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Research Report
Challenges of DCFTAs: How can Georgia, Moldova and Ukraine succeed?

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The imbalance between the costs and benefits of DCFTAs is a call to the EU to display greater thoughtfulness and pragmatism if it does not want to lose support for reforms in its neighbourhood.

Association Agreements (AAs), together with Deep and Comprehensive Free Trade Agreements (DCFTAs), are important instruments of the EU’s European Neighbourhood Policy (ENP) and are designed to incentivise political and economic reforms towards democracy and the market economy.

In the long term, DCFTAs can be expected to help modernise the economies of Georgia, Moldova and Ukraine and make them more competitive, provided the envisioned reforms are actually successfully implemented. However, the hefty burden of short-to-medium term costs and associated challenges may severely jeopardise the success of the endeavour. In particular, there are vast asymmetries in the net benefits that will accrue over the course of implementation along the time axis (high costs to be faced in the short and medium terms – potential benefits accruing mostly in the longer term), as well as across regions and economic sectors (less competitive sectors and regions will face a particularly high adjustment burden and may suffer as a result of related adjustments). Nor can the associated social costs resulting from restructuring and labour relocation be dismissed.

Social tensions associated with restructuring and other effects of reform might jeopardise the initial pro-EU impulse. As a result, the incentives and the commitment to AA/DCFTA implementation may weaken and the political landscape in the signatory countries may switch towards greater populism and Euroscepticism, thereby possibly stalling or even ruining the progress of AA/DCFTA implementation.1
What is DCFTA about?

The ultimate objectives of the ENP are to stabilise the neighbourhood region and turn ‘neighbours’ into ‘friends’ through closer economic, institutional and political integration. As part of this agenda, the EU concluded AAs with Georgia, Moldova and Ukraine in 2014. Since 2016 these agreements have been in force in Georgia and Moldova (provisional application started in 2014) and have been provisionally applied in Ukraine. The DCFTAs, an integral part of the AAs, constitute the economic core of agreements which govern the implementation of a wide range of trade-related reforms. The aim of these reforms is not only to liberalise trade in goods and services (‘trade-related aspects’), but also to facilitate the adoption of EU standards in various areas such as food safety, technical regulations, public procurement, competition policy, intellectual and property rights and the energy market (‘deep and comprehensive aspects’), as well as approximation to the EU’s body of law (‘acquis communautaire’) in a variety of other areas relevant for economic development. The EU hopes that the implementation of AAs/DCFTAs will facilitate sustainable economic growth and development and thus stabilise the EU’s Eastern Neighbourhood.

Economic rationale has not played the most critical role in the EU decision to develop closer ties with the DCFTA countries; hence, the benefits for the EU are mostly geopolitical rather than economic, not least owing to huge disparities in the size of the respective economies (Table 1).\(^6\) Importantly, however, the potency of the internal split between ‘pro-European’ and ‘pro-Russian’ sentiments within the countries and the reaction from ‘neighbours of neighbours’ were miscalculated by the engineers of the ENP, and the destabilisation of the neighbourhood brought about quite the opposite of what the EU was initially striving to achieve. It is highly questionable whether the progress made to date with regard to revision of the ENP and AA/DCFTA implementation has been satisfactory.

