a greater integration with the European Union. However, there are still many steps that need to be taken to fulfill economic integration goals set by the European Partnership Initiative. The

process involved with Azerbaijan's accession to the WTO can simultaneously contribute to a more open and trade-friendly environment that follows the spirit of European integration.

In fact WTO accession must remain a priority for Azerbaijan as it:

- is key to effective economic diversification,
- it will render the domestic market more competitive,
- it will help domestic companies compete abroad.

Despite its strategic location, rapid economic growth and economic reforms, Azerbaijan must adhere to the principles and disciplines of the WTO to attract the greater levels of trade and investment by EU businesses that are warranted in the long run.

As much as for its rich but concentrated domestic market, Azerbaijan is of interest to EU businesses from a regional perspective as a promising platform or bridge for expansion. Given Turkey's WTO membership and Russia's impending WTO accession, Azerbaijan's WTO status will necessarily become an increasingly important consideration for EU businesses. As EU businesses elaborate their regional business strategies, WTO membership could well be the decisive factor in attracting trade and investment into Azerbaijan over its neighbors.

Inconsistency and a lack of transparency in the implementation of customs rules and procedures are routinely cited by EU businesses as major hurdles to increased trade with Azerbaijan. EU businesses also highlight greater transparency and consistency in the application of other regulatory provisions and government tenders as necessary to encourage more investment. Through the discipline and coordination that may be imposed under the PCA and WTO in conjunction, EU businesses are accustomed to addressing such issues in many emerging markets and by increasing transparency and predictability, in a rules-based trade system, the resulting gains for the local economy are likely to be very significant.

By joining WTO, the CIS countries have committed to adjusting local regulations to comply with international norms and to replacing the GOST (Soviet) system with those that meet WTO standards. As a norm, implementation of this commitment has been a **legal limbo**. Consequences are the following:

- the GOST system of standards is not recognized in the major export markets (i.e. restricts the acceptability of products in non-GOST markets),
- barrier to international trade, barrier to innovation as well as costly for businesses.

In addition to standards themselves, the procedures through which products are evaluated for conformity to regulatory requirements have important implications for market efficiency and trade expansion.

Example: quality infrastructure (metrology, accreditation, standardization and certification) systems in Kazakhstan and Kyrgyzstan. In this case, negative impact will be on the output of local production, the ability of local suppliers to export products and services, and the start-up costs for new businesses.

Perhaps one of the greatest needs of the Azerbaijan Government, with reform efforts has been foreign assistance, is drafting modern legislation to meet the requirements of the WTO and other international trading partners. Azerbaijan has shown interest in seeking foreign assistance by participating in multiple programs. An example is the program implemented by the United Nations Development Programme and co-financed by the PCA and TACIS programs, which was entitled "Modernization of Customs Service in Azerbaijan." The project aimed at developing customs legislation that was in line with European legislation and international standards. Azerbaijan's cooperation with an international team of experts led to a successful draft of a new customs code. This is a very positive step for Azerbaijan in becoming a more transparent and efficient trading partner and also follows the goals laid out in the Azerbaijan developed a "State Programme on Development of Customs System of the Republic of Azerbaijan in 2007-2011", which was developed by Presidential Decree in February of 2007. However, this code is still waiting final approval by the President and the Cabinet of Ministers and has not become an official law. It is recommended that the Parliament approve this new Customs Code to replace the current outdated Customs Code that was developed in 1997. In addition, if this new Customs Code is adopt-

ed, special trainings and seminars should be held to ensure that Customs employees would be able to efficiently implement and operate the new system. Moreover, changes to Customs Code will also help with Azerbaijan's process of accession to the WTO.

Our research found out also that Ukraine as a Useful Analogy for EU Businesses, since;

- Ukraine's PCA with the European Union entered into force in 1998, approximately at the same time as Azerbaijan's (1999),
- however, EU businesses' confidence in Ukraine has increased markedly since the country's WTO accession in 2008,
- practical implementation by Ukrainian authorities of many key trade and investment provisions remains problematic,
- however, EU businesses are more reassured because recourse is now available under multiple legal regimes,
- Ukraine has thus figured more prominently in regional business strategies, whether to supply Ukrainian domestic consumers or as a platform for exports to the European Union, Russia and South-Eastern Europe.

The paper found that producers in the CIS countries members of the WTO face:

- diminished demand for their products,
- increased competition from foreign producers, and
- lower prices and release of their potential competitiveness.

Joining the WTO is a great step towards being more connected with the European Union trading partners and the international trading community as a whole. Accession to the WTO requires Azerbaijan to comply with the Technical Barriers to Trade Agreement that would simultaneously comply with trading requirements set by the EU. This agreement aims to create a transparent environment where no technical rules unnecessarily impede trade between countries. As part of the WTO process, Azerbaijan has begun liberalizing its trade regime and has drafted new legislation on TBT. Therefore, it is recommended that Azerbaijan continue the accession process without the delays that have existed in the 13 years since it officially began the negotiations process.

The WTO membership will also lead to increases in direct foreign investment flows and expansion of export opportunity of import-oriented industry. Practices of WTO members show that following accession, the results are different for each member. The WTO accession attracts direct foreign investment: not only the investment into the membership is increased, but also it leads to economic growth. For example, serious improvements are observed in the amount of foreign investments after Kyrgyzstan, a “pioneer” in the CIS-space, joined the WTO. Notably, the WTO is a unique international global institution regulating trade relations between nations. WTO’s activity is based on agreements with the states. These agreements rest upon negotiations conducted between the countries and are ratified by these countries parliaments. The WTO charter indicates that its key goal is to assist producers, exporters and importers of commodities or services to manage and expand their businesses. WTO membership will promote foreign investment flow into Azerbaijan’s export sectors.

And it means assumption of commitments to protect the right of creditors and from this viewpoint, the regional governments cannot pursue discrimination policy in the foreign investment field after WTO accession. Horizontal investments (investments into the local market) will be directed to the regions where population is densely concentrated and vertical investments (export investments) will target the overseas sectors where more qualified employees are accumulated. On the other hand, regardless of Azerbaijan’s WTO membership, the improvement of the investment environment will promote long-term economic growth.

