Understanding the EU's Association Agreements and Deep and Comprehensive Free Trade Areas with Ukraine, Moldova and Georgia

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Overview of macroeconomic trends in Georgia, Moldova, and Ukraine under the Association Agreements since 2014

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Abbreviations

AA	Association agreement
CIS	Commonwealth Independent States
COVID-19	Coronavirus disease
DCFTA	Deep and comprehensive free trade area
DPL	Development Policy Loan Program
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EU	European Union
FDI	Foreign direct investments
GDP	Gross domestic product
GEL	Georgian lari
ICT	Information and communication technology
IFI	International financial institutions
IMF	International Monetary Fund
NBG	National Bank of Georgia
NBM	National Bank of Moldova
NBU	National Bank of Ukraine
PPP	Purchasing power parity
SBA	Stand-By Arrangement
SIGMA	Support for Improvement in Governance and Management
TAIEX	Technical Assistance Information Exchange
UAH	Ukrainian hryvnia
USAID	United States Agency for International Development
USD	US dollar
VAT	Value added tax
WB	World Bank
WJP	World Justice Project
WTO	World Trade Organisation
bn	billion
m	million

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1. Introduction

The year 2020 has brought enormous challenges for the entire world. The COVID-19 triggered the global economic crisis with risks of high unemployment, a decline in real disposable income, and the need to find fiscal space to finance increased health needs and support the business during lockdowns.

Georgia, Moldova and Ukraine got a chance to strengthen their economies after 2014, when they signed the Association Agreements (AAs) with the EU, embedding the establishment of the DCFTAs. The AAs envisaged a broad spectrum of reforms, aimed at making all three economies more resilient and sustainable, partly thanks to deeper economic ties with the EU.

Moreover, between 2014 and 2019, all three countries were supported by the IMF on their path towards the implementation of much-needed reforms. All three succeeded in achieving macroeconomic stabilisation, although the implementation of the reform programs was not smooth.

Another common factor for all three countries is their unresolved secessionist confrontations with Russia. However, only Ukraine is in active military conflict with Russia after the latter annexed Crimea and occupied a part of Donbas in 2014. In the case of Georgia, a creeping occupation takes place at the so-called dividing line with occupied South Ossetia, while there is a standstill situation with occupied Abkhazia.

In this article, we analyse whether the three countries used the window of opportunity provided by the AA/DCFTAs to become more sustainable, prosperous and resilient by the time they entered the coronacrisis in 2020. The economic developments during the coronacrisis are not considered.

The article is structured as follows. We start with the policy framework in all three countries and then proceed to the discussion of major macroeconomic parameters, including data for the economy as a whole, the fiscal policy and external sectors, and labour market. In the end, we provide conclusions.

2. Policy framework

The provisional application of the Association Agreements between the EU and Georgia, Moldova and Ukraine began in 2014. The AAs envisages extensive institutional changes and legal harmonisation with the EU *acquis* in multiple political and economic spheres, with the particular focus on trade-related changes foreseen in the Deep and Comprehensive Free Trade Areas (DCFTAs).[2] The broad scope of reforms and tasks embedded in the AAs has affected the reform agenda in all three countries. The reform efforts have been supported by the EU technical assistance through TAIEX, SIGMA and Twinning and financial support, funded under the European Neighbourhood Instrument.

The implementation of the AAs, including the embedded DCFTAs, was expected to result in the acceleration of economic development in all countries (*see Annex)*. Real GDP was expected to grow faster, taking into account better access to the EU market and higher

[2] See https://3dcftas.eu/publications/ for Handbooks reviewing three AA/DCFTAs and for other publications on the reforms implementation in all three countries

inflow of investments. At the same time, the implementation of the DCFTA was also expected to help in lowering consumer inflation.

Moreover, between 2014 and 2019, the IMF supported the three countries in support of their macroeconomic and financial stability, and to put them on the path of sustainable economic growth.[3] The IMF support was essential for each of them in this period.

Table 1: The "3" DCFTAs and the IMF*

Country	The IMF program
Georgia	*SBA in July 2014[4] (SDR 100 m), cancelled in 2017* In 2014, the external outlook worsened, which opened a balance of payments needs. The widespread poverty and high unemployment were among the challenges faced by the Government, and the response required fiscal stimulus. Only two disbursements were made in the program (in 2014 and 2015).
	EFF-supported program in April 2017 (SDR 484 m) Georgia is not graduate from the SBA program due to lack of political will to implement intended changes. After the October 2016 parliamentary elections, the authorities committed to implement policy reforms to boost economic growth. High level of state debt, broadened fiscal deficit, as well as external vulnerabilities, were the focus of the new EFF program. The Program implementation delayed, and it was extended to 2021.
Moldova	*Arrangements under the EFF and the ECF in November 2016 (SDR 86.3 m and SDR 43.1 m, respectively)* Moldova faced a substantial banking crisis in 2014 after USD 1.0 bn was fraudulently taken from the banking system with the apparent collusion of public authorities. As a result, the country suffered a political crisis. Simultaneously, the economic crisis occurred in 2015 with a decline of real GDP due to several reasons, including in the sharp drop in real exports due to the trade embargo imposed by Russia, and a bad harvest due to unfavourable weather conditions. The political turmoil did not permit fast cooperation with the IMF. Only at the end of 2016, the Government formulated the reform agenda to assure a sound banking sector and a more robust

[3] The IMF web-site contains all the respective documents on the cooperation with three DCFTAs: https://www.imf.org/en/countries
[4] The previous Fund-supported program expired in April 2014.

Country	The IMF program
	economy overall. The country was generally on track with the program in 2016 and 2017. In 2018, the IMF suspended the program after the Government passed a package of controversial tax and capital amnesty laws. The corrective measures to return program on the track were approved in 2019. As a result, the IMF Executive Board completed the 4th, and the 5th reviews under the program and the program extension was approved. The Program was successfully completed in March 2020.
Ukraine	*SBA in 2014 (about SDR 11 bn), cancelled in 2015* Ukraine's economy suffered a severe economic downturn in 2014 after Russia annexed Crimea and occupied part of the Donbas region. High external vulnerabilities, high fiscal pressure, and the substantial general government deficit all required support from the IMF and other international partners. The program arrangement was prompt due to the fast decisions taken by the Government. It was substituted by the EFF in 2015.
	EFF-supported program in 2015 (SDR 12.3 bn), cancelled in 2018 The economic crisis appeared to be deeper than initially expected in 2014. The war required a substantial increase in fiscal spending on defence and security, while the economic downturn negatively affected fiscal revenues. The country faced double deficits: high general government deficit as well in the balance of payments. As a result, there was an urgency to substitute the SBA-2014 with the longer and larger support under the EFF. The Program was not completed but replaced by the SBA in 2018.
	Bridge SBA in 2018 (SDR 2.8 bn) Ukraine did not implement all the reforms envisaged in the EFF while approaching double elections scheduled for 2019. The EFF program was to expire in spring 2019. Therefore, the Government asked the IMF to arrange the SBA to help the country to pass through the election period. The Program again was not completed (only the first tranche was disbursed).
	After the elections of the president and the parliament, the new Government started the negotiations with the IMF on a new EFF-supported program in September 2019. The staff-level agreement was reached at the end of 2019; however, two prior actions were

Country	The IMF program
	not fulfilled. As a result, the negotiations continued into 2020. The new staff-level agreement on the program was approved in May 2020. *SBA in 2020 (SDR 3.6 bn)* New 18-months SBA was approved by the IMF Executive Board on June 9, 2020 (with access equivalent to about USD 5 bn). The focus of the program is made on mitigating the economic impact of the coronacrisis and ensuring economic and financial stability.

Note: SBA – Stand-By Arrangement, EFF - Extended Fund Facility, and ECF - Extended Credit Facility.*
Source: https://www.imf.org/en/countries

The IMF programs in all three countries created an additional push for market-oriented reforms. The following measures were present to some extent in all programs:

- Fiscal consolidation with the extension of the tax base and containment of current expenditures;
- Price stability through improved inflation targeting;
- Greater exchange rate flexibility that allows for an increase in international reserves;
- Financial sector strengthening; and
- Structural reforms implementation.

The EU contributed co-funding of all three IMF programmes.

The international rankings of three countries did not show consistent results, though the rankings by the Doing Business and Index of Economic Freedom improved for all three countries (see Table 2). Moldova and Ukraine have achieved substantial progress in the improvement of business regulation, while Georgia had good positions in rankings already in 2014. At the same time, there was slight or insignificant changes in the Corruption Perception Index, the Global Competitiveness Index, and the Human Development Index.

Table 2: The "3" DCFTAs in international rankings

Name of index	Georgia		Moldova		Ukraine	
	2014	recent year*	2014	recent year*	2014	recent year*
Index of economic freedom	22	12	110	87	155	134
Doing Business	8	7	78	48	112	64
Global Competitiveness Index, 2013/14 and 2019	72	74	89	86	84	85

Name of index	Georgia		Moldova		Ukraine	
	2014	recent year*	2014	recent year*	2014	recent year*
WB Government Effectiveness Index (Percentile Rank), 2014 and 2015**	72	74	39	36	40	38
WJP Rule of Law Index, 2015 and 2020	29	42	69	82	70	72
Logistics Performance Index (LPI), 2014 and 2018	116	119	94	116	61	66
Corruption perception index, 2014 and 2019	51	44	103	120	142	126
Human Development Index, 2013 and 2019	79	70	114	107	83	88
The Legatum Prosperity Index, 2014 and 2019	57	53	88	81	94	96

*Note: * 2020, if not specified otherwise*
*** Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to the lowest rank, and 100 to the highest rank.*
Source: the web-pages of respective indices

The indices reveal that Georgia, Moldova, and Ukraine share the same problems, including a weak rule of law and low efficiency of the judicial system, which is depicted by the *WJP Rule of Law Index*. Improvements in the effectiveness of government administration are required in all three countries, even though the situation varies. Ukraine and Moldova are reported to have higher levels of corruption, which create a challenge for the investment climate.

Still, the improved macroeconomic situation and gradual progress in reforms implementation resulted in the improvement of credit ratings of all three countries:

- *Georgia*: Fitch improved the credit rating from BB- in October 2014 to BB in February 2019. Standard & Poor's credit rating for Georgia stands at BB.

- *Ukraine*: Fitch gradually improved the credit rating from CCC in 2014 to B in 2019. S&P's credit rating improved from CCC- in December 2014 to B in September 2019.