**Table 1 / Key economic characteristics of the DCFTA economies, 2015**

<table>
<thead>
<tr>
<th></th>
<th>Moldova</th>
<th>Georgia</th>
<th>Ukraine(^1)</th>
<th>EU-28(^2)</th>
<th>EU-CEE(^4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at PPP, bn EUR</td>
<td>13.7</td>
<td>27.1</td>
<td>257.7</td>
<td>14,699</td>
<td>2,000</td>
</tr>
<tr>
<td>GDP at PPP, per capita</td>
<td>3,900</td>
<td>7,300</td>
<td>6,000</td>
<td>28,800</td>
<td>19,300</td>
</tr>
<tr>
<td>Exports, fob, % of GDP</td>
<td>30.3</td>
<td>15.8</td>
<td>42.1</td>
<td>31.3(^3)</td>
<td>51.1(^3)</td>
</tr>
<tr>
<td>Imports, cif, % of GDP</td>
<td>61.4</td>
<td>55.3</td>
<td>41.4</td>
<td>29.2(^3)</td>
<td>51.3(^3)</td>
</tr>
<tr>
<td>Population, thousands</td>
<td>3,554</td>
<td>3,717</td>
<td>42,845</td>
<td>509,608</td>
<td>103,733</td>
</tr>
<tr>
<td>Employment, thou., avg</td>
<td>1,204</td>
<td>1,780</td>
<td>16,443</td>
<td>220,845</td>
<td>44,706</td>
</tr>
<tr>
<td>Unemployment, %</td>
<td>4.9</td>
<td>12.0</td>
<td>9.1</td>
<td>9.4</td>
<td>7.8</td>
</tr>
<tr>
<td>FDI stock, per capita</td>
<td>911</td>
<td>2,715</td>
<td>1,323</td>
<td>11,411</td>
<td>5,535</td>
</tr>
<tr>
<td>Ease of Doing Business</td>
<td>52</td>
<td>24</td>
<td>83</td>
<td>.</td>
<td>.</td>
</tr>
</tbody>
</table>

1) Data for Ukraine excluding Crimea and Sevastopol and (except for population) parts of Donbas.
2) wiw estimates and Eurostat.
3) EU-CEE: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

Sources: wiw Annual Database, Eurostat, World Bank, UN Comtrade, national statistics, own estimates.

**Difficult transition**

Economic growth and transition progress in the three DCFTA countries since the collapse of the Soviet Union have mostly been disappointing. DCFTA countries belong to the lower-middle-income level group; regional peers in Central and Eastern Europe are much more affluent (Table 1). Employment in Ukraine and Moldova has fallen by about one third in the past two decades, and in Georgia it has stayed more or less stable. Recently all three countries have been facing numerous challenges, including a generally weak external environment, poor export performance, significant outward migration and a decline in remittances. These have been compounded by do-
mestic issues such as fiscal austerity, weak investor confidence, widespread corruption, political tensions and ‘frozen conflicts’. Compared to regional peers, DCFTA countries are also characterised by a relatively weak manufacturing sector and sizeable subsistence agriculture, which is also reflected in the composition of their exports – skewed towards agri-food products and commodities.

**Figure 1 / Recent foreign trade developments in the DCFTA countries**

Mixed picture of DCFTA trade effects so far
All three DCFTA countries are members of the WTO and access to their markets had already been liberalised to a significant extent before the AA/DCFTA was signed. Georgia represents an example of almost complete unilateral liberalisation, not only vis-à-vis the EU but also with respect to the rest of the world thanks to the profound reforms undertaken in the 2000s. By contrast, Ukraine and Moldova allow for transition periods of 3 to 10 years for liberalisation of certain product categories. Likewise, the EU also applies significantly more trade restrictions to Ukraine and Moldova than to Georgia.

Preliminary trade data for 2016 – the first year of DCFTA implementation – provide a mixed picture. Georgia’s exports to the EU fell by about 10%, while Moldova’s increased by 10% and Ukraine’s by just 3%. Imports from the EU increased in all three DCFTA countries (most in Ukraine, less in Georgia and least in Moldova) and trade deficits expanded. The disappointing export performance of Ukraine is related largely...
to the economic crisis and geopolitical tensions, whereas Georgia’s and Moldova’s trade with the EU has been much more dynamic in the last couple of years (Figure 1). In relative terms, however, the EU has gained prominence as a market destination. Exports from Georgia and Ukraine to the EU currently represent about a third of their total exports. In Moldova, the share going to the EU is much higher: two thirds of total exports in 2016 — largely thanks to intensive trade links with Romania and Italy.