By WTO experts’ estimates, liberalization of foreign trade may be implemented more rapidly through regional and bilateral trade agreements. The number of Regional Trade Agreements (RTAs) has been steadily increasing over the last 20 years as has the share of preferential trade in world trade. By the beginning of 2005, more than 250 RTAs had been notified to the WTO, of which 130 were reported after 1995. Out of these 170 are currently in force. The total amount of agreements in force could come close to 300 towards the end of next year. The regional and bilateral trade agreements may give an impetus to the processes on multi-lateral trade agreements. The most recognized regional trade

agreements may include: the European Union, the European Free Trade Association, the North American Free Trade Agreement, the Southern Common Market, the Association of Southeast Asian Nations, Asian Free Trade Area and the Common Market of Eastern and Southern Africa, the Economic Cooperation Organization. The WTO membership will help Azerbaijan take advantage of going beyond at least the regional frontiers. Besides, the regional trade agreements within the CIS-space are not effective. For this purpose, it is not worth comparing WTO membership with the regional trade agreements. Moreover, the countries prioritising regional trade agreements are WTO members. For example, the countries of European Union are WTO members and these states are represented in this organization in the form of sole institution. And the majority of WTO members have joined one or more regional trade agreements. So, Azerbaijan's WTO accession will not have a negative impact on its position and role in the regional trade agreements. In fact, it will help make it a more attractive trading partner for the European Union.

As for standardization systems, the current Azerbaijan laws are not fully compliant with international and European rules in the area. Convergences as close as possible to relevant EU sectoral policy rules is the best way of ensuring that Azeri policies and system comply with the WTO Agreement on Technical Barriers to Trade, while providing for the most favourable conditions in order to foster trade between Azerbaijan and the EU. By following "European Standards" for products, Azerbaijan will be setting itself up for an access to the European Single Market, which requires standardization and no product discrimination. Policy convergences are to be made in the more general context of legislative adaptations currently taking place in other CIS (Commonwealth of Independent States) countries in respect of technical barriers to trade and standardisation. This will also assist Azerbaijan with increasing trade with other regional countries. Since joining the WTO will require Azerbaijan not to discriminate against foreign imported products, Azerbaijan must begin taking steps to revamp the local production industry and prepare factories for the import of competitive goods.

For instance, Azerbaijan could aim at fostering, in a first stage, compliance of imported products (depending on the priority set

forth by Azeri government; e.g. import of compatible agricultural and food products such as nuts, fruit and vegetable juices) with international standards. On the other hand, Azerbaijan may decide to initially encourage compliance of its domestic production with international standards. Such a policy convergence might for instance be carried out with a view to enhance exports of its domestic productions to geographical areas other than the CIS countries.

Another reason might be to develop local production in connection with future import of cheap and compatible products following accession to the WTO. Emphasis on the national production might thus be targeted at the economic areas where harmonization is most lagging behind. Another option could also be to select as a priority the industrial or service sectors that hold the largest share of the economy, should they present the best prospects for exports. Such an analysis in the early stage of the project will allow to map the relevant policy landscape in Azerbaijan, conducting a policy gap analysis and regulatory need assessment for sector policy convergences in TBT and custom fields, all necessary for developing recommendations, and conducting effective policy convergence and advocacy.

No matter which path Azerbaijan chooses to take in regards to standardization, it is very important that the government follows the lead of other standardization bodies, such as the European Committee for Standardization that brings “together all interested parties such as manufacturers, consumers, and regulators of a particular material, product, process or service” when setting regulations.<sup>12</sup> It is of utmost importance that a dialogue is created and that manufacturers are given the correct information, time, and resources needed to change standards for more effective regional trade.

All of these measures of Trade and Customs modernizing can be huge in making Azerbaijan more integrated with the EU. However, while the EU’s presence is large in Azerbaijan with its EaP, ENP and PCA, as well as multiple development projects and programs implemented with involvement of state and civil society actors, EU awareness however is very low in Azerbaijan; it is lower

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<sup>12</sup> European Committee for Standardization. FAQs. <http://www.cen.eu/cen/Pages/FAQ.aspx> (accessed November 1, 2010)

than the awareness in the neighboring countries, and lower than one would expect given the range and scale of EU involvement in Azerbaijan and the region. This ignorance applies now not only to the society in general, but also to civil society organizations and state officials/public servants, including even many of those involved with EU projects and programs. This is why the promotion of EaP is an urgent task in the context of raising the awareness of EU and its policies, programs and priorities in the national and regional levels.

For that reason, advocacy and communication have to be planned within this context towards effectively identifying and reaching the target groups and promoting the outputs of sector policy convergences discussed in this paper. Such an advocacy and communications strategy will have side effects on raising the awareness and interest for other EU activities in Azerbaijan and the region, including ENP, PCA and also WTO related reforms.

In conclusion, in order for Azerbaijan to further integrate with European Union, the government must (1) draft customs and trade legislation that moves to meet EU standards while still being conscientious of local needs, (2) effectively include the input and cooperation of local entrepreneurs and producers (3) create an action plan that will allow the effective implementation of the new legislation and (4) ensure that these new implementations are monitored and prepared for any shocks from the new legislation. Azerbaijan has the ability to be a stronger EU trading partner. This integration will help facilitate the movement of services, information and people in the region. It will also help strengthen the non-oil and gas sectors that need to be developed as oil revenues decrease over the next decade. The WTO accession is a good step towards being a more global and open trading partner. It can have great advantages in increasing investment, trade, transparency, and encourage large-scale technology transfers. It will also bring legislation against TBT, give Azerbaijan an incentive to conform to international standards, and open the country to increased foreign products that help to increase competition in domestic firms and aid in increasing transparency, while decreasing corruption. To meet these goals, Azerbaijan must show strong leadership and commitment to meet the many international requirements. How-

ever, the tough short-term disadvantages during this transitional period will lead to a more diverse, transparent, and stable, long-term economy for Azerbaijan.

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# THE EU AND ITS EASTERN PARTNERS: CONDITIONALITY AND EXPECTED BENEFITS - HOW DOES THE RUSSIA FACTOR MATTER?<sup>1</sup>

*Zsuzsa Ludvig*

## Introduction

Slow progress within the EU Eastern Partnership (EaP) program and disappointment of all affected partners can be explained by both problems arising on the EU and the Eastern Partners' side. Besides recent economic difficulties, diverging member state interests and approaches including the 'South versus East' problem<sup>2</sup>, shared competencies between EU institutions, uncertainties of conditionality<sup>3</sup>,

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<sup>2</sup> Visegrad countries and Sweden for instance are among major supporters of the Eastern Partners, while France and other member states from the Southern part of the EU are more interested in the other direction of the ENP, that is in the Euro-Mediterranean Partnership. Germany's positions are of key importance.