- *Moldova*: Moody's set the credit ranking for Moldova at B3 in 2015 and 2017, though the outlook was improved from negative to stable. The rating B3 with stable outlook was affirmed in 2019.

All three states suffered costs from trade restrictions imposed by Russia during the period under review. Moreover, the continuous conflicts with Russia result in higher

uncertainty in all countries hampering investment climate. In particular, Ukraine's economy was harmed by broken supply chain due to the annexation of Crimea by Russia and occupation of part of Eastern Donbas. Moreover, Ukraine should spend up to 5% of GDP on defence and security due to the military conflict in the East. Moldova has not solved the issue of Transnistria, which is *de facto* under the control of Russia, which imposes restrictions on government policies. Meanwhile, Georgia did not achieve the progress on the reconciliation with regions of Abkhazia and South Ossetia. Moreover, Russian forces are continuously pushing further the dividing line with occupied South Ossetia on the territory controlled by Georgia and kidnapping people, which results in broken supply chains and contributes to poverty.

Overall, between 2014 and 2019, Georgia, Moldova and Ukraine have conducted a large set of reforms on the path of implementation of the AA with the EU and/or the IMF programs. These reforms impacted the economic development of all three countries. Still, the list of structural reforms to be conducted remains substantial. In particular, there is a need for improvement of the rule of law, with an increase in fairness and efficiency of the judicial system.

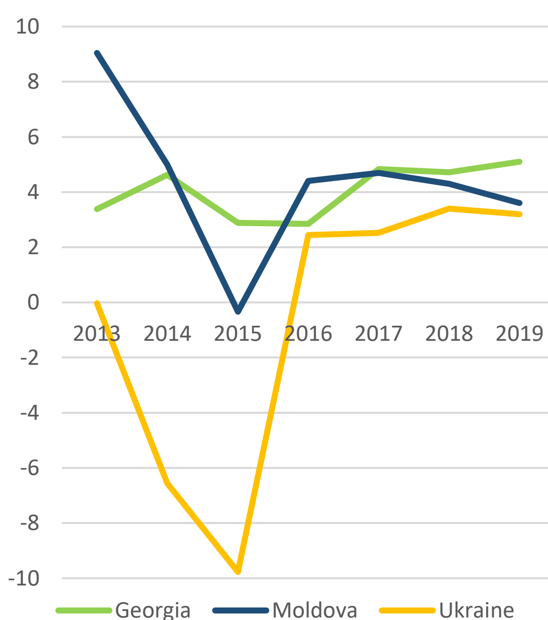
3. GDP

Summary

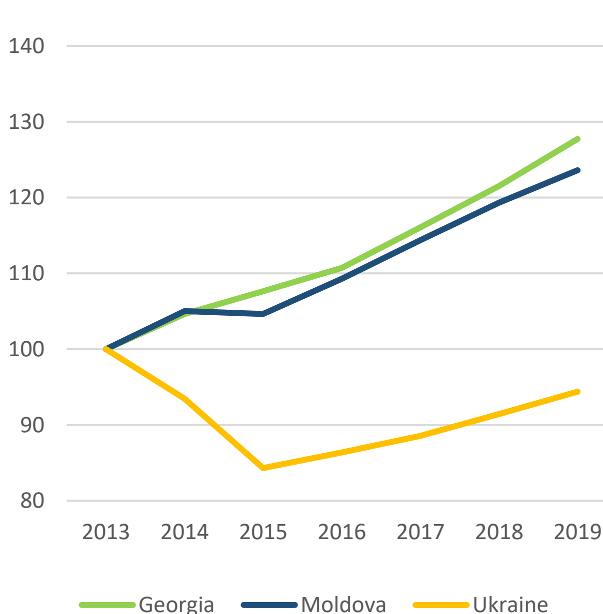
The economic dynamics of the three countries was quite different between 2013 and 2016, but in 2017-2019 all three countries achieved stable economic growth. Domestic demand was a driving force of economic growth in all countries. External vulnerabilities declined during these years, but all three economies remained highly dependent on external factors. Still, the growth rates remained rather low, given the need to increase income levels. One of the reasons for that was low productivity. Besides, tensions with Russia (either trade or real wars) was a negative factor.

Figure 1: Real GDP in Georgia, Moldova and Ukraine

Real GDP growth rates, %



Real GDP index, 2012 = 100



Source: WEO, April 2020

Georgia

The economy of Georgia showed resilience despite the deterioration of the economic performance of main trading partners in 2014. Still, the economic growth in the country decelerated to 2.9% on average in 2015-2016 due to the weak external environment in main trading partners (in particular, Russia and Greece) and low productivity (which hampers competitiveness). As a result, industrial production declined by 1% in 2015. At the same time, growth was supported by the growth of non-tradable sectors.

Real GDP growth accelerated to 4.8% in 2017 and remained close to this level in 2018. Economic performance of Georgia was supported by increased domestic and external demand.

In 2019, Russia imposed sanctions in the tourist sector on Georgia, which resulted in the GEL's depreciation and acceleration in inflation. Still, the economy turned out to be resilient to this external shock, and real GDP grew by 5.1%. Private consumption, net exports, and public investments positively contributed to economic growth.

Still, structural weaknesses undermine the potential economic growth in the country. They include low productivity, high unemployment (despite its decline) and skills mismatches.

Moldova

Moldova is one of the poorest countries in Europe. It relies heavily on remittances by migrants and foreign trade.

The trade ban of Russia imposed in 2013-2015 and simultaneous reduction of remittances from Moldovans working in Russia hampered the economic development of the country in 2014 and 2015 due to lower exports and domestic demand. In particular, in 2015 exports to Russia declined by 43.2%, while remittances from labour migrants in Russia reduced by about 30%. Besides, Moldova's exports to Ukraine more than halved due to the economic crisis in Ukraine.

Additionally, the economic development in 2015 was also seriously harmed by the banking crisis that occurred in late 2014, taking into account that three banks had to be liquidated. This as well as political turmoil resulted in a termination of international financial assistance by the IMF, the World Bank, and the EU in summer 2015. All factors above resulted in sharp deceleration of leu against US dollar (by 10% in 2014 and an additional 25% in 2015). Overall, the economic growth at 5.0% in 2014 switched to the decline in real GDP at 0.3% in 2015.

Financial assistance of international partners was restored at the end of 2016 after the Moldovan Government introduced reforms under the IMF program. Overall, financial support of the IMF and other donors, including the EU, have been essential for the macroeconomic sustainability of the country.

Investments and private consumption were crucial drivers of economic growth in 2016-2019. Still, during recent years public and private investments started playing a higher role in economic growth. Consumption was supported mainly by remittances, even though the part of the latter declined during recent years. Net exports had a negative contribution to economic growth.

Ukraine

Ukraine faced a steep reduction in real GDP in 2014-2015 due to military aggression from Russia and the loss of territories, couples to the banking and foreign exchange crisis. The Government had to respond with the implementation of major reforms, which were backed up by the IMF. That included the banking reform, which resulted in the closure of numerous banks. Besides, the Government went through an unprecedented fiscal consolidation. Administrative tariffs for gas and heating for the population were sharply increased, which along with the sharp depreciation, resulted in a surge of inflation by almost 50% in 2015. At the same time, social safety nets were introduced in the form of housing and utility subsidies for households to pay higher housing and utility bills. A new transparent public procurement system was built, tax administration improved, and the transparency of public data was increased.

All these measures achieved macroeconomic stability. In 2016 real GDP increased by 2.4% It accelerated in 2017-2018, but it remained insufficient to compensate for the initial drop. Domestic demand – both investment and final consumption – were the major driving forces, while the contribution of net exports to economic growth was negative.

Still, hryvnia depreciation and decline in purchasing power of households against the background of somewhat favourable external conjuncture contributed to the improvement of the current account balance (which was positive in 2015). Increase in remittances from labour migrants (in particular, working in the EU) also had a positive impact on the current account balance.

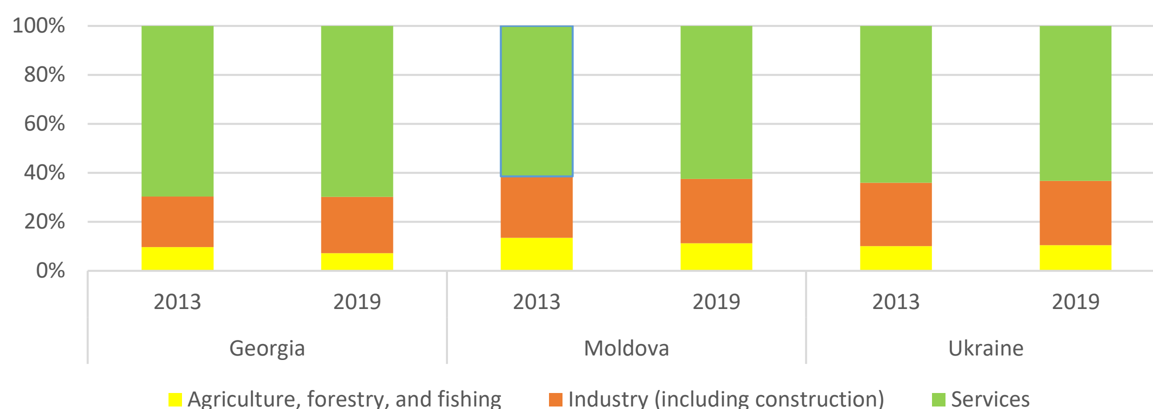
In 2019, real GDP increased by 3.2% after a sharp deceleration of growth in the last quarter of the year. In particular, industrial output declined due to weak external demand, the decline in world prices of metals, hryvnia appreciation, and reduction in the production of tobacco products. Consumer inflation reduced to the lower bound of the inflation target and was equal to 4.1% year on year in December 2019 due to the decline in the price of imported natural gas and hryvnia appreciation. The current account deficit narrowed to only 0.7% of GDP in 2019 due to high remittances and exports.

4. Sectoral trends

Summary

At the aggregate level, the structures of the three economies are very similar to the services sector as the primary source of the value added. Despite the traditional perception of agriculture playing a dominant role in the region, the share of the agriculture has been rather small primarily due to low productivity, varying from 7.8% of gross value added in Georgia to 12% in Moldova and Ukraine.

