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Now So Near, and Yet Still So Far: Economic Relations between Ukraine and the European Union

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- Kiev is not so far away from Brussels as one might expect. Ukraine already performs quite well when compared to the other countries in the queue for entry into the EU. Especially the fiscal and external debt figures are better than in other countries. On the negative side, there is a considerable backlog with respect to the development of administrative and judicial institutional capacities, and a potential for macroeconomic instability due to monetary expansion, rising inflation rates, and real exchange rate instability.
- From a macro perspective, the most pressing issue is to end inflationary pressures resulting from targeting the exchange rate to a weakening dollar. Among the alternative frameworks available to Ukraine, the current exchange rate anchor can be made more flexible by targeting a basket made of the US dollar and the euro. Such an exchange rate anchor framework provides a clear indication to the public about monetary policy, disciplines fiscal policy, and is relatively easy to manage. Additionally, a clearer link to the euro may be useful for a greater integration into the EU.
- From a micro perspective, the most pressing issues which can be targeted in the short run are taxation and competition policy. The tax system is unstable, complex, and inconsistent. A reduction of tax exemptions could broaden the tax base and allow for lower nominal tax rates. Privatization has been rather limited in the non-traded goods sectors. Additionally, the completion of privatization needs to be coupled with a more robust and consistent regulatory framework in order to attract more FDI, as was the case in the new member states of the EU.
- Sandwiched between the EU and Russia, Ukraine is likely to derive substantial gains from EU integration. Excluding the energy sector reveals that Ukrainian trade with the EU already outperforms its trade with Russia. In addition, EU integration is likely to attract more inflows of foreign capital if the new government is able to provide a more attractive macroeconomic and institutional environment.
- Ukraine should press for fast reforms and use the "honeymoon" period of the new government to open negotiations for EU membership by submitting a formal application. This will, among other things, help to prevent vested interest groups from blocking the reform process. A pragmatic approach for an integration strategy would include four elements: identifying reform priorities; harmonizing Ukraine's legislation with EU law; undertaking steps to get a market economy status from the EU; and, finally, signing a free trade agreement with the EU.
- The EU, on its side, should actively support the continuation of the reform process in the country, especially with respect to institution building. Finally, one must stress that the EU itself will gain from this enlargement, as it has gained from all the previous ones. In our view both sides are now facing a historic opportunity that should not be missed, neither by Kiev nor by Brussels.

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1 Introduction

After several months of political conflict, a new leadership was elected in Ukraine in late 2004. Viktor Yushchenko's Presidential Inauguration took place in Kiev on January 23, 2005. This election followed months of high drama, domestic strife, and different degrees of external involvement, but is also perceived as a harbinger of change and hope, after the 10-year-long government of Leonid Kuchma.

Since 1996, Ukraine repeatedly has stated its intention to become a member of the European Union (EU). So far, the EU has shown little enthusiasm towards a potential Ukraine's membership, with even rather dispiriting statements by some EU officials,[1] while the Ukrainian government itself has shown a rather limited commitment to actually introduce the necessary reforms to achieve such a stated goal: Kuzio (2003) aptly describes the EU–Ukrainian relationship as a *virtual* one.

With not only a new, more Western-oriented government in Kiev, but with an enlarged European Union with 25 member states—several of them with a direct stake in a prosperous and stable Ukraine—and long direct borders with the former Soviet Union, the moment to seriously reassess a potential Ukrainian membership has arrived. The aim of this paper is to analyse such a possibility, as is our view that both sides are now facing a historic opportunity that should not be missed, neither by Kiev nor by Brussels.