<sup>3</sup> Belarus is a good example where the EU has been hesitating or has had problems when trying to establish conditionality for the past few years. Here on the one hand the EU would like to send clear and definite messages to the recent authoritarian Belarusian leadership, on the other it does not wish to put punishment on the population. A second problematic country is Ukraine, where conditionality got impetus due to the negative turn in domestic political developments, but where even most recent 'conditions' of the EU are not clear. (According to the Council conclusions on Ukraine, of 10 December 2012, the EU is ready to sign the already initialled Association Agreement in case Ukrainian authorities "address the cases of politically motivated convictions...", but the document does not mention the Julia Timoshenko case as a concrete condition.) Relations with Azerbaijan also raise the problem of conditionality: the EU has been often blamed of being too tolerant with the country possessing huge energy sources in which the EU is interested.

problems on EU side include some major deficiencies like the lack of incentive of EU membership or the slow progress in the visa-free movement of people, the a second major issue for most EaPs. All in all the ‘carrot’ offered by the EU is a small one compared to the appetite of the targeted countries. At the same time Eastern Partners can also be blamed since most of them delay in ‘doing their homework’ to transform their political, juridical or economic systems. The paper argues that in some cases this ‘delay’ that is the lack of real commitment to doing the homework is greatly influenced by a third factor, namely the forced choice on foreign policy orientation for which Eastern Partners seem to be either not ready or not dedicated enough. The next EU-EaP summit to be held in Vilnius in the Autumn, 2013 might become a milestone in this respect. The core of the problem roots in the EU ‘offer’ of deep and comprehensive free trade agreements (DCFTAs) that institutionally exclude the possibility of the Eastern Partner’s parallel economic integration towards East. The first-ever EU EaP Association Agreement including a DCFTA is expected to be signed in this summit with Ukraine.

Eastern Partners can be divided into two groups. The first includes those partners that declared their willingness to become members of the European Union: Ukraine, Moldova and Georgia. These states have been expecting clear signs, reflecting worthy of their European choice from the EU. The European Neighbourhood Policy (ENP), and particularly the EaP, as the answer to these expectations on part of the EU is not convincing enough for them. Meanwhile, their domestic political landscapes have been changing as well. For instance, Ukraine has become a more reluctant or at least hesitating partner, while due to most recent domestic political events Moldovan commitment might become also uncertain in the future. Shifts in these two countries are important, since after the initial period when Ukraine was the pioneer country in the Eastern dimension of the ENP, for the past few years Moldova has been seen as the ‘best pupil in the class’ that is the most advanced in rapprochement to the EU. Definitely, now, Georgia remains the most determined Eastern Partner. Although members of the second group, Armenia, Azerbaijan and Belarus, have less definite goals and they intend to establish close ties without any real commitment to the EU, the forced choice might be relevant even for some of them in the future.

## Eastern Partners between the European Union and Russia

After a short period of cooperative approach at the beginning of the 2000's<sup>4</sup>, the EU and Russia evidently got involved into a competition or even rivalry over their common post-Soviet neighbours with a most obvious struggle for Ukraine evolving for the past few years. In 2003 the EU launched the European Neighbourhood Policy followed by a more targeted program within the Eastern Partnership initiative in 2009. EaP offers 'deep and comprehensive free trade agreements' (DCFTAs) as a core economic element of the planned Association Agreements.<sup>5</sup> On its side, Russia also initiated an ambitious integration project in the post-Soviet space, namely the Customs Union (CU) within the Eurasian Economic Community in 2010 now called as 'Single Economic Space' (SES), and with the final goal of creating an Eurasian Economic Union.

Both 'offers' have their severe economic consequences making the choice for the EaPs hard. The necessity of the choice is due to the fact that the Russia-led CU/SES goes beyond the level of a free trade regime which makes the two parallel rapprochements impossible for institutional reasons. However, while economic benefits of the DCFTAs with the EU might be expected mainly in the long run (like the positive changes of the economic structure, more keen market competition leading to increased competitiveness, economic growth and increased welfare etc.)<sup>6</sup>, the economic disadvantages of rejecting the Russian offer will arise immediately.

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<sup>4</sup> In 2002 the EU and Russia jointly worked out a 'White Book' on their economic co-operation with a possible extension of the results of bilateral co-operation such as the planned Common Economic Space to other post-Soviet states. (Belaja Knyiga, 2002)

<sup>5</sup> In fact, it is not possible to conclude the Association Agreement (AA) on political co-operation without signing the DCFTA and DCFTA cannot be applied without a signed AA, which is a major hampering factor in the whole process in both cases: either in a case when a country is politically determined (Georgia) or when it is ready for deeper economic co-operation but political conditions are still not satisfactory (the case of the finalised DCFTA of Ukraine).

<sup>6</sup> Long-term economic benefits have been predicted in several impact assessments studies made by up till now either for Ukraine or Georgia. See for example CEPS, IFW and ICPS (2006) for Ukraine; Kakulia (2013) for Georgia. However, interestingly there are Ukrainian estimations, according to which Ukraine will not benefit from the DCFTA at all. One of them was made by the Institute for Economics and Forecasting of the Ukrainian National Academy of Sciences. Sidenko (2013) and Shynkaruk (2013)

The European Union is not ready to offer the membership perspective to the Eastern Partners in the foreseeable future and seems to be rather reluctant in providing visa free regime for them as well. Visa free movement has been linked to very strict, mainly technical conditions.<sup>7</sup> Reluctance on the EU part concerning the free movement of citizens of EaPs might turn to be a bad policy in this competition as well. Despite the strong pressure from some EaPs for visa-free movement of their citizens to the EU, visa free regimes can be expected only in the long term.<sup>8</sup> At the same time citizens of most post-Soviet countries can enter Russia without visa, with Georgia being the only EaP for which visa is needed. Georgia is not only the most distant post-Soviet partner regarding new post-Soviet integration projects but belongs to the small group of two post-Soviet countries outside the CIS as well.<sup>9</sup> The visa regime introduced by Russia towards Georgia well illustrates its differentiated and presumably differentiating policy approach towards certain post-Soviet countries in the future.

Eastern Partners face a challenging integration/orientation dilemma. Most of them still have very close ties to other post-Soviet economies, mostly to Russia, in several cases and sectors even with strong dependencies, while they are in the process of developing privileged economic links with the EU as well. Now, they are or in the future they will be forced to choose between integration course to the West or East, between Russia or the EU, since in the EU approach integration to the EU Single Market excludes economic integration into other integration groups at the same time for institutional reasons.<sup>10</sup> While this choice, often considered to be a political one, does not seem to be a problem for some EaPs (like Georgia), it creates difficulties for others (at the time being the hottest for Ukraine) with serious short, medium or long term economic consequences.