Figure 2: The structure of value added in Georgia, Moldova, and Ukraine



Source: World Bank database

Georgia

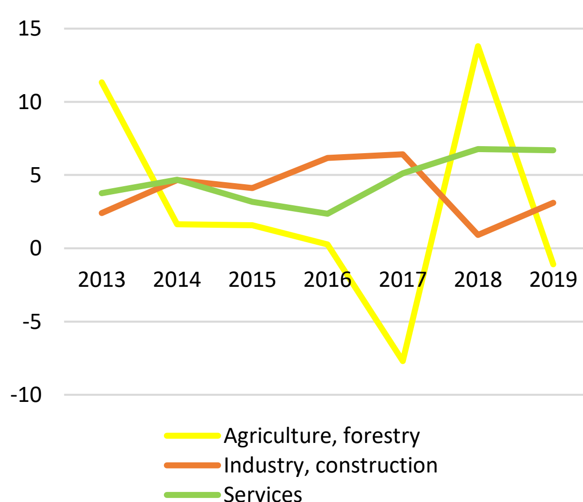
Services account for nearly two-thirds of GDP with most services, apart from tourism, dependent on domestic demand: domestic trade, transport, restaurants, financial services, and communication.

In manufacturing, the largest share is attributed to food, beverages, and metal and mineral products. Then more or less similar shares belong to, chemicals (e.g. fertilisers), medicines, plastics and rubber, and apparel products.

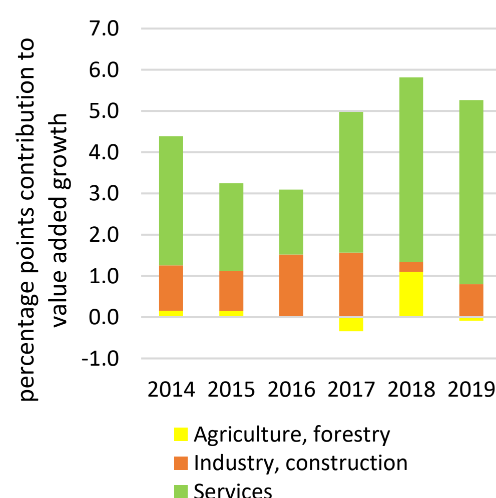
Agriculture accounts for about 7% of Georgia's GDP. The efficiency and productivity of the sector are rather low due to outdated machinery, small land plots and low labour productivity. There is also a lack of access to cheap and long-term financing from banks, although there are several state programmes providing farmers with grants and loans co-financing. Besides, the output in the sector depends on the external factors that cannot be controlled. In 2017, agricultural output declined due to a stink bug invasion.

Figure 3: Trends in sectoral structure, Georgia, 2013-2018

Real growth rates of sector value added, % yoy



Sector contribution to gross value added growth, percentage points



Source: World Bank database, own estimates for 2019

Moldova

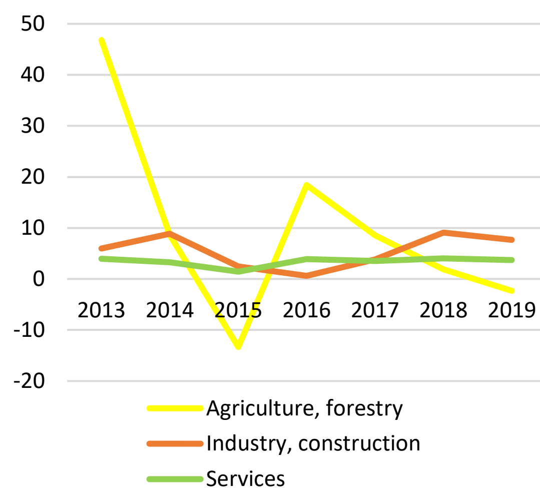
Agricultural sector plays a crucial role in Moldova. It stands for about 10% of GDP but employs around 30% of the workforce (from which about one fifth are classified as self-employed) due to low labour productivity. The main products include vegetables, fruits, grain, grape, sunflower seeds, milk and milk.[5] Agriculture is a strategic supplier of raw materials for the agri-food sector and is essential for exports.

The role of the industrial sector declined over the years, even though it is still a large employer (of about 17% of the workforce). Manufacturing stands for 11% of GDP. The automotive sector in free economic zones saw strong growth in recent years and is the largest exporter. Food processing and textiles, apparel and footwear are also among the largest sectors in generating value added. Construction growth over recent years was attributed to increasing pubic investments.

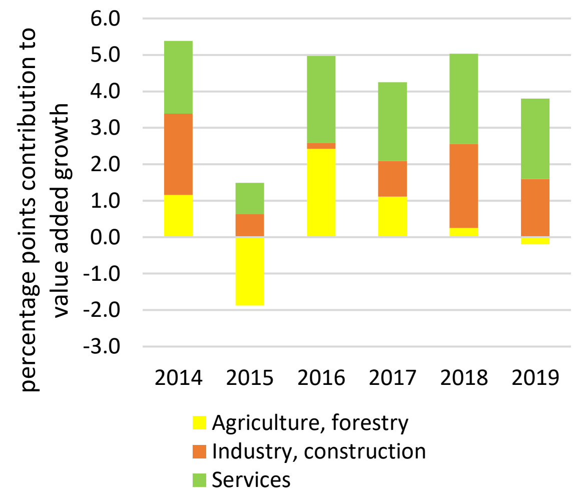
Insurance, legal consultancy, and ICT drive growth of the services sector, which now accounts for slightly more than half of GDP. Besides, the increase in private consumption contributes to the strong growth of retail trade.

Figure 4: Trends in sectoral structure, Moldova, 2013-2019

Real growth rates of sector value added, %



Sector contribution to gross value added growth, percentage points



Source: World Bank database, own estimates for 2019

Ukraine

Services and agriculture are the main drivers of the economic growth in Ukraine. The recovery of industrial production after the recession in 2012-2015 has lagged, dampened by both domestic and external factors. After slow growth in 2016-2018, industrial output again declined in 2019 due to the fall in metal prices, the drop in production of tobacco products (due to lower consumption), as well as the termination of work of some companies at the end of the year (due to the repairs and maintenance). Besides, the warm winter negatively impacted the production and distribution of gas, heating and water.

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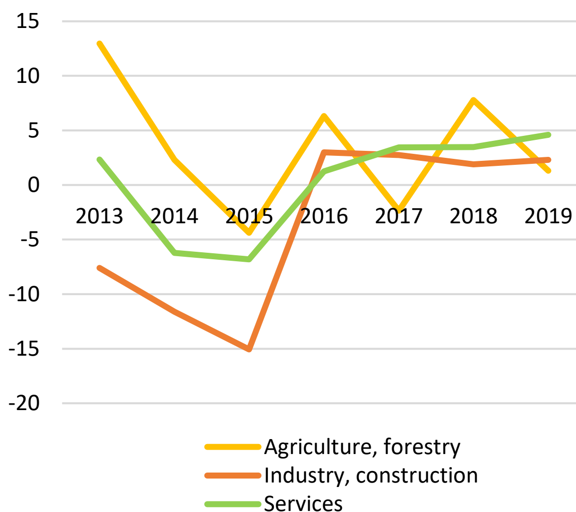
[5] https://santandertrade.com/en/portal/analyse-markets/moldova/economic-outline

Agricultural production is highly dependent on the weather. However, during recent years the grain harvest reached new record levels. At the same time, livestock production still does not demonstrate strong growth with a decline in cattle breeding. However, poultry and egg production were on a growth path supported by both strong domestic and external demand.

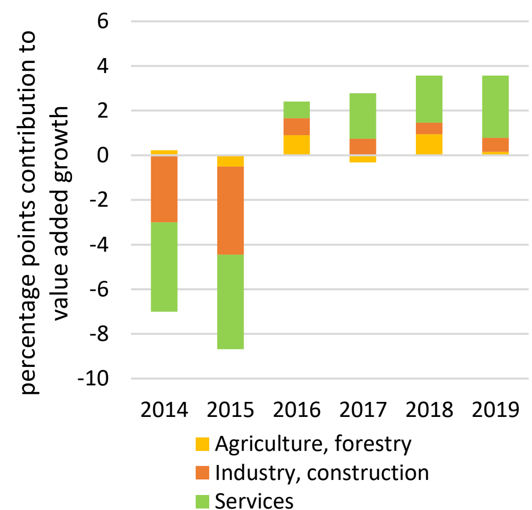
The ICT sector remains one of the key drivers in the services sector and plays an essential role in exports of services. Domestic demand growth during recent years contributed to the growth of retail trade as well as passenger transports. At the same time, the inefficiencies on railroad transportation became a bottleneck in logistics of metals and grain from Ukraine to exports.

Figure 5: Trends in sectoral structure, Ukraine, 2013-2018

Real growth rates of sector value added, %



Sector contribution to gross value added growth, percentage points



Source: World Bank database, own estimates for 2019

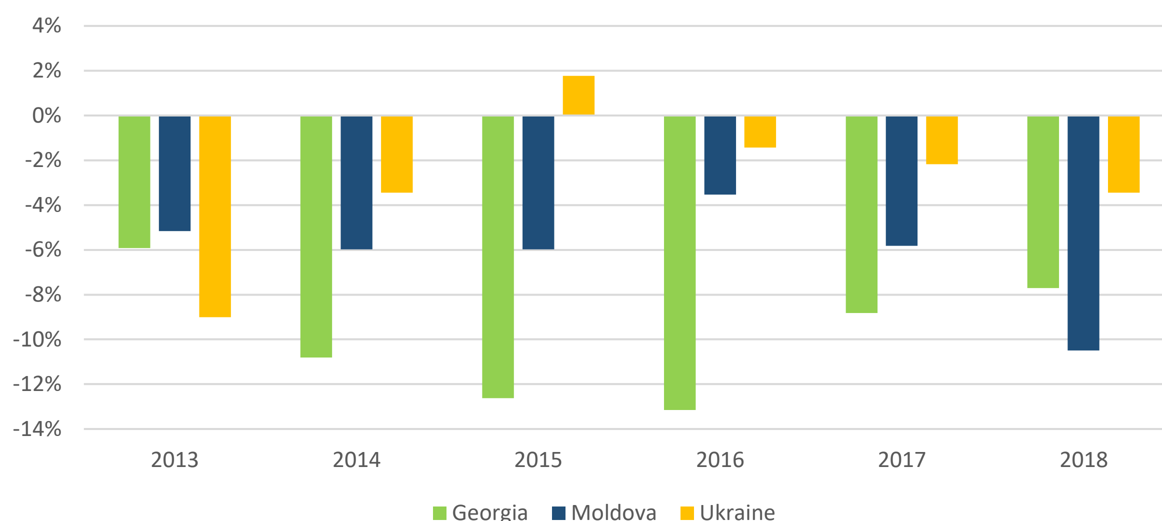
5. External balance

Summary

The trade policies of the "3" are framed not only by the provisions of the AAs but also by WTO rules. Currently, the European Union is the major trading partner for all three countries, stimulated by the DCFTAs.

