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# **How to Intensify and Diversify Ukrainian Exports? The Case of Bilateral Trade with Germany**

This policy brief focuses on trade relations between Ukraine and Germany. In particular, it analyses bilateral trade in goods and examines the possibilities for increasing Ukrainian exports to Germany, in both the extensive and the intensive margins. The brief identifies prospective product groups for such increases and discusses potential obstacles to trade intensification. Finally, it provides recommendations for the further trade development.



## German-Ukrainian trade

Germany has recently become one of the most important trading partners for Ukraine. In 2018, Germany was fifth in terms of Ukrainian export destinations and third in terms of its import source countries. While Ukraine, not surprisingly, is less important for German international trade (in 2018, Ukraine ranked 42<sup>nd</sup> in terms of Germany's export and 45<sup>th</sup> in terms of its import), bilateral trade between Ukraine and Germany showed positive dynamics over the last five years.

Since Germany is a member of the European Union, its trade relations with Ukraine are regulated by legislation common for all EU member states. The EU's political and economic cooperation with Ukraine is stipulated by the Association Agreement (AA). The AA is a

comprehensive agreement provisioning the Deep and Comprehensive Free Trade Area (DCFTA) between Ukraine and the EU. While the provisional application of the AA began in the fall of 2014, the document fully entered into force on September 1, 2017. The abovementioned intensification of trade relations between Ukraine and Germany was to a significant extent driven by the signing of the DCFTA and a loss of a significant share of the Russian market.

The main Ukrainian exports to Germany include ignition wiring sets used in vehicles, aircraft and ships; low erucic acid, rape or colza seeds, iron ores agglomerated, maize, electrical switches etc. (see Table 1). Together, the top-15 product groups at a 6-digit level of the Harmonised System (HS) give 57% of the total exports from Ukraine to Germany.

*Table 1. Top-15 Ukrainian product groups by export to Germany as of 2018* Source: UN Comtrade

Subheading	Product	Export, USD mln
854430	Insulated electric conductors; ignition wiring sets and other wiring sets of a kind used in vehicles, aircraft or ships	313,5
120510	low erucic acid rape or colza seeds, whether or not broken	308,1
260112	Iron ores and concentrates; agglomerated (excluding roasted iron pyrites)	157,5
100590	Cereals; maize (corn), other than seed	141,7
853650	Electrical apparatus; switches n.e.c. in heading no. 8536, for a voltage not exceeding 1000 volts	45,4
730441	Steel, stainless; cold-drawn or cold-rolled (cold-reduced), tubes and pipes of circular cross-section	42,6
320611	Colouring matter; pigments and preparations based on titanium dioxide, containing 80% or more by weight of titanium dioxide calculated on the dry matter	33,3
620342	Trousers, bib and brace overalls, breeches and shorts; men's or boys', of cotton (not knitted or crocheted)	32,3
722220	Steel, stainless; bars and rods, cold-formed or cold-finished	29,6
440710	Wood, coniferous; sawn or chipped lengthwise, sliced or peeled, whether or not planed, sanded or end-jointed, of a thickness exceeding 6mm	29,2
940360	Furniture; wooden, other than for office, kitchen or bedroom use	26,6
40900	Honey; natural	25,2
848220	Bearings; tapered roller bearings, including cone and tapered roller assemblies	24,9
120190	Soya beans; other than seed, whether or not broken	23,5
630790	Textiles; made up articles (including dress patterns), n.e.c. in chapter 63, n.e.c. in heading no. 6307	22,8



This brief argues that both countries are likely to gain additional benefits from further intensifying bilateral trade relations. It summarizes the results of the research (Iavorskyi P. et al., 2019) on how to further expand and diversify Ukrainian exports to Germany, it identifies the prospective product groups and obstacles to their exports, and provides policy recommendations for trade development.