1.1 Ukraine after Independence: A Brief Review

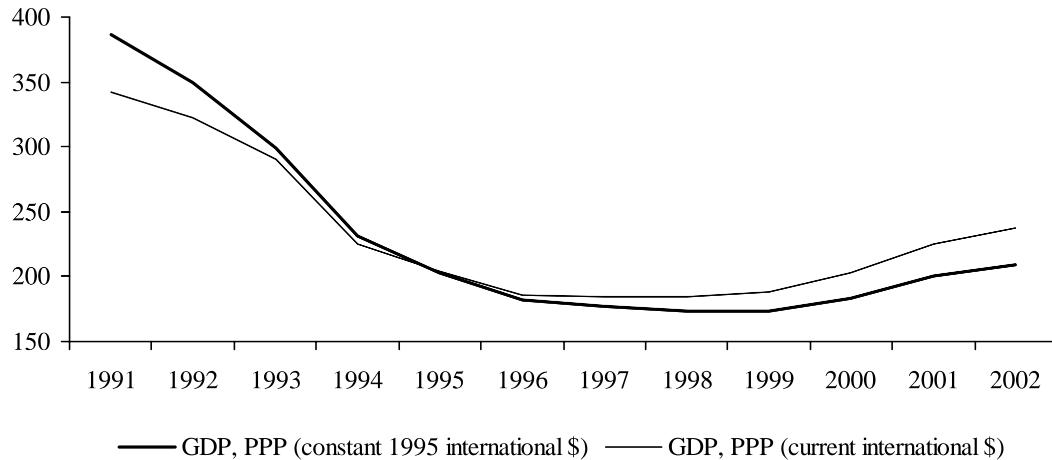
Ukraine only decided to opt for independence from the late Soviet Union after the August 1991 attempted coup by anti-reformists in Moscow: before that Ukraine had a very limited experience with a national governance (the first national government in Ukraine was formed in 1917, but the country lost sovereignty several years later). One must remember that such a limited experience with nationhood, far from being unique to Ukraine, is mirrored by several of the new EU member states (for this group we will use the acronym NMS throughout the paper to indicate the nations that entered the Union in May 2004): the Czech Republic, Estonia, Latvia, Lithuania, Slovakia, and Slovenia either were only created as national entities during the 1990s, or had very limited previous nationhood experiences.

The Ukrainian independence movement was led by a member of the former Ukrainian Communist Party (UCP), Leonid Kravchuk, who became the first elected president of this new political entity. The early independence years were occupied by the creation of national institutions and by a limited attempt to assure macro stabilization. The limited progress in this last front led to a call for change, and Mr. Kravchuk agreed to early parliamentary and presidential elections in 1994. Leonid Kuchma, who had served briefly as prime minister under Mr. Kravchuk, defeated the incumbent president in the July 1994 election. The first Kuchma term (1994–1998) was marked by a first serious attempt to macro stabilization and by a series of pro-Western overtures.[2] Inconsistent policies, plus the Russian 1998 crisis, led to a resurgence of instability during the early years of Mr. Kuchma's second term (1999–2004), which was accompanied by a sharp deterioration of its relationship with Western partners—amid several allegations of improper behaviour by Mr. Kuchma—resulting in some moves that were perceived as an overture towards the CIS (Commonwealth of Independent States, a rather loose organization that includes most of the former

[1] Probably, the most (in)famous is the one made by the previous President of the European Commission (EC), Romano Prodi, to the populist Dutch newspaper *Die Volkskrant* on 27 November 2003.

[2] Including the signing of a Partnership for Peace with NATO: significantly, the linkages of the Ukrainian military with its Western counterparts have been considerably more consistent than the ones observed in other spheres. Ukraine holds a NATO training centre at its Yavoriv military base and has already participated in several NATO operations (most notably in Kosovo, with the joint Ukrainian-Polish Battalion (UKPOLBAT) of KFOR, and in Bosnia; Ukrainian troops are also based in Iraq, again, significantly, under the Polish-managed sector in Southern Iraq: there are strong ethnic, cultural, linguistic, and historic ties between Poland and Ukraine).