The 3 DCFTA countries feature negative current account balances driven by deficits in goods and services trade. The trade deficit is balanced by remittances inflows (reducing the current account deficit) and foreign direct investments (financing it).

Figure 6: Current account balance, 2013-2018, % of GDP

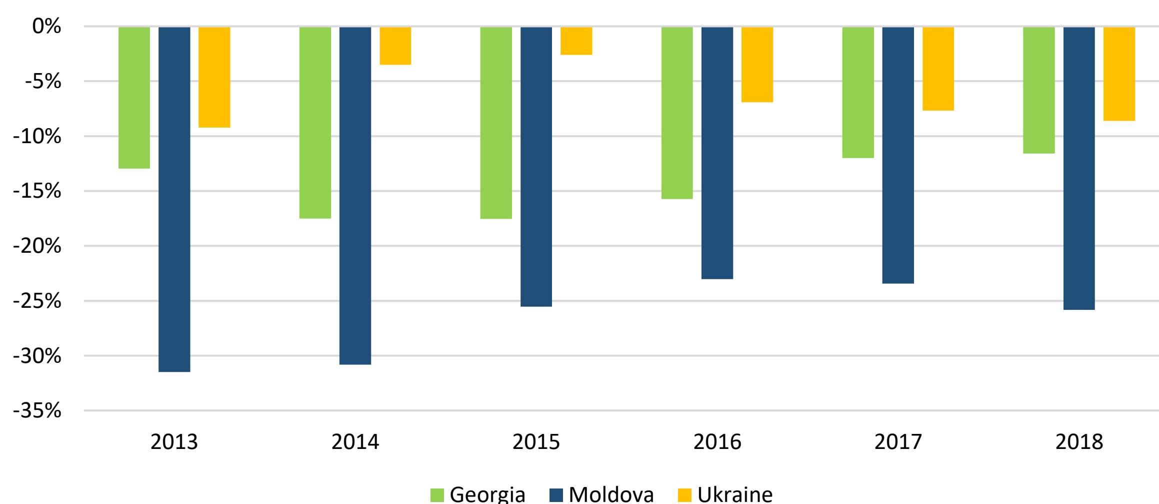


Source: World Bank database

External vulnerabilities in all three countries were exceptionally high at the beginning of 2014 with substantial depreciation of the national currencies, and lower than required foreign capital inflows. Moldova and Ukraine were challenged by trade sanctions imposed by Russia, which resulted in reduced exports to Russia. Over several years, trade with the EU increased with the implementation of the DCFTA.

One of the sources of external vulnerabilities is energy (natural gas and oil) imports, which comprise a high share of imports in all three countries and for years this was another example of their exposure to Russia's policies. However, since then Ukraine has substantially increased its energy independence from Russia through supplies of natural gas from the EU.

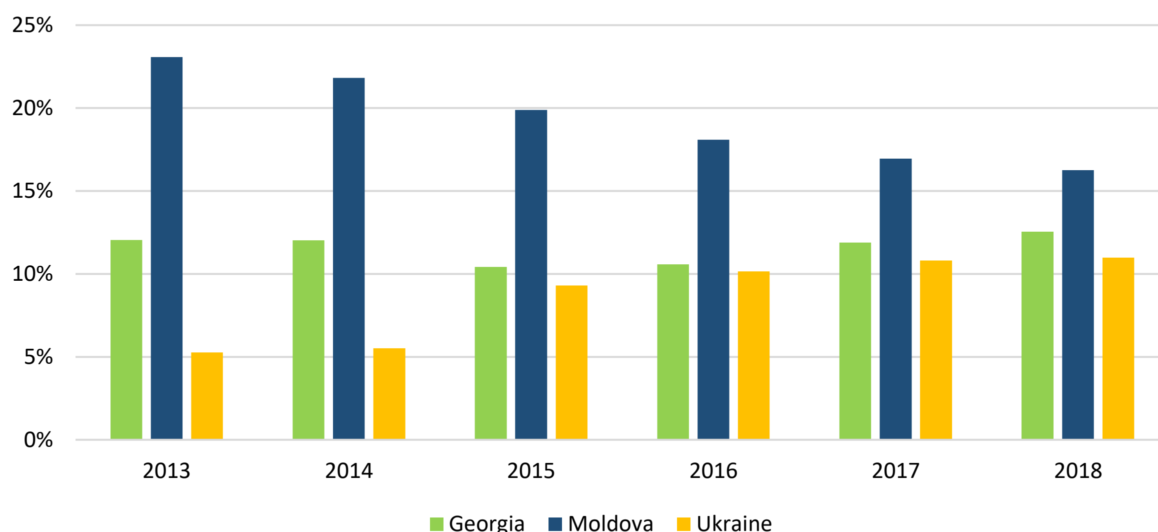
Figure 7: External balance of goods and services, 2013-2018, % of GDP



Source: World Bank database

Remittances play an essential role in all three countries. While in Georgia, remittances are rather stable at around 12% of GDP on average, in the other two countries, there were diverged trends reported. However, the sharp increase in remittances as reported for Ukraine is primarily attributed to the change in methodology by the NBU (which did not recalculate the inflow for the previous years). At the same time, the decline in remittances in Moldova was explained by much lower income from labour migration to Russia partially due to depreciation of Russian rouble as well as the consolidation of migrant families abroad.[6]

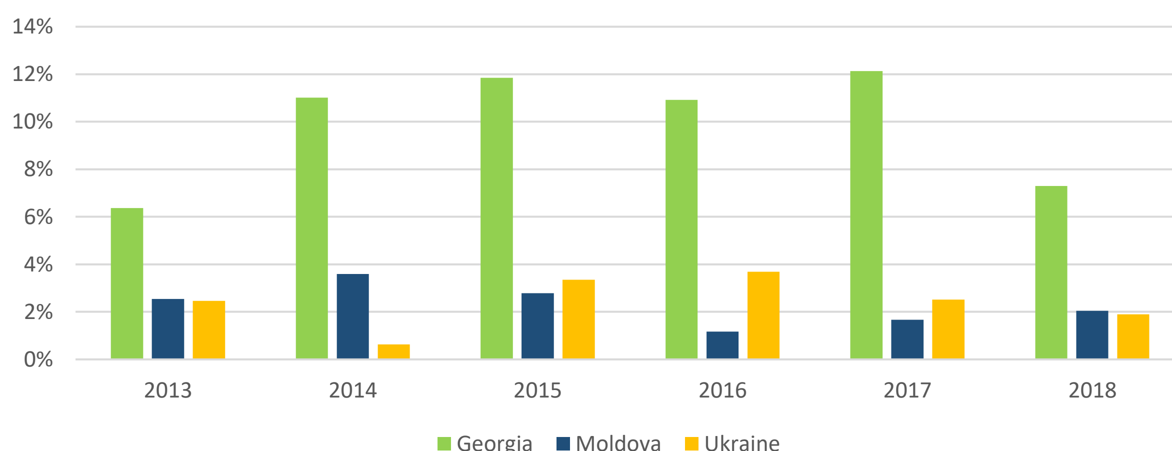
Figure 8: Inflow of personal remittances, 2013-2018 (% of GDP)



Source: World Bank database

FDI inflow is higher than remittances only in Georgia due to its favourable investment climate, including the strong protection of investors' rights and strong policies to encourage foreign investors. In Moldova and Ukraine, inflows remain low due to unfavourable investment climates; overall, in these countries, FDI is significantly lower than remittances.

Figure 9: FDI Inflow, 2013-2018, % of GDP



Source: World Bank database

[6] https://www.expert-grup.org/media/k2/attachments/MEGA_editia_XXI_engleza.pdf

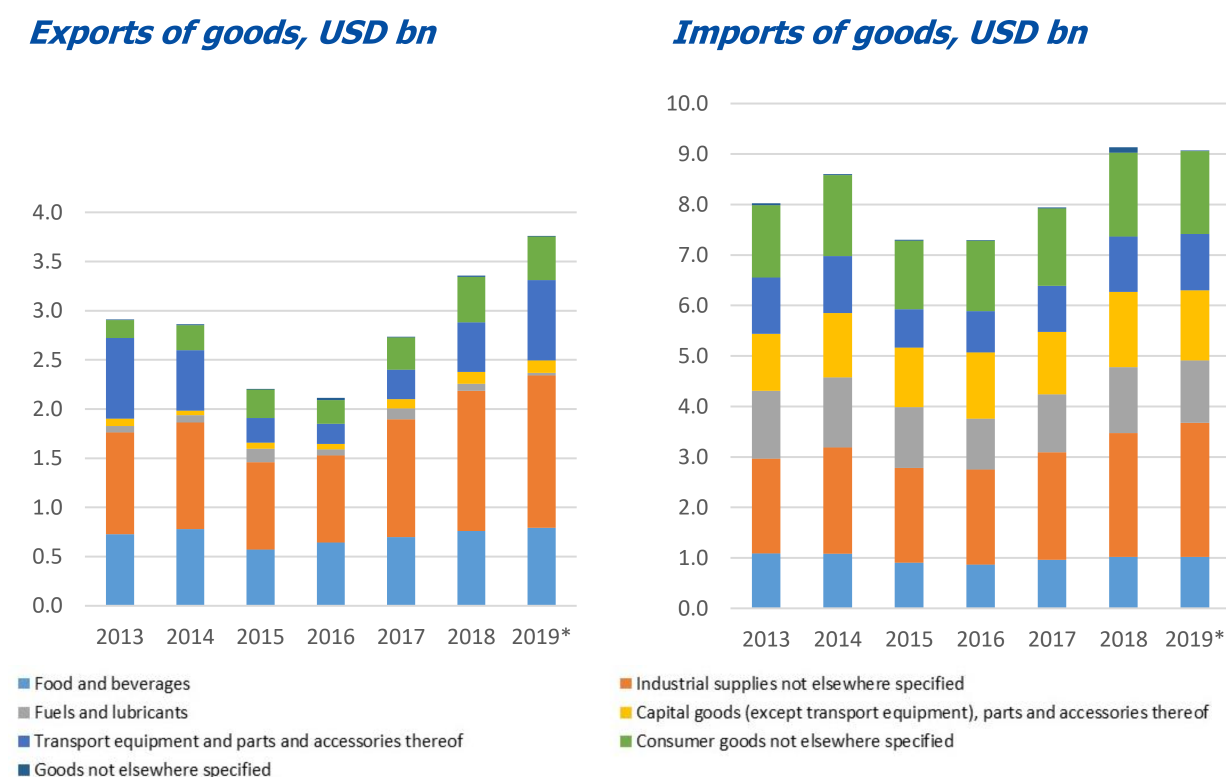
Georgia

The current account deficit in 2014-2016 widened relative to GDP to 12% in 2015-2016. It was a result of the decline in remittances, the widened trade deficit, as well as the GEL's depreciation. In particular, remittances in 2015 (primarily from Russia and Greece) dropped by 23% (in USD terms).