What are the benefits for DCFTA countries?
Barring the prospect of full EU membership, the AA/DCFTA is arguably the best instrument the EU has managed to devise to date that can potentially trigger positive changes in the beneficiary countries in many institutional, social, economic and political spheres. Successful implementation of the DCFTA will de facto bring Georgia, Moldova and Ukraine ‘closer’ to the EU where these aspects are concerned, even though there is no prospect of EU membership (however, the relative strength of the AA/DCFTA as a reform anchor is often questioned). Therefore, the key issue is not whether to proceed with deeper EU integration along the lines of the AA/DCFTA, but how to proceed in order to achieve the best results given the challenging circumstances. In particular, it will be crucial to find the optimal pace, sequencing and depth of reform implementation that are less socially costly, while remaining politically feasible and still sufficiently ‘transformative’.

Assisted reform implementation
The EU has been committed to providing technical and financial assistance to the DCFTA countries. However, this support is much lower than either the EU’s pre-accession assistance or transfers provided to the new EU Member States. The most important benefits of DCFTA implementation are associated with the improved opportunities it creates to gain access to the EU market, accelerate FDI inflows and modernise the economies through strengthened institutions, a better business environment and higher competitive pressures due to further trade liberalisation.

Elimination of trade barriers
Importantly, the DCFTA framework is targeted at the elimination of the remaining obstacles to bilateral trade for most products, including both tariff and non-tariff barriers. In that respect, the key obstacles to trade that remain are related to non-tariff barriers, and the EU market is notorious for being well-protected by high food-safety requirements and technical standards pertaining to the safety of industrial goods and production processes. The greatest added value of the DCFTA, in contrast to conventional free trade agreements, is associated with the legally binding framework it establishes to deal with non-tariff barriers in a multifaceted way with financial and technical support from the EU institutions.

FDI inflows and economic modernisation
The expected acceleration of FDI inflows as a result of a better regulatory environment and closer market integration with the EU owing to DCFTA implementation might help to facilitate access to European and global value chains and supply networks. A more predictable and familiar (to foreigners) regulatory environment that will result from approximation to the EU acquis should encourage foreign investment, the major benefits of which expand beyond bridging the gap in investment needs but also include technology spillovers, better managerial and marketing practices and logistical improvements. The recent experience of new EU Member States shows that FDI inflows have significantly contributed to modernisation and economic restructuring, particularly inflows to the tradable sectors. On the other hand, FDI in retail and wholesale trade, in real estate activities and partly also in financial services has been more problematic, as it may contribute to the widening of current account deficits as well as to creating unsustainable financial bubbles.

What are the costs for DCFTA countries?
While the opportunities are significant, the challenges involved in taking full advantage of the
DCFTAs are perhaps even greater. In particular, the DCFTA countries are less advanced and generally uncompetitive, while their exports to the EU are highly concentrated in just a few, usually less-sophisticated sectors. Moreover, agricultural and food products – among the dominant export sectors of the DCFTA countries – still face significant EU non-tariff barriers. While for the majority of product lines the DCFTA agreements envision full elimination of trade barriers, for certain sectors, primarily agriculture and the food industries, the liberalisation is only partial, and remaining export constraints include tariff rate quotas (TRQ), entry price regulation and other provisions. These obstacles to truly free and comprehensive trade are compounded by de facto difficulties in complying with stringent EU safety standards, limited knowledge of distribution networks, challenges in finding business partners in the EU and fierce competition in the saturated EU market.

Reform rewards mostly in the long term
The net benefits associated with DCFTA implementation are highly asymmetric in time (high short-run costs while benefits accrue mostly in the longer term) and across regional and sectoral dimensions (weak industries and regions will face particularly high costs of adjustment). Moreover, while costs are immediate and real, it is not obvious whether and when reform implementation efforts will be rewarded, owing to a number of significant domestic and external obstacles. Even successful implementation of the DCFTA reforms does not guarantee that the DCFTA countries will be able to integrate into EU markets successfully. At the same time, there is an implicit asymmetry in the trade relationship between the EU and DCFTA countries, with EU exporters facing few obstacles in exporting to the DCFTA markets as they already abide by the acquis and are much more competitive with well-recognised brands with established marketing and distribution channels.