## Promising products

In order to find the most promising ways for increasing Ukrainian exports to Germany, this study employs a two-step approach. First, using a normalized revealed comparative advantage (NRCA) index (Run Yu et al, 2009) we distinguish goods, which Ukraine has world-wide comparative advantage in and Germany does not. A positive (negative) NRCA indicates that country's actual share of a product in national exports is higher (lower) than the world average, – so that the country has a comparative advantage (disadvantage) in this commodity. According to this criterion, product groups with a negative NRCA for Germany and a positive NRCA for Ukraine were selected.

At the second stage, for the goods identified during the first step, a gravity model was estimated. A gravity model predicts bilateral trade flows based on the size of the economy and trade costs between them (such as distance, cultural differences, free trade agreements, tariffs, etc.). Being a general equilibrium model, it captures not only immediate impact of economic and political changes on trade between two countries, but also how it influences trade with other countries. A gap between current and potential export volumes predicted by the model is a potential for exports increase (which we refer to as undertrade).

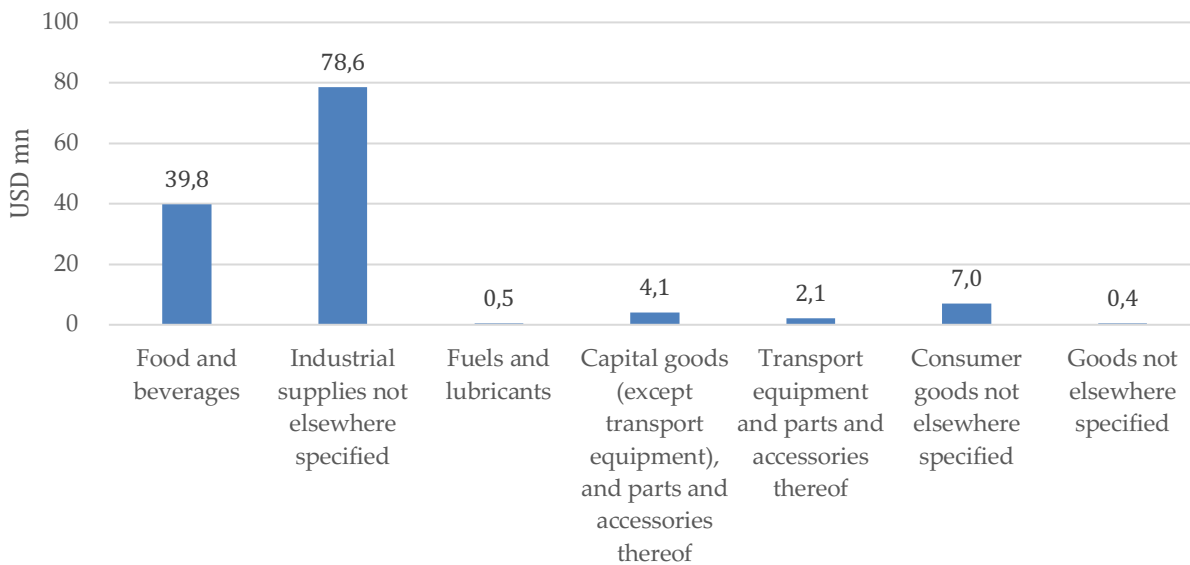
The gravity model estimates the total undertrade between Ukraine and Germany at \$ 500 million in 2016, or 35% of the total exports from Ukraine to Germany in the same year. Moreover, Ukraine has the potential to increase trade in both goods already exported to Germany as well as goods not yet supplied by Ukrainian companies to this market.

As for the structure of our findings, agricultural and mining commodities, as well as products of traditional Ukrainian export industries, such as metallurgy, are widely represented on the top of the undertraded commodity list. For example, more than a half of the estimated undertrade falls on primary food and primary industrial supplies, such as soybeans, barley, tomatoes, grain sorghum, iron ore, zirconium ores, etc. These categories already account for a large share of the current exports composition, and production in these sectors provides for a significant share of employment. Foreign currency inflow stipulated by exporting these products is also important for the Ukrainian economy.