However, since 2017 the situation started improving with exports growing faster than imports and remittances regaining their lost momentum. Revenues from tourism grew in 2016-2018 rapidly.

In mid-2019, Russia imposed sanctions on tourism in Georgia, which along with the decline in FDI inflow resulted in the lari depreciation by 7.3% against the US dollar. That negatively contributed to imports last year. Russia's sanctions stopped the growth of inflows from tourism. Meanwhile, exports of goods increased by 12% due to higher external demand for wine and fertilisers, as well as re-export of cars and copper ores. As a result, the current account balance narrowed significantly to 4.4% of GDP in 2019.

Figure 10: Exports and imports of goods in Georgia, USD bn



Source: NBG

The share of exports to the EU increased from 20.9% in 2013 to 29.3% in 2015 primarily due to a drop in exports to Russia. In 2018 and 2019, it reduced as Russia lifted sanctions from the trade with Georgia: exports to the EU in 2019 equalled to 21.0%. Still, between 2013 and 2019 exports increased by 34.9% in nominal terms but more than doubled in real terms due to the implementation of the DCFTA.

At the same time, imports from the EU countries increased by only 2.6% in 2013-2019. Its share declined from 28.2% in 2013 to about 25% in 2019.

FDI and official loans remain the major sources of external financing. The EU is the major donor of the support to Georgia (under the European Neighbourhood Instrument). Another notable donor is the USA (through the USAID).

FDI inflow is strong, which is attributed to favourable national legislation: overall, the same national legislation is applied to both domestic and foreign companies and investors.[7] Besides, the Georgia National Investment Agency plays a proactive role in supporting all investors, including foreign investors.

Moldova

After Moldova signed the AA with the EU, Russia in 2014 imposed trade bans on Moldova's exports of fruits, canned products, and meat in addition to the already banned exports of alcohol in 2013. The EU could only partially compensate for the lost market of Russia in 2014 and 2015 but fully compensated it in the following years.[8] In particular, the DCFTA increased exports to the EU, with a notable effect on agri-food exports.

Overall, between 2013 and 2019 exports of goods increased by 11.5% (to USD 2.1 bn), while exports of services grew by 34.3% (to USD 1.5 bn). In particular, exports to the EU increased from USD 1.0 bn in 2013 to USD 1.6 bn in 2018 due to the implementation of the DCFTA (Italy and Romania are vital destinations). The share of Moldova's exports to the EU increased by 22 p.p. to 69% in 2018.

Exports of automotive industry products accounted for about 23.3% of all exports in 2019. Agri-food exports accounted for 22.9%, and manufacturing products (primarily apparel and consumer good) totalled 20.9% of goods exports. At the same time, energy resources and goods with high value added (including spare parts for the automotive industry) are essential imports products. Even though imports of goods increased by only 7.8% between 2013 and 2019, the merchandise trade deficit remained high reaching USD 3.3 bn in 2019.

Remittances play an important role in the economy. They account for about 17% of GDP on average during recent years and support consumption as well as private investments. Still, they declined from 19% of the total income of the population in 2014 to 16% in 2018. Remittances positively contribute to the current account balance. The share of remittances generated in the EU has gradually increased, while those from CIS declined, which reflects the changes in the countries of destination of labour migrants.

Official development aid plays a vital role in the financial balance of the country. The EU and the European institutions largely supported Moldova through different instruments, which were extended due to the implementation of the AA between Moldova and the EU. The USA is also an important donor of the country. The IMF has supported the country during the considered period with loans provided both to the international reserves of the NBM and for budget purposes.

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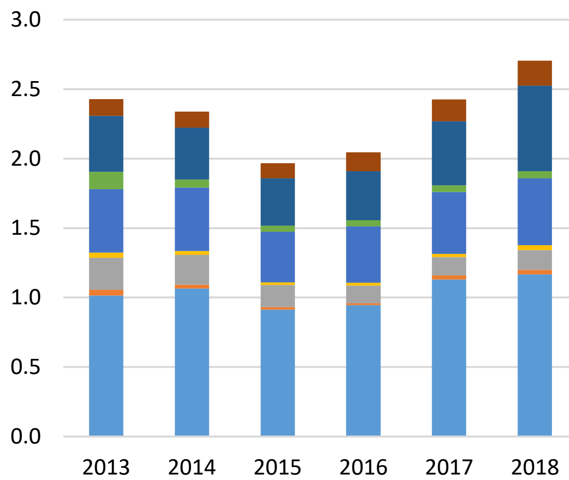
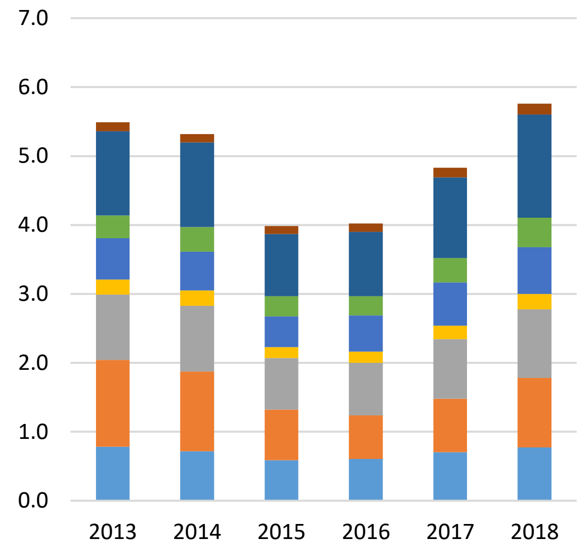
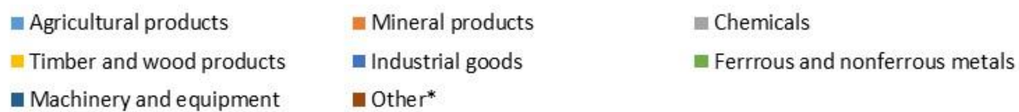
[7] 2019 Investment Climate Statements: Georgia, https://www.state.gov/reports/2019-investment-climate-statements/georgia/

[8] https://www.expert-grup.org/media/k2/attachments/Studiul_4_ani_DCFTA_en.pdf

Figure 11: Exports and imports of goods in Moldova, USD bn







Source: National statistical office of Moldova

FDI flows are essential for the economic sustainability of the country. However, the FDI inflow is insufficient for assuring adequate job creation, despite the provision of tax breaks to several large foreign companies.[9] The investment climate is hampered by political uncertainty, lack of qualified labour, high emigration, weak property rights protection.

Ukraine

Ukraine has started 2014 with the balance of payment problem due to the economic crisis. Negative financial account balance resulted in the balance of payment deficit of 10.1% of GDP in 2014. At the same time, the current account deficit narrowed in 2014 to 3% of GDP from 9% of GDP in 2013.

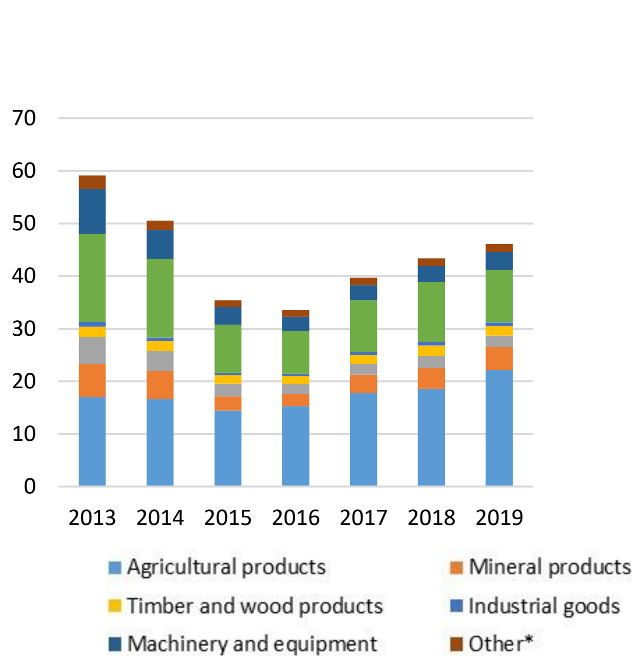
The decline in purchasing power of households and worsened financial results of companies against the background of sharp hryvnia depreciation and high inflation in 2014-2015 resulted in the narrowing of trade balance deficit (and current account surplus in 2015) due to sharp decline in imports. Besides, Ukraine sharply reduced its energy imports due to lower consumption as well as diversification of energy imports.

Prices of major Ukraine's exports, namely grain and metals, were lower in 2019 than in 2013. Overall, between 2013 and 2019 the exports of goods and services decline by 22%, while imports dropped by 25.6%.