Implementation costs
Among the major weaknesses of the AA/DCFTA design and implementation strategy has been the lack of assessment of the costs involved in implementation in general and for individual sectors and regions in particular. It has been quite common so far for AA/DCFTA promotion and awareness campaigns to cherry-pick aggregate potential long-run benefits of the DCFTA while being mostly silent on costs. This may result in distorted expectations among the population as regards the outcomes of the DCFTA, and in early disappointment during the challenging transition period. There needs to be comprehensive discussion of the costs and challenges involved in proceeding along the DCFTA implementation path. These include the direct costs of shouldering the regulatory burden of implementation and enforcement by the public sector, and the costs to the private sector of adjusting to the new regulations. In addition, there are multiple indirect costs, including social costs due to job losses, and risks associated with higher competition and economic restructuring, which are conditional on other factors such as the implementation of reforms, awareness among businesses, the availability of funding to comply with the new regulations, and reorientation to new markets.

Low awareness
A closely related issue is low awareness of DCFTA content and of the regulations required in the signatory countries, which are particularly critical when it comes to successful adjustment by businesses and other stakeholders. The DCFTA negotiations were not transparent with regard to the specifics (e.g. which industries are to be shielded by longer transition periods, the determination of TRQs, etc.), and the bargaining power of the negotiating parties has been unequal. The costs associated with DCFTA implementation were not communicated to the public in a transparent way. Not only aggregate but also sector-level analysis and a broader public debate related to the costs of implementation, as well as discussion of how to address these challenges with a particular focus on the vulnerable segments of the population and economic sectors, would have been needed in order to arrive at a cost-effective implementation strategy, rather than leaving the sensitive issues out. The three countries under consideration are also confronted with political risks stemming from the internal split between ‘pro-Western’ and ‘pro-Russian’ sentiments, which are aggravated by external geopolitical influences and internal ‘frozen conflicts’. It is thus important that policy-makers
in both the EU and the countries concerned establish mechanisms that facilitate sustained progress in implementing the reforms, ensuring as far as possible that they are irreversible, as well as putting additional efforts into promoting public support of reforms and devising relevant communication strategies.

**Adjustment to EU standards**

Harmonisation of domestic regulations with the EU *acquis* and implementation of EU standards will be difficult and may not always be beneficial. Adjustment to EU standards and related reforms is a wide-ranging process (some 80-90% of EU legislation is to be approximated) and has to follow a negotiated time schedule. In general, the implementation effort is frontloaded, placing a heavy burden on local government and businesses in the short-to-medium term. EU standards will be adopted by the DCFTA countries, while any conflicting standards have to be withdrawn — a rather costly process for the public authorities and the private sector alike. While this may help to enhance consumer safety and facilitate exports to the EU and the rest of the world, it is not always clear whether the adoption of some of these regulations is relevant for less advanced countries, especially for those that do not have EU membership prospects. The generally poor access to finance by businesses aggravates the burden of adjustment, which may lead to the shrinking of inefficient sectors and associated labour-market adjustments which will be painful. The implementation of the AA is also asymmetric in the sense that the DCFTA countries do not have any control over the evolution of EU laws and regulations, but nevertheless have to accept most of them.

**Uncompetitive economic sectors**

Several weak sectors in the DCFTA countries that will be seriously affected by the DCFTAs play a particularly important role in their economies. Food processing and basic metals, which will be affected by safety and environmental standards, are very important in the DCFTA countries. Manufacturing industry accounts for just 10 to 14% of GDP in all three DCFTA countries, which is much less than in most new EU Member States, where the respective shares are close to or even higher than 20%. At the same time, the shares of GDP accounted for by agriculture, including small-scale subsistence private farms, and retail traders in the DCFTA countries are still very high, especially with respect to employment, the latter being particularly vulnerable to the adjustments flowing from the DCFTAs.