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<sup>7</sup> EU membership is a no. 1. priority for three countries (Ukraine, Moldova and Georgia), while visa free movement of citizens is key issue for all the six countries.

<sup>8</sup> EaPs argue that the state of their technical preparedness and the general level of migration 'threat' they represent is not really worse than it was in some Western Balkan countries that were exempted from EU visa regime during the past few years, pointing to the political character of the decision instead of the technical one emphasized by the EU.

<sup>9</sup> Turkmenistan is the other one.

<sup>10</sup> A major problem originates from the lack of WTO-membership of Belarus and Kazakhstan.

The EU is a key economic partner for the European post-Soviet countries. The economic interests of the EU are most manifest regarding the energy sources of the post-Soviet region, although developing trade and investment opportunities are also on the agenda. The European Union is already a major trade partner for four of the European post-Soviet economies, except for Ukraine and Belarus (based on figures for 2010 and 2011). Here, Ukraine represents a major issue with its so-called ‘double ties’ manifested also in foreign economic relations, a challenge which the country seemingly has not been able to address so far. Although the European Union is not ready to offer membership perspective to these affected countries, it intends to get these economies involved into its Single Market through its DCFTA idea. The idea is open to all EaP countries that are members of the WTO, that is Azerbaijan and Belarus, possessing only observer status in the organization, are at the moment out of the scope of the initiative.

Russia still constitutes the economic centre of the post-Soviet space. On the one hand, it is the major partner or can be found among most important economic partners for most post-Soviet economies. Russia constitutes a major trade partner, an important investor and an attractive centre for labor migration in almost all cases. Besides, the ‘Russia issue’ cannot be neglected in the sphere of energy, neither in the case of energy exporters nor for energy importers of the region. Transit aspects also largely matter. On the other hand, it has the ambition to be the centre for them evidenced by its integration plans and ideas, already in the process. However, Russian ambitions and plans for integrating the analyzed countries face competition on part of other regional powers, like the EU (or Turkey). Even so, Russian intentions to achieve economic integration with other countries of the post-Soviet space by creating an independent power centre have rarely been taken seriously by the West so far. The argumentation behind this neglecting approach has been basically linked to the failures of different post-Soviet or Russian-led integration initiatives, the phenomenon of ‘institutions on paper’, treaties with thousands of exceptions, up until now. We argue that these new Russian projects, namely the Single Economic Space (SES) based on the Customs Union of Russia, Belarus and Kazakhstan and the dreamed Eurasian Eco-

conomic Union the core of which is the Eurasian Economic Community (EurAsEC) including Kirgizstan and Tajikistan beside the three above mentioned states, deserve a deeper attention, as they have taken concrete forms and constitute one of the main focuses of Russia's current foreign policy. Economic factors and economic methods are getting to constitute a more and more important dimension of competition between countries and regional powers. Russia intends to build up or rebuild a Russia-led economic power centre in the Eurasian continent, particularly in the post-Soviet space, which is naturally a 'political plan' at the same time. This ambition has become manifest during the last decade when Russia experienced considerable economic growth (especially in the years 2000-2008) and political stability, which allowed it to focus on projecting its power in the "near abroad". Russia has both attempted to develop close and strong political relations with the countries in the region, and formulated a concrete economic integration plan in its neighbourhood.

A basic question is whether Russia will be able to be a real and attractive gravity centre in her near area, abroad or not. Naturally the answer will be partly 'yes' and partly 'no'. Some post-Soviet countries (some EaPs) are likely to join or have already joined the Russian-led integration grouping, while others want to and may vote against this option.

The common post-Soviet European neighbourhood is evidently a most important issue in recent EU-Russian dialogue. It is even more: one of the main hampering factors in EU-Russian rapprochement. No significant development in EU-Russian relations can be achieved without arriving at a compromise on this issue. Although the EU has been emphasizing that the EaP is not an anti-Russian project, the EaP created deep tensions between the two partners. It received a rather chilly welcome from Russia who considered it as an initiative in conflict with its own ideas. Beyond the general political motivations for being a gravity centre for the region, energy and trade issues constitute the most evident fields of clashing interests between Russia and the EU.<sup>11</sup>

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<sup>11</sup> European Foreign Policy Scorecard 2012.

## The forced choice

Tensions between Russia and the EU over Ukraine became public during 2011, although they existed well before this year.<sup>12</sup> Ukraine followed its well-known multivectoral policy during the nineties, and tried to keep it even after its euro-integration priority had already been declared. ENP evidently targeted Ukraine as a no. 1. country in 2003-2004 (in 2003 within the Wider Europe concept) but as a slight shift from a balanced multivectorism Ukraine joined the Russian initiated Common Economic Space involving Russia, Ukraine, Belarus and Kazakhstan also in 2003 but leaving it soon after the orange revolution. Since these times, Ukraine has been balancing between East and West, Russia and the EU, trying to collect benefits from both sides, but at moment the country is under high pressure to make a choice.

The EU's DCFTA plan has been most deeply elaborated in relation with Ukraine. The DCFTA is part of the EU-Ukrainian Association Agreement and is based on Ukrainian WTO membership and the declared Ukrainian commitment to the EU integration course. Although recent Ukrainian political leadership has been critical of the content of the DCFTA agreement basically negotiated under the previous Ukrainian government, negotiations were finalized at the end of 2011. The first ever EU DCFTA was initialled in spring 2012, but its signing and ratification has been held up by domestic Ukrainian events, among others the imprisonment of the ex-prime minister, Yulia Tymoshenko and the prosecution of other representatives of the opposition evidently on political ground. Although several conditions of the EU have already been met by Ukraine, the Tymoshenko-case seems to be a crucial point in the future of the Association Agreement.

Meanwhile, Russian ideas on post-Soviet reintegration have been also developing and getting concrete forms. Three economies established the Customs Union, a formula very similar to the Common Economic Space (CES) initiative launched in 2003. Ukraine's absence from the new organisation constitutes the dif-

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<sup>12</sup> See for example Ludvig (2007).

ference between the two country groupings.<sup>13</sup> However, beside the importance of bilateral Ukrainian-Russian economic ties on the micro level, any post-Soviet integration grouping would need Ukraine, the second biggest and most advanced post-Soviet economy. Ukrainian participation is evidently necessary to achieve the dream of a post-Soviet economic centre as an important pillar of the multipolar world. Moreover, the decisions of Ukraine, the largest and most influential country within the EaP, may have an impact on the course of other EaPs as well.<sup>14</sup> This is why for the past few years Russia has been making pressure on Ukraine to join the CU.