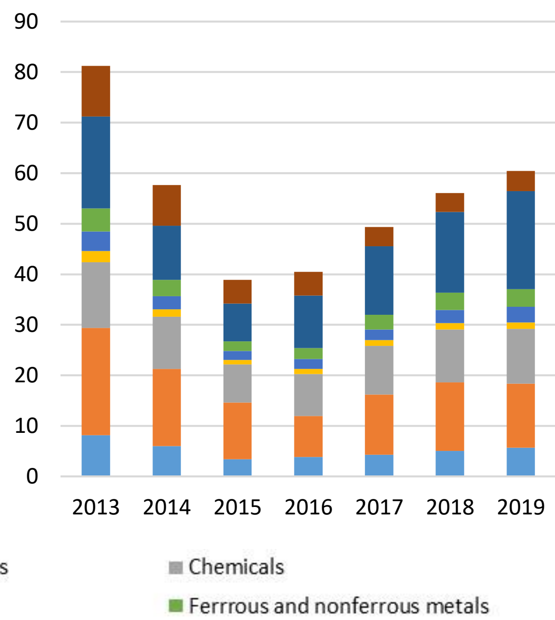
[9] 2019 Investment Climate Statements: Moldova, https://www.state.gov/reports/2019-investment-climate-statements/moldova/

Figure 12: Exports and imports of goods in Ukraine, USD bn

Exports of goods, USD bn



Imports of goods, USD bn



Agricultural products
Mineral products
Chemicals
Timber and wood products
Industrial goods
Ferrrous and nonferrous metals
Machinery and equipment
Other*

Source: NBU

During the period, Russia lost the role of the major trading partner. At the same time, the share of Ukraine's exports to the EU increased by 13.1 percentage points to 37.1%, while the share of imports from the EU grew by 9.5 percentage points to 43.1%. Moreover, the value of exports to the EU increased by 20.1% to USD 23.5 bn, while imports remained at the level of 2013 (USD 32.6 bn). Increase in exports is attributed to the DCFTA implementation.

Increase in remittances also contributed to the sustainable levels of current account deficits in 2016-2019.

Foreign investors are attracted to Ukraine by its large consumer market, high-educated labour, and natural resources endowment. Still, FDI in Ukraine remained low throughout 2014-2019 due to economic and political uncertainty, the military conflict with Russia in the East of the country, as well as weak property rights protection and poor infrastructure.[10] To fight corruption, which is one of the impediments to the FDI, under pressure from the IMF and the EU Ukrainian authorities has started building the institutional framework from entities aimed at the fight and prevention of corruption.

[10] 2019 Investment Climate Statements: Ukraine, https://www.state.gov/reports/2019-investment-climate-statements/ukraine/

6. Fiscal balance and state debt

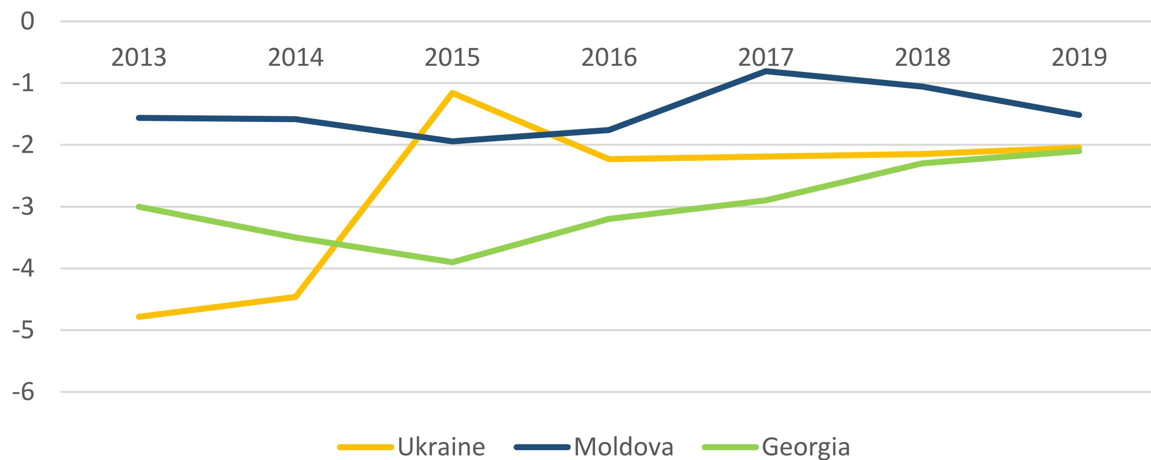
Summary

Public finances were the subject of close attention by the IMF during 2014-2019 as all three countries were under the IMF programs of in negotiations with the IMF. Overall the fiscal deficits of countries were mainly under 3% of GDP (with Ukraine as an exception in 2014-2015).

During 2014-2016 Ukraine and Moldova went through substantial fiscal consolidation due to the economic challenges they faced. Overall they followed the provisions of the IMF programs: to reduce the size of the Government, keep deficits low and conduct prudent fiscal policies.

Georgia has occasionally exceeded the IMF target and run budget deficits close to 4% of GDP. It also conducted corporate profit tax reform, which resulted in the loss of fiscal revenues from this tax, partly compensated by the increase in excise rates for tobacco and fuel.

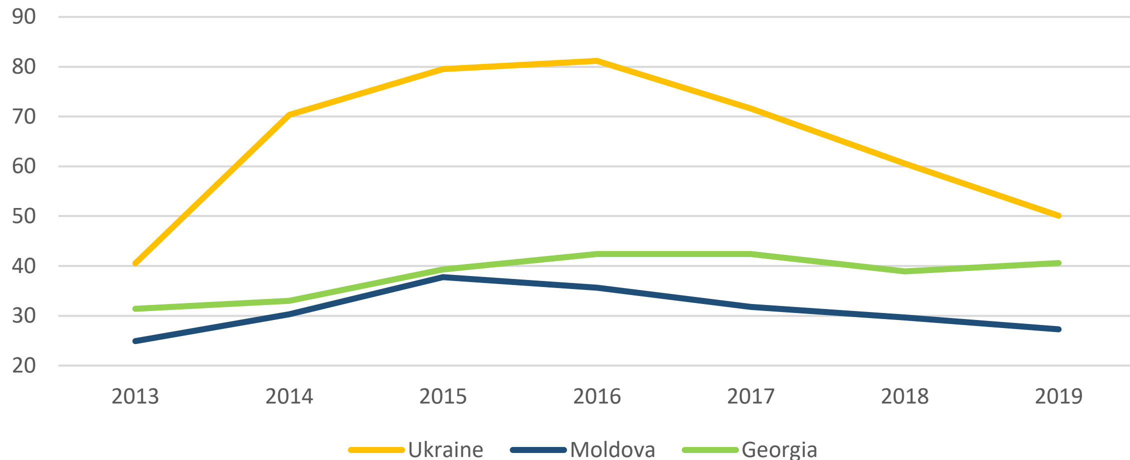
Figure 14: General Government Balance (% of GDP)



Source: WEO 2019

The public debt in Moldova remains relatively low at below 30% of GDP. In Georgia, public debt increased to around 40% of GDP in 2016 and remained at that level. In Ukraine, the sharp hryvnia depreciation in 2014 and 2015 contributed to the increase in public debt relative to GDP. All three countries are reliant on concessional lending, including from the IMF, the EU, and other IFIs.

Figure 15: General government gross debt (% of GDP)



Source: World Bank database, Ministry of Finance of Georgia

Georgia

Georgia overall attempted to run prudent fiscal policies with a view to smooth cooperation with the IMF. Still, occasionally it runs fiscal deficits above the IMF target, which resulted in the termination of the IMF program in 2017.

Since 2017, Georgia introduced an exit capital tax (Estonia type dividend tax) in the framework of corporate profit tax reform. To compensate for the loss of respective fiscal revenues, the Government increased excise rates for fuel and tobacco products, which contributed to the one-off acceleration of inflation. At the same time, current spending was frozen to free space of high public investments.

Overall, during recent years the Government defined the financing of public investments as the priority, even though pension expenditures were also increased.

Public debt increased to about 40% in 2016, primarily due to the GEL's depreciation as external debt accounts for about 80% of total debt. The further depreciation of national currency did not allow the Government to reduce the debt to GDP ratio despite substantial economic growth. Besides, the Government increased borrowings for financing investment projects, intended to improve the economic performance of the country in the medium and long run. Overall, in 2019 public debt increased marginally to 40.6% of GDP.

Moldova

The Government of Moldova has successfully restrained the fiscal deficit, which on average in 2014-2019 comprised 1.4% of GDP. In 2019 higher expenditures were allocated to social spending and wage increases against the background of elections. Budget capital spending was under-executed.

The state debt of Moldova is not high as compared to peer countries as the country relies on the revenues to the budget and grants provided by official creditors. The general government debt is estimated to decline to 27.3% of GDP in 2019 after rising to 37.8% in 2015.

In 2018 the Government narrowed the tax base and increased tax expenditures on the eve of the elections and conducted a new tax amnesty, which undermined the IMF program. However, in 2019 the Government approved a set of measures to increase revenues and strengthen the tax administration as prior actions to renew the cooperation with the IMF.

Ukraine

The economic crisis in 2014, with the paramount need to increase financing of defence and security, pushed the Government to conduct two substantial budget sequesters[11]. The IMF tranches under the new program were partially allocated for budget purposes, while the EU has provided loans under its macro-financial assistance programs. The World Bank provided financing primarily in the form of Development Policy Loan Program (DPL), while the EU launched assistance under programs of macro-financial assistance. Other IFIs also provided as concessional loans, which helped to finance investment projects.

Since 2015, fiscal decentralisation became one of the essential reforms in the country, which are evaluated to have been notably successful. It was aimed at the strengthening of local government entities both financially and economically. Ukraine has created many amalgamated territorial communities (the process is to be finalised in 2020) to ensure higher efficiency of the public finance system. These communities received higher revenues as well as more substantial liabilities, which are expected to increase the equity in access to services at a local level.

The number of taxes was reduced since 2015, and the payroll tax rate was halved in 2016. Besides, the tax administration was improved between 2015 and 2019, even though there was no comprehensive tax reform. In particular, the efficiency of VAT administration was improved, and VAT refunds became automatic. In 2019, the State Fiscal Service reforms were launched with its separation into State Tax and State Custom Services. The increase in concessional lending, sharp hryvnia depreciation in 2014 and 2015, as well as recapitalisation of state-owned banks (including the nationalisation of one of the largest banks – PrivatBank) resulted in the surge of public debt to 81.2% of GDP by the end of 2016. Overall, Ukraine secured increased concessional lending, primarily from the IMF, the EU, and other IFIs to return to the sustainable economic path of growth. During recent three years, fiscal consolidation (with fiscal deficit at about 2.2% of GDP and positive primary surplus), improved efficiency of state debt management and economic growth resulted in a sharp reduction of state debt level to 50.1% of GDP by the end of 2019.