**Dislocation of workers**

Industrial restructuring and modernisation triggered by the DCFTA implementation will inevitably result in the dislocation of workers. Especially vulnerable are low-skilled workers engaged in small-scale subsistence agriculture and retail trade, and in manufacturing sectors that are not competitive in the EU and/or were originally predominantly oriented to the Russian markets. Efforts to retrain workers and other active labour-market policies are therefore essential to help offset the inevitable negative consequences of labour-market adjustments. As recent EU experience illustrates, another potential challenge comes from the enhanced labour mobility that will result from closer integration with the EU. Although visa liberalisation is one of the most powerful incentives the EU can currently offer with association, even without full labour market liberalisation the enhanced integration and openness will also lead to an accelerated outflow of labour, particularly of high-skilled young workers. This may adversely affect human capital development in the DCFTA countries and damage not only future business prospects but also the sustainability of social security systems. This has already been the case in many post-Soviet economies, including the new EU Member States. Large groups of self-employed workers – up to 60% of total employment and about 1 million persons in Georgia, for example – will be vulnerable. A similar employment challenge – albeit on an even greater scale – is facing Ukraine, where about half of the total in employment (more than 8 million persons in 2015) were also self-employed, predominantly also in agriculture and retail trade. While not all these adjustment pressures can be directly related to the implementation of DCFTAs, it is clear that the latter will (if successful) definitely increase existing adjustment pressures.
<table>
<thead>
<tr>
<th>Benefits and opportunities</th>
<th>t</th>
<th>Costs and challenges</th>
<th>t</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Businesses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>↑ access to larger markets (EU via DCFTA and indirectly the rest of the world)</td>
<td>(S)M</td>
<td>↑ compliance costs for businesses</td>
<td>SM</td>
</tr>
<tr>
<td>↑ investment confidence and FDI inflows</td>
<td>ML</td>
<td>↑ income inequality and poverty in less competitive regions</td>
<td>M</td>
</tr>
<tr>
<td>↓ cost of capital and ↑ access to finance</td>
<td>(M)L</td>
<td>↑ competition from EU producers</td>
<td>S</td>
</tr>
<tr>
<td>↓ costs of imports =&gt; ↓ cost of inputs and</td>
<td>S</td>
<td>– contraction of less competitive industries =&gt;</td>
<td>SM</td>
</tr>
<tr>
<td>↑ modernisation efficiency</td>
<td>ML</td>
<td>↑ unemployment in those sectors</td>
<td>SM</td>
</tr>
<tr>
<td>↑ efficiency and external competitiveness of exporters in EU markets and globally</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>↑ financial and technical support from EU institutions and other donors</td>
<td>SM</td>
<td>- opportunity cost of participation in alternative trade arrangements</td>
<td>S</td>
</tr>
<tr>
<td>↑ domestic market efficiency due to competition from imports and stricter standards</td>
<td>SM</td>
<td>- elimination/reduction of imports from countries not complying with EU standards</td>
<td>SM</td>
</tr>
<tr>
<td>↑ potential access to EU public procurement</td>
<td>L</td>
<td>- low awareness of AA/DCFTA content</td>
<td>S</td>
</tr>
<tr>
<td>↑ quality and stability of business environment due to adoption of EU law</td>
<td>L</td>
<td>- lack of access to finance</td>
<td>SM</td>
</tr>
<tr>
<td>↑ opportunities to participate in global value chains</td>
<td>(M)L</td>
<td>- trade restrictions on some exports to the EU</td>
<td>SM</td>
</tr>
<tr>
<td>↑ adoption of business regulations which facilitate sustainable development</td>
<td>L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>↑ employment in efficient sectors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>↑ opportunities for the labour markets</td>
<td>L</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Consumers</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>↓ costs of imports =&gt; ↓ prices on final products</td>
<td>S</td>
<td>↑ price for some low-price products due to greater regulatory burden, stricter standards, removal of subsidies</td>
<td>SM</td>
</tr>
<tr>
<td>↑ quality of products due to higher standards</td>
<td>S</td>
<td>↓ elimination of some products from the market due to non-compliance with the new standards</td>
<td>SM</td>
</tr>
<tr>
<td>↑ variety of products</td>
<td>S</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Government</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>↑ better regulatory practices consistent with EU legislation</td>
<td>ML</td>
<td>↑ costs of implementing reforms and supporting infrastructure</td>
<td>SM</td>
</tr>
<tr>
<td>↑ financial and technical assistance of EU agencies in the implementation of reforms</td>
<td>SM</td>
<td>↓ import tariff revenues</td>
<td>S(M)</td>
</tr>
<tr>
<td>↑ opportunities to effectively fight corruption</td>
<td>M</td>
<td>↑ loss of independence in certain policy areas due to adoption of the EU acquis</td>
<td>M</td>
</tr>
<tr>
<td>↑ tax revenues due to broader tax base as economy expands</td>
<td>L</td>
<td>↑ costs of training and maintaining public sector experts</td>
<td>SM</td>
</tr>
<tr>
<td>↑ internal consistency of legislation, modern law, anchoring of reform commitments</td>
<td>M</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: S, M, L indicate, respectively, short-, medium- and long-term time horizons (t) over which the effects are likely to manifest themselves. Short-term signifies the period within a year after the inception of provisional DCFTA implementation, medium-term indicates the period of phasing-in of trade liberalisation and other DCFTA reforms (10 to 15 years), and long-term signifies the period after DCFTA implementation is complete. Source: Adarov and Havlík (2016).
Policy recommendations