The EU argues that a potential Ukrainian membership in the Russian-Belarus-Kazakh Customs Union would not match with the planned EU-Ukrainian DCFTA and is definitely against Ukrainian WTO commitments. But Russia made it clear that without joining the Customs Union Ukrainian intentions to renegotiate principles of gas pricing, agreed under the Timoshenko-government, are only illusions. In exchange for the Ukrainian participation Russia not only offers cheap gas but the elimination of export duties concerning its oil and oil products, providing compensation for potential Ukrainian payments due to WTO members' claims and the elimination of safeguard measures introduced against several Ukrainian producers. Altogether according to Russian calculations the Russian offer totals to about 6.5-9 billion dollar a year.<sup>15</sup> Furthermore, keeping distance from the CU threatens Ukraine with facing new product wars, a widely used tool for the past years by Russia, and as a counter measure by Ukraine, as well. This is how Ukraine became the object of a double mill game.<sup>16</sup> At the moment, Ukraine is in an "either or" sit-

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<sup>13</sup> Ukraine participated in the CES at its starting phase, signed the basic agreement, but after the orange revolution the new Ukrainian leadership decided to leave the project, stating that Ukraine is interested only in a FTA level of the Russia-led integration. Both CES aimed and recent CU aims at a higher than FT stage of integration among members.

<sup>14</sup> Shumylo –Tapiola (2012) p. 20.

<sup>15</sup> Shumylo –Tapiola (2012) p. 21.

<sup>16</sup> On the significance of the CU head of the Ukrainian Ministry of Foreign Affairs, Leonid Kozhara stated the following in Washington, 9th May 2013: „...no country can change its geographical position. This means that Ukraine has no other option but to strive to maintain good neighbourly and partnership relations with Russia...Thus, Ukraine will seek the modalities of its cooperation with the Customs Union.”

uation since none of its two major partners seem to seek compromise. Ukraine suggested having observer status in the CU, but it is not in Russian interests and plans to not have Ukraine fully. Although, according to the basic document of the CU, in the long term Russia is thinking of a large Eurasian Economic Union linking the SES/CU to other states of the Eurasian continent in the longer run perhaps even with the EU<sup>17</sup>, in the short run the competitive element of the Russian approach seems to be stronger than the cooperative one. At least, the officially stated Russian vision on a future Pan-European common economic area is not in accord with its strongly negative reactions to the EU DCFTA plans.<sup>18</sup>

Moldova and Armenia might also create tensions. Although, Moldovan economy with its small size and insignificance is not really crucial for any Russian plan, a definite Moldovan choice for the EU may lead to serious economic consequences in the country. Russia would not welcome such a decision for political reasons.<sup>19</sup> Though Armenia at the moment is further from achieving a DCFTA with the EU than Ukraine or Moldova are now, a potential Armenian-EU DCFTA would also be painful for Russia and could lead to difficulties in both EU-Russian bilateral relations and Armenian-Russian relationship. Furthermore, although the country is not a formal member of the EurAsEC, neither of the Customs Union, it takes part in the Collective Security Treaty Organization (CSTO) and in some EurAsEC-operated entities as well, like the Anti-Crisis Fund and Innovation Fund which indicate its interests in post-Soviet initiatives aimed at (partial) re-integration of post-Soviet economies.<sup>20</sup>

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<sup>17</sup> The final aim of the Russian projects is to “proceed towards creating the Eurasian Economic Union with other countries, international economic blocs, and the European Union, with the attainment of common economic space”, that is Russian initiatives would make part of a broader integration process on the whole Eurasian space. Sidenko (2011)

<sup>18</sup> Though not so evidently, Russia launched a similar competition in another ‘common neighborhood’, in the West-Balkans in 2011 when inviting Serbia and Montenegro, now both being EU candidates, to the Russia-led CU.

<sup>19</sup> Although according to Moldovan expert calculations the potential balance of benefits and costs of an eventual membership in the CU/SES would be negative mostly due to the high Russian/CU import tariff rates leading to price increase in the country (Lupusor, 2013), in a situation of a concrete Russian offer Moldova could easily face similar to the current Ukrainian pressure. But evidently Transnistria constitutes the most sensitive issue.

<sup>20</sup> Sidenko (2011)

For three countries the orientation dilemma does not exist, at least not in the foreseeable future. Georgia surely has not been a target country for new Russian post-Soviet (re)integration intentions due to the political tensions between the two countries. On its side recently Georgia follows, probably, the most definite European course from among EaPs with full readiness to meet European expectations. Contrary to Georgia, Belarus's path is just the opposite not only because without WTO-membership EU DCFTA offer is out of question, but for political reasons as well.<sup>21</sup> From among EaPs Belarus is represented in all Russia-initiated post-Soviet integration groupings.

The third country, Azerbaijan is in a favourable situation not being dependent neither on Russia, nor on the EU due to its endowment in natural resources, the EU and Russia are both interested in. Azerbaijan is most likely to follow its multipolar foreign (and foreign economic) policy in the foreseeable future.<sup>22</sup>

Table 1.

Relevance of the 'Forced Choice' Dilemma for the Eastern Partners

EU membership wanted, declared		No EU membership but different benefits from the EU wanted	
	the existence of integration dilemma (+ or -)		the existence of integration dilemma (+ or -)
Ukraine	+	Armenia	- , but may turn to: +
Moldova	- , but may turn: +	Azerbaijan	-
Georgia	-	Belarus	-

<sup>21</sup> However, a radical domestic political turn, not being likely right now, but cannot be excluded in the long run, would put the orientation dilemma on the agenda immediately.

<sup>22</sup> Mazziotti, M. – Sauerborn, D – Scianna, B. M. (2013)

## **Foreign economic relations (trade, FDI, labour migration) in the mirror of statistics – EU versus Russia and the Customs Union**

When analysing the ‘in-between’ situation of the Eastern Partners and the attractiveness of the two gravity centres, concrete strength of foreign economic relations between the EU and EaPs on the one hand, and Russia and EaPs on the other should be taken into consideration as well. Trade, FDI and migration flows and tendencies are subjects to analysis in this chapter in order to evaluate the prospects and relevancies of economic integration initiatives with this or that partner.