7. Consumer prices

The national banks of all three countries use inflation targeting as a monetary policy regime: Georgia since 2009, Moldova since 2013, and Ukraine since 2016. Georgia gradually reduced the target from 6% in 2010-2014 to long-term value of 3% in 2019. Moldova and Ukraine defined 5% as their long-term value for inflation. The exchange rate in all three countries is flexible, with interventions of national banks to reduce excessive volatility and increase international reserves.

In 2014 and 2015 all three countries were challenged by the sharp depreciation of national currencies that resulted in the acceleration of inflation but to a different degree. Still, inflation in Georgia increased only to 4.0% in 2015. Inflation in Georgia and Moldova

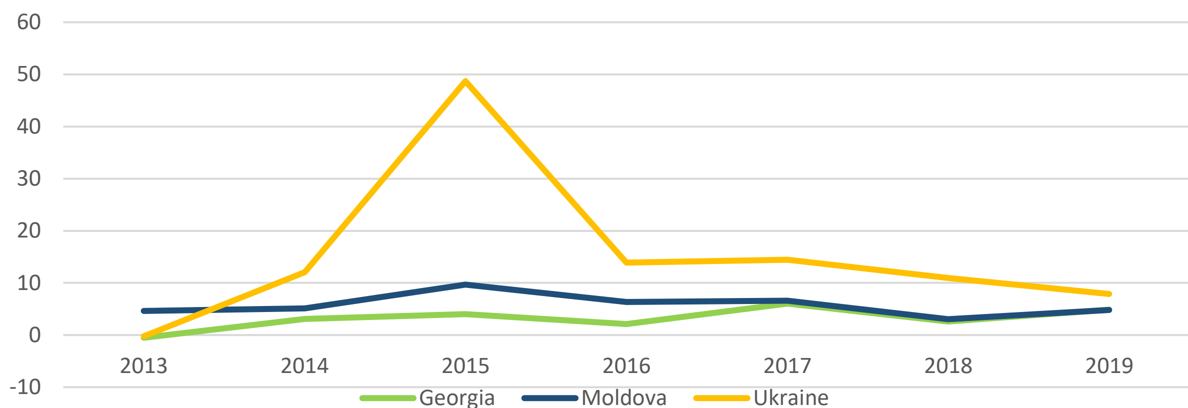
[11] As the Government faced substantial contraction of revenues the budget expenditures were reduced for most of spending items including not only capital outlays, but also financing of social spending and wages.

decelerated again already in 2016 to levels of below boundaries of inflation targets of the national banks. The hike in inflation in Georgia in 2017 was attributed to the increase in excise rates.

In Moldova, inflation accelerated to 4.9% in 2019 from 3.1% in 2018 due to the increases in regulated prices and imported-food prices. In December, it picked up to 7.5% year on year.

In Georgia, average inflation also accelerated to 4.9% on average in 2019 due to GEL's depreciation and increase in excise rates on tobacco products (with inflation at 7.0% year on year in December 2019).

Figure 16: CPI in Georgia, Moldova and Ukraine (annual average, %)



Source: World Bank database, National statistical services

Ukraine faced double-digit inflation in 2014-2017 (with inflation at 48.7% in 2015), which was attributed not only to the sharp hryvnia depreciation but also to the war on the East and annexation of Crimea as well as increases in administrative prices (e.g. gas and heating). Inflation in Ukraine reached to a single-digit number only in 2018 thanks to prudent fiscal policy and tight monetary policy. In 2019, the inflation decelerated to the lower boundary of the inflation target of the NBU (4.1% year on year in December) mainly due to hryvnia appreciation and no increases in administrative prices. The latter was partly attributed to the lower imported natural gas prices. Still, inflation on average was 7.9% in 2019.

8. Labour market

All three countries have structural problems in the labour market. All three have low labour productivity, what hampers competitiveness. Informal employment is also widespread, which impacts negatively social safety systems. Skill mismatch is a challenge for them, which puts high into agenda education reform, including the education of adults.

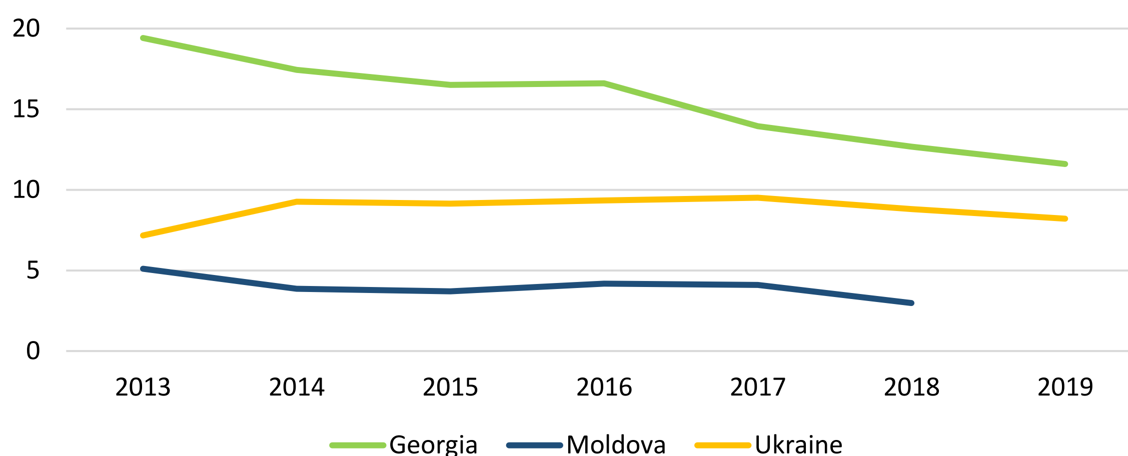
Labour migration is substantial, which creates pressure on the domestic labour markets. However, it supports economic development through high remittances.

Unemployment is at two-digit numbers only in Georgia, declining gradually to 11.6% in 2019, which is the lowest level for the last 16 years. The unemployment rate for women is lower than for men. However, more employed women are self-employed (especially in agriculture), which often is in the informal sector.

The unemployment rate in Moldova remains low at about 5%. It is explained by high emigration and employment in the agricultural sector employing around 30% of the population.

In Ukraine, the unemployment rate increased from 7.2% in 2013 to 9.3% in 2014 due to the economic crisis. It remained close to these levels in 2015-2018. In 2019, economic growth resulted in a decline in the unemployment rate to 8.2%.

Figure 17: Unemployment rate (percent of the total labour force), %

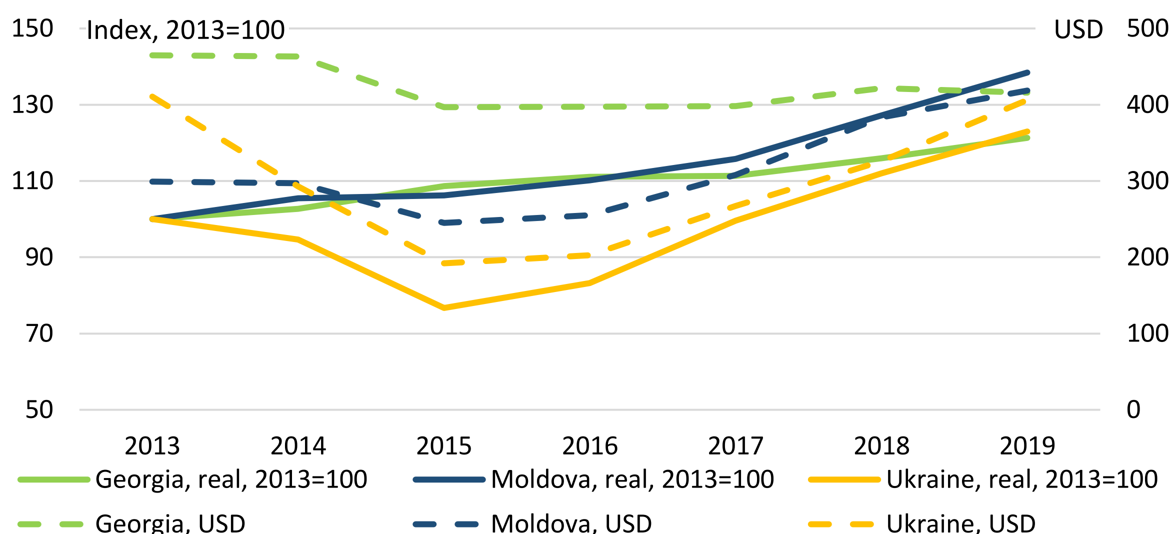


Source: World Bank data, National statistical services

Average wages in all three countries increased in real terms (see Figure) primarily against the background of economic growth and tight labour market conditions. Wages in US dollar terms increased only in Moldova, while it declined in Georgia and even more in Ukraine due to substantial depreciation of national currencies.

In Ukraine, the pattern of real wages changed from a sharp drop in 2014 and 2015 due to high inflation to the rapid growth of wage in recent years due to minimum wage increase and high labour market pressure created by labour migration.

Figure 18: Average wage in 2013-2019



Source: National statistical services and National banks of 3DCFTAs

9. Households' income and poverty

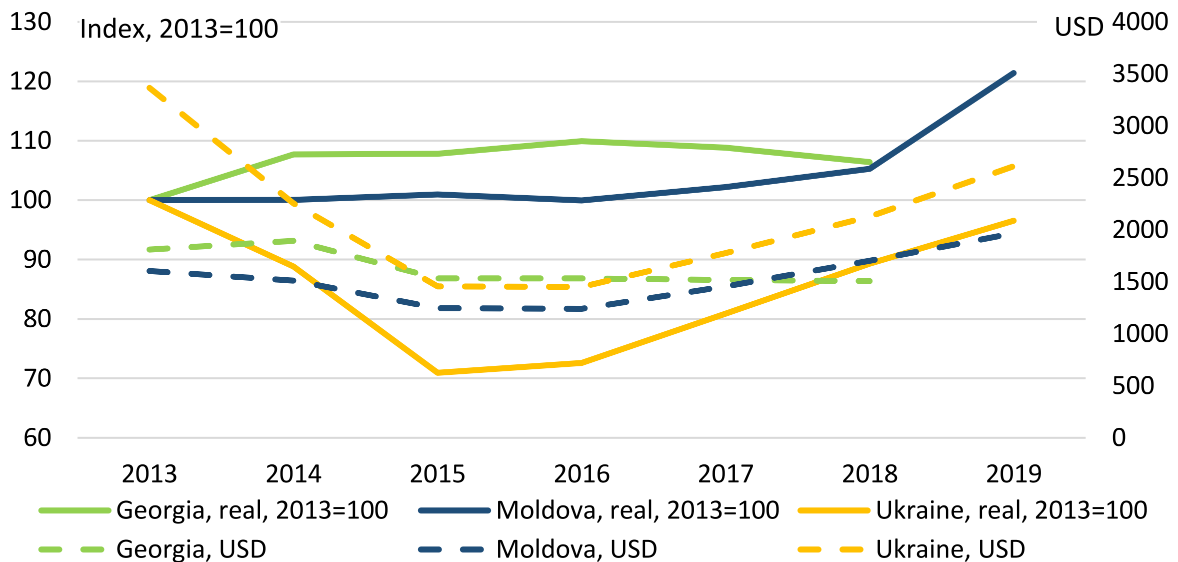
Household income levels in Georgia and Moldova in USD terms as well as their trends are similar. In Ukraine, incomes per capita are higher. However, the difference narrowed between 2014 and 2019, as Ukraine faced the period of sharp hryvnia depreciation and high inflation. The income difference is more substantial in PPP terms when the price level differences between countries are taken into account.