Pragmatic implementation and proper sequencing of reforms, with a strong emphasis on pro-growth modernisation and diversification strategies, access to the EU market and FDI promotion, are recommended.

Careful selection of priorities is paramount in view of the limited resources and a range of economic and geopolitical challenges which the signatory countries face if they are to ensure that economic transition along the lines of the DCFTAs is smooth and sustained. Improving the business environment, attracting investment to export-oriented sectors and integration into global value chains are needed to ensure economic restructuring and long-run competitiveness. At the same time, policies aimed at mitigating the costs associated with possible adverse effects are essential, in order to maintain the necessary public support for DCFTA-related reforms. Much greater efforts need to be made by the EU and the local administrations to increase the chances of success. On the basis of the analysis, we propose a number of policy recommendations that will facilitate smoother DCFTA implementation and are grouped in three pillars: (I) background conditions and public awareness; (II) strategic sequencing of reforms and gradualism; and (III) increased financial and technical support from the EU, with strict conditionality. Whereas some progress has already been made along these lines, in general much further work still needs to be done, especially in Ukraine and Moldova.

Pillar I: Background conditions and public awareness

- Facilitate rapid transition to supportive macroeconomic and political background conditions.
- Prioritise and accelerate institutional reforms that are directly relevant to the business environment.
- Devote more effort to increasing specific rather than generic awareness of the AAs/DCFTAs by stakeholders, especially the private sector.
- Enhance cross-border dialogues between business communities in the EU and in the DCFTA countries.

As a precondition for successful implementation of the DCFTAs, it is critical to establish supportive macroeconomic and political background conditions, to facilitate institutional reforms and foster specific awareness of DCFTA content and operation in the EU market among the business community. This sounds trivial yet it is a prerequisite for successful institutional and economic transformations and boils down to dealing with the ‘frozen conflicts’ and addressing the challenges of macroeconomic and political crises. In this respect, normalising relations with neighbours is also an important ingredient of sustainable development and regional security. Needless to say, however, this should not come at the expense of progress in AA/DCFTA implementation. As a closely related matter, institutional reforms relevant to the business environment should be prioritised and accelerated, especially in view of the challenges posed by deep-seated corruption in Moldova and Ukraine. More effort should be devoted to informing businesses about how to operate under the new AA/DCFTA regulations as well as to cross-border dialogue between business communities in the EU and the DCFTA countries, to ensure that DCFTA countries can adjust to the regulations and are in a better position to gain access to EU production and supply networks. This is particularly important for lagging regions in the DCFTA countries, which are more prone to the risks associated with poor access to information and with outdated business practices. Joint efforts by public authorities and NGOs in specific business-related areas will help to mitigate the effects of limited administrative capacity.