From among EaP economies, Ukraine is the most interesting one since the EU and Russia are almost equally important economic partners of the country. Trade figures for the past few years have been very close to each other. Regarding FDI, both actors have considerable influence on the economy, while Ukrainian labor migration also intensively targets the EU, Russia (and Turkey!) as well. For Belarus, the EU and Russia are major economic partners at the moment, but taking into consideration all kinds of economic links and dependencies, Russia is the dominant one. Belarusian economy is evidently dependent on Russia in several aspects. For Moldova and Armenia the EU is by far the most important economic gravity centre; however, these countries also have strong links to the Russian economy in some sectors even with deep dependency on it. Georgia and Azerbaijan represent the two special cases. Economic relations between Georgia and Russia were almost entirely cut due to the political tensions that led to the 2008 August war, but this cut caused serious harms to the economy. Furthermore, Russian capital is still present in key companies and Georgian sectors. The Azerbaijani economy is the only one being not dependent on Russia. The country enjoys economic benefits of being important partner both for Russia and the EU. However, in the post-crisis period a new tendency has appeared

with the rise of influence and significance of third countries like China or Turkey. On their side, post-Soviet countries under the pressure of the forced choice make also efforts to develop or strengthen third pillars of their set of economic links. Next sub-chapters provide more detailed information on recent state and trends in the development of these economic ties based on statistics.

Table 2.

Ranking and Share (%) of EU and Russia in EaPs Exports and Imports, in 2010-2011

		2010		2011	
Moldova	EXPORTS	1. EU (47.5)	2. Russia (26.2)	1. EU (51.6)	2. Russia (20.8)
	IMPORTS	1. EU (44.4)	2. Russia (15.3)	1. EU (55.6)	3. Russia (8.8)
Ukraine	EXPORTS	Russia (26.2)	2. EU (25.5)	1. Russia (28.9)	2. EU (26.5)
	IMPORTS	1. Russia (36.2)	2. EU (31.3)	1. Russia (35.4)	2. EU (31.2)
Belarus	EXPORTS*	EU (43.8)	2. Russia (31.5)	1. EU (37.9)	2. Russia (35.1)
	IMPORTS*	Russia (58.5)	2. EU (23.0)	1. Russia (54.7)	2. EU (19.0)
Armenia	EXPORTS	1. EU (48.1)	2. Russia (15.4)	1. EU (45.5)	2. Russia (16.7)
	IMPORTS	1. EU (27.5)	2. Russia (22.3)	1. EU (28.3)	2. Russia (21.5)
Azerbaijan	EXPORTS	1. EU (47.9)	7. Russia (3.7)	1. EU (59.4)	3. Russia (4.5)
	IMPORTS	1. EU (25.4)	2. Russia (17.4)	1. EU (32.4)	2. Russia (16.8)
Georgia	EXPORTS	1. EU (18.3)	9. Russia (2.2)	1. EU (19.5)	18. Russia (0.5)
	IMPORTS	1. EU (28.4)	6. Russia (5.6)	1. EU (29.1)	36. Russia (0.1)

\* Data for Belarus are for 2009 instead of 2010.

Source: Eurostat

## Trade

International trade was hit strongly by the world economic crisis bottoming in 2009. 2010 and 2011 already showed growing tendency worldwide and across Europe as well. In these two years the EU was a major partner for Moldova, Armenia, Azerbaijan and Georgia both in export and import side, while ranking first in Belarus exports also both in 2010 and 2011. Russia was the biggest export and import partner for Ukraine and ranked first in Belarusian imports during 2010-2011 with a share above 50 per cent (*see table 2*).

To conclude, the EU is by far the most important trading partner of the Eastern Partners, with a slightly growing significance for the region as a whole. However, in Ukraine, the key country within the EaP framework Russia is the number 1. trade partner, while Russia ranks first in the second biggest economy, in Belarus as well.<sup>23</sup> As a new element Eastern Partners have started to develop trade relations with third countries heavily and this has been leading to strengthening positions on part of China and Turkey in the first line, but others as well. These new tendencies can be linked both to intentions to reduce dependency on Russia and to EU internal economic problems. However, economic links with other than Russian post-Soviet economies are also strong and on rise among EaPs and with others like Kazakhstan, providing argumentation for thinking over joining new post-Soviet integrations.<sup>24</sup>

It is worth having a closer look at Ukrainian figures of the past years in order to have a deep insight into the Ukrainian orientation dilemma. Since 2007, exports to the three countries of the CU have been exceeding exports to the EU27, while Russian shares alone have been higher than EU ones since 2010. On the import side 2009 was the turning point for the CU and 2010 for Russia to have higher shares as compared to the EU ones.

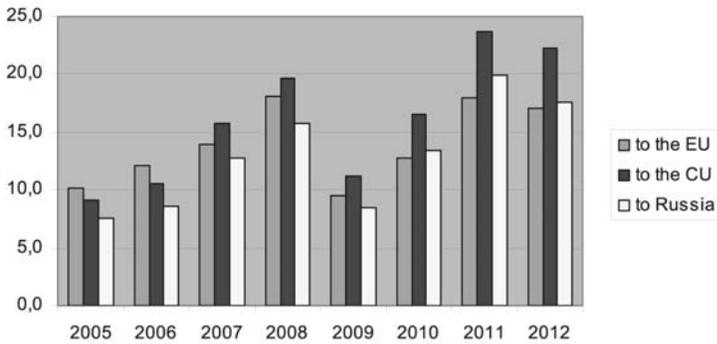
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<sup>23</sup> In 2011 Turkey represented the 3. most important export destination for Moldova and Ukraine, while it was 3. in Armenian imports. China ranked 3. in Moldovan, Ukrainian, Belarusian and Georgian imports. Iran was the 3. export partner for Armenia according to Eurostat data base.

<sup>24</sup> Ukraine was the 2. import partner for Moldova and the 3. for Belarus, while the latter ranked 2. in Georgian import list in 2011. Exports from Georgia to Kazakhstan, the 2. top export partner totalled to almost 20 per cent in 2011.

Figure 1.

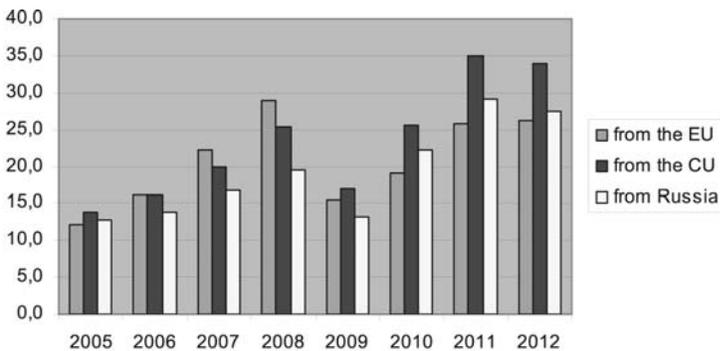
Ukrainian Exports to the EU, the CU and Russia, 2005-2012 (billion USD)



Source: State Statistic Service of Ukraine

Figure 2.