At the same time, the undertrade in categories of final consumption, capital goods and transport is much lower. However, these product groups are important for exports diversification. These, for example, include liquid dielectric transformers, refrigerator cabinets, telescopes, tugs and pusher craft in capital goods, rail locomotives, railway cars, gas turbine engines in transport; automatic washing machines, electric space heaters, fans, coffeemakers, synthetic curtains, and leather apparel in consumer goods. Despite the complex regulation and relatively small amount of estimated undertrade, export diversification from primary to manufactured goods is important for overcoming export instability and long-term economic growth (Cadot et al. 2013), which is why promotion of trade in such areas is important.



Figure 1. Estimated undertrade according to broad economic categories



Source: Own calculations based on UN Comtrade data

## Obstacles to trade

Following the abolition or reduction of EU import duties between Ukraine and the EU under the DCFTA, tariffs do not significantly restrict exports of Ukrainian goods to the EU. Instead, technical regulations, sanitary and phytosanitary measures, geographical indications, licensing, etc. create significant barriers to bilateral trade. Thus, "non-tradability" can be explained, for instance, by the negative effects of various non-tariff barriers (both at European and national levels) or other factors, such as low competitiveness (in terms of price or quality) of Ukrainian goods compared to similar goods supplied by other countries, taste preferences of German consumers, peculiarities of importers' associations, specific requirements of retailers, etc. Thus, harmonization of Ukrainian regulations with those of the European Union in accordance with the AA will help reduce customs barriers and existing divergences in regulations, and thus simplify the export of Ukrainian goods to the EU and Germany in particular.

## Policy recommendations

Based on the findings of the qualitative and quantitative research carried out, Ukrainian policy makers are advised to:

- Timely and effectively align Ukrainian legislation, standards and practices with those of the EU, in line with the Action Plan and Commitments undertaken by Ukraine under the DCFTA within the framework of the AA with the EU, in particular in such areas as technical barriers to trade, sanitary and phytosanitary measures, customs, and protection of intellectual property rights.
- Accelerate preparations for the signing of the ACAA (the Agreement on Conformity Assessment and Acceptance for Industrial Products) for the top three priority sectors of Ukrainian industry, which Ukrainian authorities agreed with European side, namely in the areas of low-voltage equipment, electromagnetic compatibility and machine safety, which will boost industrial technological exports to the EU and other countries.



- Conduct government level negotiations with the EU and Germany regarding the removal of those barriers to the single market faced by the promising Ukrainian goods that will not be lifted as a result of harmonization of regulations with the European ones.

- Take advantage of the Regional Pan-Euro-Mediterranean Preferential Rules of Origin Convention (the Pan-Euro-Med Convention), which establishes identical rules of origin for goods between its member-states under free trade agreements, and will facilitate the opening of new production facilities and involvement in regional and international value chains.

- Provide information and consulting support to local manufacturers and exporters regarding the most promising destination markets, help them find partners on such markets, advise on the best ways to penetrate such markets by organizing trade missions, etc.

Another push to the German-Ukrainian trade promotion may arise from facilitating German FDI to Ukraine. German entrepreneurs and investors are interested in localizing German production facilities in Ukraine and establishing joint German-Ukrainian enterprises, STIs, in particular in such areas as agriculture, light industry (including textiles), civil engineering, renewable energy, and circular economy (GTAI 2018a, 2018b, 2018c). This form of cooperation also boosts Ukrainian exports, since such enterprises often produce intermediate inputs for German production. **In order to promote joint enterprises setup Ukraine should:**

- Establish effective mechanisms for protecting foreign investments, including export-oriented ones.

- Ensure the rule of law and effective protection of property rights.

- Create favorable macroeconomic conditions to ensure access to financing for both Ukrainian and foreign businesses.

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