Figure 1:
Ukrainian GDP per Capita in PPP



Source: World Bank WDI.

members of the Soviet Union) and the Russian Federation as a political alternative to the West.[3]

The strong return to growth after 1999, initiated under Mr. Yushchenko's—governor of the Ukrainian central bank, the National Bank of Ukraine (NBU), from 1993 to 1999—brief term as a Prime Minister, was followed by an increase in internal political conflict, which resulted in the change in government following the 2004 elections.

1.2 Recent Macroeconomic Performance

1.2.1 The Initial Years of Transition, 1992–1994: Output Collapse and Hyperinflation

The first years of transition resulted in substantial adjustment costs for Ukraine. This was partly due to unfavourable initial conditions: Ukraine had one of the highest shares of large-scale intermediate goods industrial enterprises of the former Soviet Union, highly integrated and dependent on the rest of the USSR economy.

Not only this made Ukraine one of the potentially most vulnerable CIS countries[4] during the beginning of "transition", but this over-industrialization[5] created a domestic industrial lobby that at first attempted to delay market-oriented reforms and later attempted to capture the state and block reforms that were perceived to be against its interests (Havrylyshyn 2000).

As a result of these elements, Ukraine suffered one of the largest cumulative declines in output among the transition countries (IMF 2004),[6] with manufacturing output declining by over 60 per cent in the first five years of "transition" (Figure 1).

Monetary and fiscal policies were clearly on an unsustainable path during this period: budget deficits were close to 10 per cent of GDP (a substantial part of which was linked to para-fiscal operations to support the energy sector, see IMF 2004). As these deficits were monetized to a large extent, they also resulted in inflation, which reached almost 5000 per cent in 1993 (Kravchuk 2002).

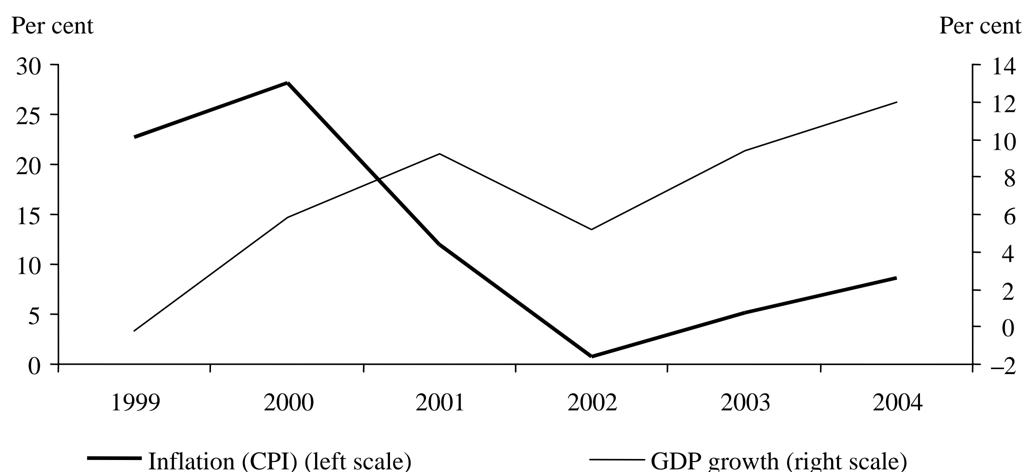
[3] Probably the more peculiar of those moves was the election of Mr. Kuchma to chair the CIS Council of Heads of State in 2003, given that Ukraine was not a *de jure* member of the CIS, as it *never* ratified the 1993 CIS Charter.

[4] At par with Belarus; see Bakanova et al. (2004).

[5] Planned economies were usually estimated to have a higher share of industry in GDP than other economies with a similar GDP per capita level: this phenomenon was called "over-industrialization".

[6] Note that "over-industrialization" and reliance on Russian markets was not always synonymous with large GDP losses, even in the absence of mineral endowments, as the case of Belarus shows (see Bakanova et al. 2004).

Figure 2:
Ukrainian GDP and Inflation, 1999–2004 (percentage change over previous year)



Source: IMF/IFS and DataStream.