Ukrainian Imports from the EU, the CU and Russia, 2005-2012 (billion USD)



Source: State Statistic Service of Ukraine

## FDI

Although due to methodological reasons, it is not possible to show the exact EU and Russian shares in total FDI stock of individual EaPs, some major outlines can be formulated. EU companies have invested much more capital into these economies than Russia for the past one-two decades but the significance of the latter is also

to be emphasized. According to official Russian statistics, Belarus with 35.5 % share in total Russian OFDI stock in CIS, Ukraine (27%), Kazakhstan (12.7%) and Armenia (10.9%) are major recipient countries of Russian FDI, while in the statistics that tries to exclude the misleading phenomenon of ‘round-tripping’ and ‘hidden Russian capital’<sup>25</sup>, the leading position of Ukraine (38 %) is evident. Under this calculations Ukraine is followed by Kazakhstan (25.3%), Belarus (15.6%) and Uzbekistan (6.8%).<sup>26</sup> Although based on both statistics the first three countries are the same, the latter statistics highlight more the importance of Ukraine for the new post-Soviet, Russia-led integration groupings. Ukrainian-Russian economic links on company level are extremely strong.

Table 3.  
Russian and EU FDI stock in Ukraine, as of Dec. 31. 2012

	Official Russian FDI (ORFDI)	EU	Cyprus (1. EU source)	EU – Cyprus	German (2. EU source)	Real Russian FDI (RRFDI) ORFDI< RRFDI<Russia+Cyprus
million USD	3785.8	42979.3	17275.1	25704.2	6317.0	3785.8 <RRFDI<210 60.9
% in total	7.0	78.9	31.7	...	...	...)

Source: State Statistic Service of Ukraine

<sup>25</sup> Round-tripping means that a certain part of statistically inward FDI is not of foreign origin in reality, but domestic capital instead, that left the country for different, mainly tax-avoiding reasons and comes back as foreign. ‘Hidden origin’ in this case refers to capital of Russian origin coming to Ukraine, also as Cyprian. According to assumptions the Ukrainian part is the dominant one, but Russian share is also not negligible.

<sup>26</sup> Trudovaya migraciya v EEP (2012) p. 132. and p. 139. The statistical data base built up and used by the authors’ is based on company level information instead of macro statistics.

Although based on official statistics, the EU is by far the most important source of FDI in Ukraine, Russia as a country investor must be among leading ones when excluding the consequences of the ‘round-tripping’ and ‘hidden origin’ phenomena, with Russian sum being perhaps close to the figure for Germany, the biggest EU investor. Although due to lack of exact information on Russian and Ukrainian shares in FDI coming from Cyprus, one must be very careful with these calculations it is obvious that real sum for FDI stock of Russian origin in Ukraine is higher than the official figure indicates. Recent events in Cyprus might have a major influence on this picture but these impacts are hard to be evaluated at the time being. Presumably, Russian investors will chose other channels for hiding their real identities. This phenomenon affects other post-Soviet economies as well, but its extent is the biggest one regarding Ukraine.

Moreover, it is notable that newly launched post-Soviet Customs Union has already had strong positive impact on capital flows within its frames through the gradual introduction of national treatment. Regulations ease FDI flows from one member state to another even now.<sup>27</sup> This trend is due to maintain. As a conclusion one may state that the balance of FDI is evidently for the EU, but the influence of Russian capital should not be underestimated, neither.

## **Labour migration**

The largest EU economies like Germany, Italy or Spain are naturally most frequently chosen as target countries by post-Soviet labor migrants. According to a study made for the Federal Office for Migration and Refugees (Germany) most of post-Soviet migrants lived in Germany, Italy, the Czech Republic and Spain in 2010, with Ukraine, (Russia) and Moldova being the main countries of origin.<sup>28</sup> As for Ukraine, a major source of immigration, the number of persons with country of birth indicated ‘Ukraine’

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<sup>27</sup> As a result a massive Russian FDI outflow has been observed for the past 1-2 years from Russia to Kazakhstan mainly due to the fact that ‘doing business’ rating of Kazakhstan (and even of Belarus) is much better than that of Russia. Glinkina (2012)

<sup>28</sup> Federal Office for Migration and Refugees, Research Report (2012 )

totalled to 191.9 thousand in Italy, 155.5 thousand in Poland, 116.4 for the Czech Republic and 84.5 thousand in Spain in 2011, in all with a growth from 2010 except for the Czech Republic based on Eurostat data base. Although figures for migration from post-Soviet countries to the EU are rather high and according to calculations approximately 1.5 million migrants from the CIS lived in the EU in 2010, post-Soviet migration<sup>29</sup> targeting Russia and other CIS economies is also considerable, with Russia and Kazakhstan being on first places as destination countries.

Post-Soviet states still constitute the most important and even dominating sending country group for Russia. Based on figures of the 2010 census in Russia nearly 86 per cent of all residents with foreign citizenship were citizens of any other post-Soviet state. Between 2000 and 2006 the top 10 sources were post-Soviet states (excluding only Turkmenistan out of the top list). CIS countries are also estimated to be the main source of irregular migration with these migrants in most cases belonging to the category of labor migration. For citizens of Moldova, Ukraine, Armenia or other countries Russia offers a better living (*see table 3*).

Contrary to the tendencies of the 1990's when massive ethnic migration could be observed, 2000's can be characterized by labor migration. The figures for labor migration have been increasing since mid 2000's to the start of the economic crisis. According to the figures of Russian Federal Service on Migration, the number of labor migrants decreased from 2.43 million in 2008 to 1.64 million by 2010 from which 1.25 million arrived from the CIS.<sup>30</sup> This figure is very close to the figure of 1.5 million migrants from the CIS registered in the EU. From among EaPs Ukraine and Moldova belong to the biggest sending post-Soviet states. Remittances from work in Russia greatly contribute to the incomes of the sending countries and their population.<sup>31</sup> Even in Georgia Russian share is about 65 per cent of all remittances, the latter constituting 6 per cent of the GDP based on figures for 2011. Russian

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<sup>29</sup> IOM (2008)

<sup>30</sup> Trudovaya migraciya v EEP (2012) p. 11.

<sup>31</sup> The more than 30 per cent share of remittances in Tajikistan and Moldova compared to the GDP is the highest in the world.