Overall, the factors that influence income in all three countries over the considered period are similar. Moderate economic growth and tight labour markets stimulated increases in average nominal wages in all three DCFTA countries. Remittances play an essential role in fuelling household consumption in all three countries. Still, the external vulnerabilities, namely depreciation of national currencies, negatively impacted the purchasing power of households.

In Georgia and Moldova, household income per capita grew slightly in real terms between 2013 and 2019 due to wage and pension increases. It did not change much in USD equivalent due to the depreciation of national currencies in 2014 and 2015. At the same time, household income is estimated to increase by about 20% in the PPP terms.

In Ukraine, household income per capita declined in real terms and USD equivalent due to sharp hryvnia depreciation and high inflation in 2014 and 2015. In 2016-2019, household income resumed growth backed by an increase in all income components.

Figure 19: Household income per capita*

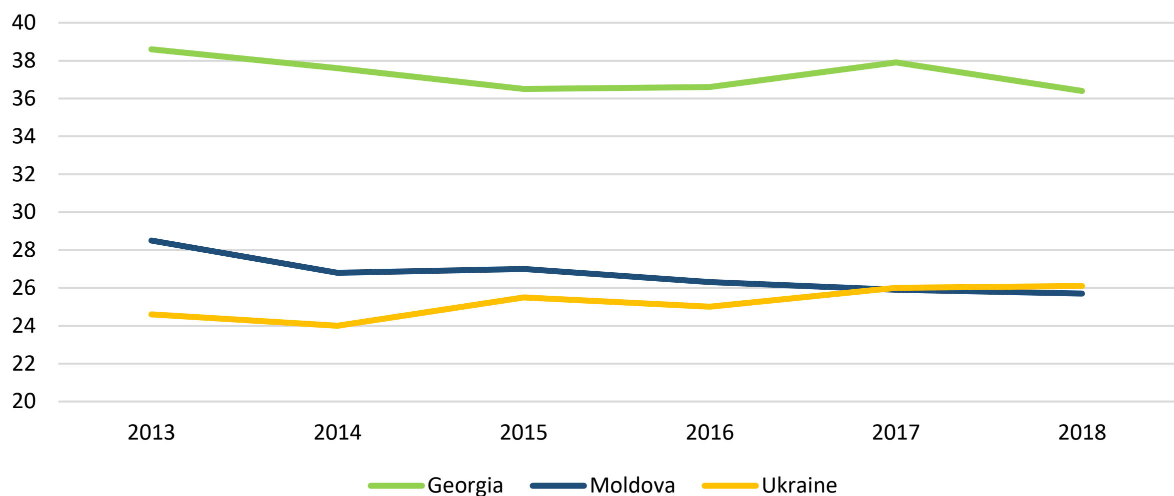


Note: for Ukraine disposable household income; for Moldova and Georgia average household income
Source: National statistical services and National banks of 3DCFTAs

In Georgia, the poverty headcount ratio declined from 26.2% in 2013 to 20.1% in 2018. According to the World Bank, the poverty headcount ratio at USD 1.90 a day (2011 PPP) declined from 6.6 to 4.5% of the population during this period. Poverty remains substantially higher in the rural area than in urban. Households with children are more like to be in poverty. Income inequality in Georgia remains high, and the Gini coefficient had only somewhat reduced from 38.6% in 2013 to 36.4% in 2018. The social exclusion factor is

estimated to be high due to low education attainment, inequity in healthcare, and high unemployment.[12] Access to credit is also unequal.

Figure 20: Gini coefficient



Note: High numbers indicate greater inequality
Source: World Bank database

In Ukraine and Moldova, the poverty headcount ratio at USD 1.90 a day (2011 PPP) is close to zero, according to the World Bank estimates. Inequality levels are still high, even though lower than in Georgia.

10. Conclusions

The economies of all three DCFTA countries have in common their dependence on the external conjuncture and political cycles. Still, between 2014-2019 the countries managed to introduce structural reforms envisaged in the AAs with the EU, signed in 2014, as well as in IMF programs. All countries faced the times of sharp depreciation of their national currencies, which contributed to higher inflation and negatively affected the growth of income and wages as well as state debt levels relative to GDP. The EU became a major trading partner for all three countries. Exports increased rapidly in nominal terms, while high demand for investment goods stimulated the growth of imports. All three countries had important IMF support programmes The EU also provided countries with financial support as well as technical support for the implementation of reforms.

Georgia showed the best economic performance among the three countries. After slow growth in 2015-2016 (about 3%), real economic growth picked to about 5% in 2017-2019. Inflation was under control (higher inflation in 2017 was a result of an increase in excise rates). The growth was supported by external and domestic demand. The external vulnerabilities in the country declined due to the growth of exports, tourism and remittances, even though external debt remains high. Fiscal sustainability was achieved, alongside increases in public investments. The banking sector was stable, despite the GEL's sharp depreciation in 2014-2015. Georgia enjoyed strong FDI inflows due to the favourable investment climate and attractive location (on the "Silk Road").

12 https://www.bti-project.org/en/reports/country-reports/detail/itc/geo/

In Moldova the economy started the period under review with serious difficulties: political turmoil, trade ban imposed by Russia, banking crisis, and unfavourable weather conditions, resulting in a decline of real GDP in 2015 by 0.3%. At the end of 2014 three of the largest banks were involved in the fraudulent appropriation of an amount close to 15% of the country's GDP from Moldova. Since then, the economic performance was rather strong with real GDP growth at 4.4% in 2016 and similar growth rates in the following two years. Growth was supported by government spending and household consumption. In 2019, real GDP growth decelerated to 3.6% due to a decline in industrial production in the 4th quarter of the year. Over the years, the FDI inflow remained lower than needed for job creation as the country was not able to ensure economic and political stability and effective property rights protection. At the same time, high labour migration resulted in high remittances, which exceeded FDI inflow.

Ukraine lags in catching up economic growth after a sharp economic decline in 2014-2015 due to the war in the East of the country and annexation of Crimea by Russia. Sharp hryvnia depreciation and two-digit inflation resulted in a decrease in the purchasing power of households in 2014 and 2015. At the same time, the external trade deficit narrowed. The state debt increased primarily due to hryvnia depreciation as well as new concessional lending. A series of several factors - fiscal consolidation, increase in efficiency of the tax system, reform of the banking sector, the proper monetary policy of the independent NBU, sound public procurement system and many other reforms, a more favourable external environment against the background - allowed the economy to grow by 3.4% in 2018. The prudent fiscal policy resulted in a decline in state debt relative to GDP. The economic performance improved substantially during the first nine months of 2019 but sharply deteriorated in the 4th quarter of the year due to the drop in industrial production. Over the years, the FDI inflow remained low as the investment climate was still weak against the background of weak property rights protection as well as the military conflict in the East.

Even though all countries improved their places in several international rankings, they still face common challenges, which include political turbulence, still low productivity, and emigration. To increase productivity, countries require investments, which still requires further reforms. Corruption and lack of property rights protection is a particular challenge for economic development in Moldova and Ukraine.

Overall, Georgia, Moldova and Ukraine improved their macroeconomic situation in 2014-2019. They entered 2020 with a more solid base and stable path of economic growth, though at still low rates. All three countries, therefore, entered 'coronacrisis' with stronger fiscal, financial, and external buffers to fight with the negative impact of COVID-19 on the economy in 2020.

Annex: Expectations of the AA cumulative impact on three DCFTA economies

Georgia

	Short term	Long term
GDP, %	1.7	4.3
Exports, %	8.9	12.4
Sectors of exports increase	Fruits and vegetables, livestock and meat products, electronics, chemicals	
Imports, %	4.4	7.5
Wages, %	1.5	3.6
CPI, %	-1.0	-0.6

** No-Doha results*

Source: Trade Sustainability Impact Assessment in support of negotiations of a DCFTA between the EU and Georgia and the Republic of Moldova. Final report. By Ecorys and Case, 2012/12: EU-Georgia and EU-Moldova DCFTA, https://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150105.pdf

Moldova

	Short term	Long term
GDP, %	3.2	5.4
Exports, %	14.8	16.2
Sectors of exports increase	Grains and crops, sugar, chemicals, metals, vehicles	
Imports, %	6.4	7.7
Wages, %	3.1	4.8
CPI, %	-1.0	-1.3

Source: Trade Sustainability Impact Assessment in support of negotiations of a DCFTA between the EU and Georgia and the Republic of Moldova. Final report. By Ecorys and Case, 2012/12: EU-Georgia and EU-Moldova DCFTA, https://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150105.pdf

Ukraine

	Short term	Long term
GDP, %	2.3	5.3
Wages for high-skilled, %	2.5	3.1
Wages for low-skilled, %	5.0	5.0
Sectors of exports increase	Meat and animal fats, machinery & electronics, metallurgy and distribution services	

Source: Trade Sustainability Impact Assessment for the FTA between the EU and Ukraine within the Enhanced Agreement, Ref: TRADE06/D01, By Ecorys and Case, 2007/12: EU-Ukraine Free Trade Agreement (FTA), https://trade.ec.europa.eu/doclib/docs/2008/january/tradoc_137597.pdf

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