1.2.2 The First Stabilization Programme and the Russian Crisis

In 1994, during the first Kuchma Presidential term, an initial stabilization programme was finally attempted. Similarly to other adjustment programmes in Eastern Europe, it included price and import/export liberalization, the unification of the exchange rate, some limited fiscal consolidation, and in 1996 the introduction of a national currency, the hryvnia, which was linked to the US dollar via an exchange rate band of 1.7–1.9 hryvnia/USD. These measures were successful in bringing down inflation from 400 per cent in 1994 to 10 per cent in 1997.

Nevertheless, the persistent fiscal deficits were incompatible with a fixed exchange rate regime. The situation came to a head with contagion from the Russian August 1998 crisis. Foreign exchange reserves fell to just over a week of imports, forcing the authorities to devalue the hryvnia (by more than 50 per cent) and to introduce strict restrictions on foreign exchange transactions. Inflation briefly increased, but returned to a downward trend by the early 2000s (Figure 2).

1.2.3 The Second Stabilization Programme: Yushchenko's Mark 1

In December 1999, Viktor Yushchenko, who in his role as a former NBU Governor had built a solid reformist reputation during and after the 1998 crisis, was appointed Prime Minister. He moved fast to introduce reforms during his brief period in power (he was voted out of office in April 2001 by a coalition of "oligarch"[7] and Communist parties, after only 16 months in power).

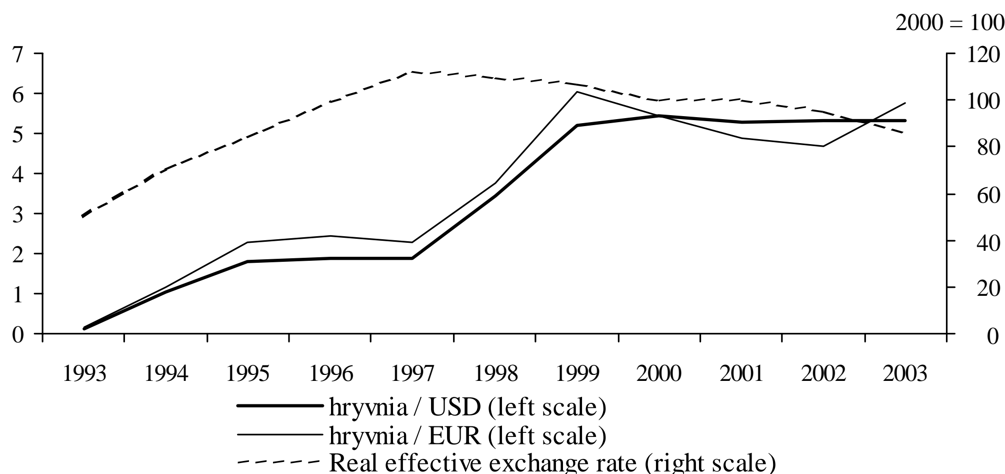
The recent strong growth resumption in Ukraine is considered by most analysts to be linked to the fiscal and tax reforms initiated during this period, the resumption of growth in major CIS markets, and to the devaluations of the hryvnia in 1998–99 and its posterior linking to the USD.[8] Given that most of Ukraine's external markets are in the euro area, the link to a weakening USD implied that the hryvnia continued to depreciate in real effective terms (Figure 3).

During subsequent years the government continued its efforts towards hardening budget constraints and making the tax system more trans-

[7] "Oligarch" is a traditional term used for the entrepreneurs that acquired large formerly state-owned assets in the CIS countries.

[8] 40 per cent of Ukraine's growth during 1999–2002 is linked to trade (World Bank 2004).

Figure 3:
Exchange Rates of the Hryvnia (USD, EUR, REER)



Source: IMF/IFS and DataStream.

parent (the general government debt ratio was more than halved between 1998 and 2004, to 25 per cent of GDP). As of January 1, 2004, the corporate tax rate was reduced from 30 to 25 per cent, and a 13 per cent flat tax on personal income was introduced. Previously, the tax base had been broadened through a significant reduction in tax exemptions. In addition, several VAT exemptions were eliminated, though these measures were not always consistent.