Table 4.  
Top Nationalities of Immigrants to Russia (2010)

	head	share of nationality in total foreign immigrants (%)
Azerbaijan	67947	9.9
Armenia	59351	8.6
Belarus	27668	4.0
Ukraine	93390	13.6
Georgia	12077	1.8
Moldova	33884	4.9
<i>EaP together</i>	<i>294317</i>	<i>42.8</i>
<b>post-Soviet together</b>	<b>590748</b>	<b>85.9</b>
Europe together (without post-Soviet)	16470	2.4
China	28382	4.1
Vietnam	11084	1.6
Turkey	5400	0.8
India	4489	0.7
<i>persons with foreign citi- zenships all together</i>	<i>686993</i>	<i>100.0</i>

Source: results of census in Russia in 2010, Rosstat

share is about 80 per cent in Azerbaijan<sup>32</sup>. One should take into account that these two countries represent the most independent economies from the Russia from among EaPs.

As an impact of the world economic crisis the level of Russian unemployment grew significantly leading to a new Russian migration policy aimed at limiting the number of labor migrants. But Russian migration policy turned not only into tightening but differentiation as well. For those post-Soviet countries ready to par-

<sup>32</sup> Kiss (2013) p. 57. and p. 63.

ticipate in new post-Soviet reintegration projects, mainly in the CU/SES not only recent visa-free regime, but even a united labor market without any restrictions will be provided. Others not joining this integration grouping and getting into conflict over it with Russia might face tough quotas and potentially even newly introduced visa regimes in the future raising the 'price list' of non-membership.

## **Being part of the EU Single Market – Challenges of DCFTA**

According to the EU rhetoric, the EU offer for integrating economies of the Eastern Partners (i. e. those with WTO-memberships) into the Single Market is definitely a huge benefit for them. But seeing from the EaP side, this statement might raise questions. DCFTAs in fact represent a package of painful measures in the short and medium term while offering benefits (improving economic structure and competitiveness, welfare impacts etc.) mainly in the long term. Since the only DCFTA up till now is finalised with Ukraine, one may take the Ukrainian example to show its contradictions with both being 'deep' and 'comprehensive'.

Firstly, in principle 'comprehensive' means gradual or rapid liberalisation regarding all products on both EU and Ukrainian side. In practice, according to the finalised negotiations on EU-Ukrainian DCFTA, opening up occurred to be limited to the industrial production with rather small impact on the Ukrainian economy at least in short and medium term. The limited benefits are closely connected both to the unfavourable structure of Ukrainian industrial exports and the low level of EU average import tariff rate for non-agricultural products (4 per cent in 2010), while the similar Ukrainian average import tariff rate was even lower (3.8 per cent) in 2010. The limited expectable impacts are partly due to the already performed Ukrainian liberalisation within the WTO-accession process. What is more important, lagging behind in technological level and in the production of goods with high added value, Ukraine would be more interested in the opening up of the EU agrarian market, in which the negotiated DCFTA offers a very

modest progress leading to disappointment on the Ukrainian side.<sup>33</sup> According to the calculations made in the Institute for Economics and Forecasting of the National Academy of Sciences of Ukraine, “all key items of Ukrainian agrarian and foodstuff exports (except sunflower seeds and rapeseed needed for bio energy) were practically excluded from the free trade regime, as free trade was granted for them only within minor tariff quotas set at the level sometimes less than 0.1 per cent of the annual value of sales in the EU internal market. Outside these quotas, the EU has extremely high (actually prohibitive) import tariffs for many agrarian products and foodstuffs.”<sup>34</sup> These facts are crucial for an economy facing serious difficulties since the outburst of world economic crisis, leading to the conclusion that the expected and promised long-term economic structural impacts are simply not motivating enough.

Secondly, ‘deep’ means not only classical opening up of markets but that a difficult process of legal approximation is expected to undertake causing potentially serious social costs. While Central East European EU candidates naturally undertook this burden, it is not so evident in the case of Eastern Partners who are lacking the EU membership perspective. In their cases, it is a crucial question what degree of adoption of EU trade acquis is reasonable and who decides on it. According to an Ukrainian expert: „Ukraine ended up having rather limited influence, with the EU having a clear, non-negotiable list of commitments demanded...”<sup>35</sup> It is not surprising that this led to the already mentioned disappointment in Ukraine. We argue that the EU should be more flexible in the DCFTA negotiation process in order to be attractive enough for its Eastern Partners. Fortunately, according to Georgian expert view, Georgia made ‘a better job’ or the EU drew the conclusions. Georgian negotiators managed to influence the process of approximation in order to protect its national interest to a higher extent.<sup>36</sup>

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<sup>33</sup> The EU argues that the limited offer regarding agricultural trade is due to the Common Agricultural Policy, which cannot be modified just for Ukraine.

<sup>34</sup> More details see in Sidenko (2013).

<sup>35</sup> Shumylo –Tapiola (2012) p. 20.

<sup>36</sup> Kakulia (2013)

## Conclusions

### *Attractiveness of the EU versus Russia in the light of the three Ms (market, mobility and money) and conditionality*

Based on the analysis of trade flows between European post-Soviet states and Russia on the one hand, and with the EU on the other, we may draw the conclusion that although Russia still considers itself as the economic centre of the post-Soviet space, this role has been greatly challenged by the growing trade importance of the EU (and others like Turkey or China). Research on other kinds of economic ties such as FDI and labor migration may tincture this picture. While EU capital is dominating, Russia as a source of FDI is also considerable, however, not always so visible. Naturally, the picture is differentiated in individual country cases. Considering labor force movements from individual post-Soviet countries, the EU is a most reluctant partner, while Russia has recently launched a policy of differentiation with offering united labor market for some countries while formulating toughening limits to the others. Why are these facts important?

Based on recent strength of economic links between individual EaPs and Russia, it is obvious that although they have been weakened to a great extent since the 1990's in several cases they are still strong enough to be a reasonable basis for joining Russia-led post-Soviet integrations. Therefore, the forced choice might be painful. The EU should take into consideration this fact to a greater extent than it does. The carrot offered to the Eastern Partners aimed at involving them both into the political association and the economic integration should be attractive enough and given in due time. Political conditionality, uncertainties of economic benefits of DCFTAs in short and medium term, reluctance to provide mobility to the citizens of EaPs and the lack of really motivating amount of EU financial support may lead to an unexpected result: pushing some of the Eastern Partners to look for other integration schemes and partners. Russia is ready to grab the opportunity. The three 'Ms' does not seem to function well. Moreover, other major international players (like Turkey, the regional power Turkey or even China, the global player) have their economic interests in the region as well, with their 'offers' often being without

(hard) ‘conditions’. For all the above reasons, the EU should be more pragmatic when formulating its Eastern Partnership policy, paying much more attention to the ‘Russia factor’. Otherwise it might be a loser due to its slowness, cautiousness and strict set of both political and economic conditions.

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