Pillar II: Strategic sequencing of reforms and gradualism

- Prioritise careful sequencing of reforms to target challenges to competitiveness and market access.
- Ensure sober accounting of adjustment costs and related pragmatic gradualism of implementation in order to balance costs and benefits over time.
- Align/develop national long-term socio-economic development strategies with the medium-term and long-term impacts of the AA/DCFTA in mind.
- Facilitate diversification of export markets and attempt to normalise relations with Russia.

Given the limits of the administrative and financial capacities, the DCFTA countries should prioritise reforms directly related to export-driven growth, access to the EU market, competitiveness gains and attractiveness for FDI inflows. This implies accelerated transition to EU standards in sectors that are already relatively competitive in the EU (the agri-food sector, metals), as well as promoting FDI along ‘horizontal’ (national and regional) and ‘vertical’ (industry-specific) lines, starting with a supportive regulatory environment and relevant public infrastructure in selected sectors and localities with the greatest potential to attract FDI and be integrated into global value chains. In this respect, a long-term economic strategy should be developed or adjusted with the implications of the AAs/DCFTAs in mind, to support higher value-added industries with the most promising long-run economic potential that can potentially breed global champion companies. Dedicated investment-promotion agencies in the DCFTA countries should gain more prominence, in order to facilitate FDI inflows. Pragmatic gradualism in reform implementation in sensitive areas is necessary: the costs associated with labour-market adjustments, poverty and income inequality that will inevitably be induced by structural transformations should be assessed and relevant strategies should be developed at the sectoral and regional levels to mitigate them, including appropriate social programmes and active labour market policies. Finally, TRQs and other barriers imposed by the EU on agri-food sector exporters in the DCFTA countries need to be relaxed, at least temporarily, given that it is one of the few areas in which they are de facto competitive in Europe.

### Pillar III: Increased financial and technical support from the EU with strict conditionality

- The EU and the global community should embark on more financial and technical assistance to the private and public sectors in the DCFTA countries.
- Enforce strict conditionality of financial assistance.
- Implement effective monitoring of financial aid use and establish a functional ‘scorecard’ system to systematically track progress of reforms in multiple dimensions.
- Prioritise a ‘more-for-more’ strategy for financial assistance: a competition element for EU funding needs to be introduced along with a mix of merit-based and need-based financial aid disbursement routes.

More financial and technical assistance should be provided for the private and public sectors in the DCFTA countries in view of the significant financing gaps and the particularly difficult macro-economic challenges faced in recent years. Strict conditionality of financial assistance should be enforced, with preference being given to positive rather than negative conditionality. Effective monitoring should be enforced and a functional evaluation system with clear communication of quantitative or identifiable qualitative benchmarks should be developed, as a means of systematically tracking the progress of reform implementation in multiple spheres using independent institutions. A competition element for EU funding needs to be introduced and a mix of need-based and merit-based (linked to de facto performance against predetermined benchmarks and peers as indicated by the scorecard evaluation system) financial aid channels should be further developed as part of an effective use of financial aid in view of the challenges posed by pervasive corruption facing Ukraine and Moldova in particular.

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The views expressed in the brief are solely those of the authors.

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2 Nevertheless, Georgia, Moldova and Ukraine are important for the EU from the perspective of further development of cross-border infrastructure and transcontinental networks, as well as for energy security.

3 Since the time of writing the Joint Working Paper (Adarov and Havlik, 2016), progress has been made along the lines of several recommendations proposed: for instance, noticeably more effort was made in 2017 to promote specific DCFTA awareness and training of stakeholders in the signatory countries; financial support initiatives by multilateral donors for small and medium enterprises in the DCFTA countries were boosted; progress was achieved on visa liberalisation and on relaxing tariff rate quotas for Ukraine.

4 In this regard, the experience of investment promotion agencies in Central European countries (e.g. PAIIZ in Poland, SARIO in Slovakia or CzechInvest in the Czech Republic) could be helpful.