In 2000, a free-floating exchange rate regime was introduced (de facto the hryvnia has been kept at an almost constant rate with respect to the US dollar, by means of foreign exchange market interventions). Since 2000, the trade and current accounts have shown surpluses, leading to an increase in the money supply, as often the monetary authorities refrained from sterilizing these inflows. The main reason behind the lack of effective sterilization was the lack of sterilization instruments and ineffectiveness of NBU rates as a monetary policy tool (Bilan 2004). Also, due to the success of the stabilization policy, the demand for financial assets increased. This led to high growth rates of money supply and a credit boom (IMF 2005). To pre-empt potential financial stability problems, the NBU increased the minimum capital adequacy ratio from 8 to 10 per cent.

2 How Far Is Ukraine from Brussels?

2.1 The Current Framework for Relations between Ukraine and the EU

Current institutional relations between the EU and Ukraine are somewhat limited, albeit the EU is not only the largest external donor (since 1991 total EU assistance has amounted to more than 1 billion euros) but also the biggest economic partner of Ukraine (see next section).

The current relations are based on the Partnership and Co-operation Agreement (PCA), which was concluded in 1994 but entered into force only in 1998, for an initial period of ten years,[9] and on the EU's Common Strategy of 1999, which lasted until December 2004. Beyond those, a number of specific agreements in particular policy areas such as trade,[10] science and technol-

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[9] The PCA actually upgraded a previous agreement existing since 1990 between the EU and the late Soviet Union. By now most of its successor states have signed PCAs with the EU.

[10] Trade in textiles between the EC and Ukraine is regulated by a separate agreement, signed in December 2000. It covers an alignment of applicable import tariffs and double-checking arrangements aimed at preventing fraud. This agreement expired at the end of 2004, but is likely to be renewed. Specific arrangements for bilateral trade in steel also

ogy, and nuclear energy are also in place. Technical assistance has been provided since the early 1990s in support of the transition process towards democracy and market economy, through the TACIS (Technical Assistance to the Commonwealth of Independent States and Mongolia) Program.

Although the PCA is wide-ranging (covering political dialogue, trade in goods and services, and economic, environmental, scientific, cultural, and legal matters) and a potentially powerful instrument in bringing Ukraine's domestic legislation into line with the legal framework of the EU's Single Market and of the WTO system, as it contains a number of "evolutionary clauses" that also include the prospect of establishing a free trade area (FTA) with the EU, it is also an inherently limited framework for EU–Ukraine relations. It does not replace a traditional "Association Agreement" that has EU membership as its final aim, nor the tool used to assess progress towards EU membership, the "Regular Reports on a Candidate Country's Progress towards Accession".[11] Therefore, the degree of commitment of national authorities towards reform induced by those different instruments is not comparable.

If anything, this "non-membership" limitation was not resolved by the new EU framework for *non-enlargement* external relations, better known as the European Neighbourhood Policy (ENP).

Between March and July 2003, the European Commission (EC) issued a communication to the European Council and the European Parliament on "Wider Europe–Neighbourhood: A New Framework for Relations with Our Eastern and Southern Neighbours". The EC further elaborated the ENP in a "Strategy Paper" published in May 2004, and, for the main countries included in the ENP, individual "Country Reports" were also published at this time, including a "Country Report" on Ukraine. The ENP is supposed to cover the CIS, North African, and the Middle Eastern countries, but, somewhat peculiarly, not the South Eastern European (SEE) countries (the main instrument to regulate EU relations with these is the Stability Pact for South Eastern Europe, SPSEE[12]). This exclusion of the Western CIS from any explicit membership framework is even more curious when one remembers that, after Article 49 of the EU Treaty, *any* European state may apply to become a member (what was

exist: following the expiry of the bilateral agreement on trade in steel products that was in place until the end of 2001, a system of autonomous import quotas to the EU applies. Negotiations have been concluded on a new bilateral agreement on steel and this should be signed and enter into force in the coming months.

[11] As decided by the Luxembourg European Council in December 1997, and also stated at the "Agenda 2000", the EC produces annual "Regular Reports on a Candidate Country's Progress towards Accession". These "Regular Reports" have a predefined and very comprehensive structure which specifically shadows the implementation of the full EU's legal framework, the *"Acquis Communautaire"*. Beyond a general evaluation of the so-called "Copenhagen" criteria, all the individual chapters of the *"Acquis"* are separately evaluated (namely, there are individual analyses concerning the free movement of goods, persons, services, capital; company law; competition policy; agriculture; fisheries; transport policy; taxation; EMU; statistics; social policy and employment; energy; industrial policy; small and medium-sized enterprises; science and research; education and training; telecommunications and information technologies; culture and audiovisual policy; regional policy and coordination of structural instruments; environment; consumers and health protection; co-operation in the field of justice and home affairs; customs union; external relations; CFSP; financial control; financial and budgetary provisions).

[12] The SPSEE is a political declaration of commitment and a framework agreement on international co-operation to develop a shared strategy among all partners—including the representatives of the SEE—for stability and growth in South Eastern Europe. In the founding document of the Stability Pact, the EU, which has assumed a leading role in the Pact, undertakes to draw South Eastern Europe "closer to the perspective of full integration into its structures", *including the explicit possibility of full EU membership,* which was reaffirmed at the EU–Western Balkans Summit in Thessalonica, June 2003. As a contribution to the SPSEE and an interim step towards EU membership, the European Union set up a new generation of Stabilisation and Association Agreements (SAA). These are aimed specifically at the five South Eastern European countries which so far had no treaty-based direct relationship with the EU, i.e. Albania, Bosnia-Herzegovina, Croatia, FYR Macedonia, and Serbia & Montenegro. Two countries, the former Yugoslav Republic of Macedonia and Croatia, have already signed SAAs with the EU in April and October 2001, respectively, which are now in the process of ratification (agreements on trade and trade-related matters between the EU and the former Yugoslav Republic of Macedonia and Croatia entered into force in June 2001 and March 2002, respectively). Negotiations with Albania were launched in early 2003 and a feasibility study is in preparation for Serbia and Montenegro. For Bosnia and Herzegovina, the feasibility study was finalized in November 2003. In March 2003 Croatia submitted an application for EU membership, which was accepted on 18 June 2004.

demonstrated by the acceptance of Turkey as a candidate country in late 2004).

This said, the lack of a clear EU policy towards Ukraine's membership was more than fully matched by a rather inconsistent European policy of the former Ukrainian government, with "virtual" initiatives (like the 1998 and 2000 "National Programs" for EU accession, which aimed for the opening of accession negotiations during 2004–2007, or the re-naming of the Ministry of Economy into Ministry of Economy and European Integration) that lacked commitment towards implementation and periodic threats to opt for an "Eastern-oriented" policy (Kuzio 2003).

Additionally, one must remember that, historically, the EC was initially sceptical about *all* enlargements (with the possible exception of the Nordic-Central European accession of 1995, involving the Republic of Austria, the Republic of Finland, and the Kingdom of Sweden). The North Sea accession of 1973 (the Kingdom of Denmark, the Republic of Ireland, and the United Kingdom) was effectively subject to two French vetoes for close to 10 years—linked to the persistent French suspicions about the intentions of the United Kingdom as a EU member state—while the formal negotiations for the Iberian accession of 1986 (the Kingdom of Spain and the Portuguese Republic) lasted for almost 10 years (Vinhas de Souza 1996).[13] The 2004 enlargement wave is again a very instructive example of this: the process took close to 15 years for some countries, and that implied continued political pressure and negotiations with the Commission and the Council.[14] There is virtually no reason to expect that a comparable long-term commitment would not also be necessary for Ukraine.

On the other hand, the EU will have to clarify its accession strategy for Ukraine. For this, a review of the ENP to take into consideration explicitly further enlargements into Eastern Europe is likely necessary. The new political realities in the EU-25 (plus the strong influx of Eastern European personnel into all EU institutions) will provide the necessary support for such a review. Nevertheless, the real driver of such a strategic reassessment will necessarily be an actual formal application for membership by Ukraine, as this will overcome the natural internal institutional inertia of the EU.

2.2 Copenhagen Criteria: Broad Institutional Performance

Sustained progress in building market-based institutions is a sine qua non condition for entry into the EU. The process of EU enlargement is tightly bound to the concept of convergence. Membership to the EU demands the fulfillment of a series of political, legal, and economic criteria (Foders et al. 2002). The member candidates must demonstrate political stability as a guarantee for a democratic and lawful order, including

[13] The history of the Iberian attempts to join the then EEC (European Economic Community) is even longer than that. Looking at the Portuguese case, Portugal applied, not for membership, but for a trade agreement with the then EC as early as 1962, and again in 1967. These applications followed the first British and other EFTA (European Free Trade Association, to which Portugal belonged) countries' attempt to join the then EEC in 1961. The first UK application, and the second one in 1967, were both blocked by France. The failures of both British attempts to join the EEC affected also the negotiations with Portugal. Only after the breakthroughs at the Hague Summit in 1969—that led to the 1971's first enlargement—was an agreement possible. The *formal* application for membership was finally made in March 28, 1977. The official negotiations lasted from October, 1978, to March, 1985. However, throughout this long waiting period several steps were taken to prepare the country for membership. Portugal duly became a member of the European Union on January 1, 1986.

[14] As early as July 1989, a G-7 meeting decided to ask the European Commission to coordinate economic restructuring measures for Hungary and Poland (resulting in the creation of the PHARE Program). After a long lag, this evolved into the European Council meetings of Copenhagen of June 1993 and Essen in December 1994, which defined an overall strategy to bring the associated countries of Eastern Europe closer to the Union. As a result of this, the formal applications for membership from the Eastern European Countries (Poland and Hungary applied as early as 1994), and the publication of the "Agenda 2000" in July 1997 by the European Commission, the EU launched in March 30, 1998 official accession processes with some of these countries, but only after another Council meeting, held in Finland in December 1999, with all the applicant countries (that in 2000). The accession negotiations where concluded at the European Summit in Copenhagen on December 12/13, 2002, and the accession Treaties were signed in April 16, 2003, allowing most of them to finally become member states in May 2004 (Bulgaria and Romania have been given 2007 as a target date for their accession).

maintaining human rights standards and ensuring the protection of minorities (political criteria). Furthermore, potential members must fully implement the "*Acquis Communautaire"* (the entire body of EU law) into national legislation, and adopt the goals of the political, economic, and monetary union (legal criteria). Finally, the candidates must have a fully functioning market economy with the ability to maintain competitiveness in the internal market (economic criteria). These so-called Copenhagen criteria for EU membership insure a certain level of institutional development. This implies that institutional development will be extremely important for potential accession candidates in order to increase their chances for entry into the EU.

Accession candidates, like other emerging market economies, will also benefit directly from institutional development (Schweickert and Thiele 2004). Empirical studies clearly show that institutions are an important explanatory variable for differences in economic performance (Edison 2003, Rodrik 2003). Some authors even suggest that institutional weaknesses are the *only* fundamental reason for development failures, i.e., that long-run differences in income levels are solely determined by differences in institutional quality (Rodrik et al. 2002). The link between institution building and economic development is even reinforced by an increase in social capital and the convergence of values.[15]

Therefore, it is rational for the EU to demand institutional convergence in order to make the EU more homogeneous both economically and politically and, thereby, to decrease the decision-making costs. Any delay in the catch-up process runs the risk of conflicting assessments of political and economic problems, thus undermining the integration process. Any delay in the catch-up process will also put great stress on the EU budget in the form of transfer payments and agricultural subsidies.

Institutional development can be measured by resorting to the World Bank Governance Indicators (WBGI). In a comprehensive project (Kaufmann et al. 1999), the World Bank compiled data for a large country sample from many different sources (e.g., the Global Competitiveness Report of the World Economic Forum and the country reports of the Economist Intelligence Unit) and came up with an assessment of six indicators, which can be aggregated to three dimensions of institutional quality: *Legislative Institutions* (Political stability and absence of violence, Voice and accountability), *Executive Institutions* (Government effectiveness, Quality of regulations), and *Legal Institutions* (Rule of law, Control of corruption).

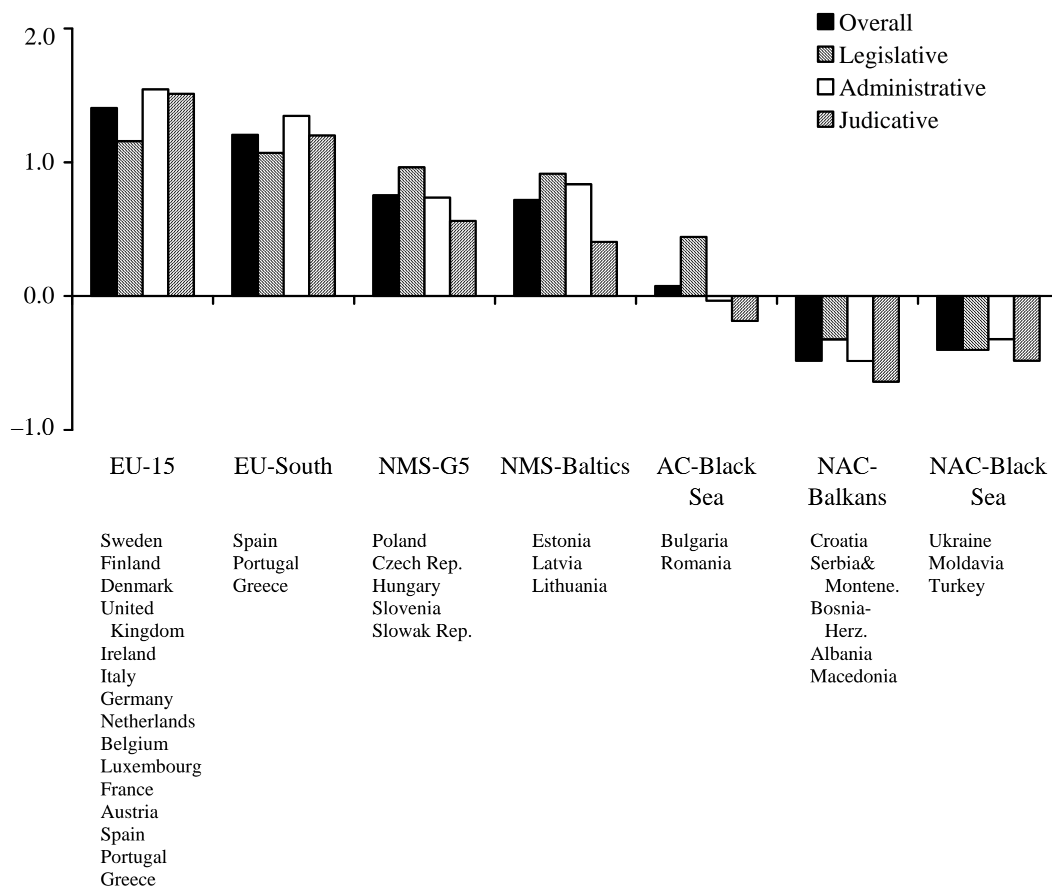
Notwithstanding technical and conceptual deficits,[16] institutions as defined by the WBGI have been proven to explain economic development. Additionally, the monitoring of the EU according to the Copenhagen criteria looks at institutions which also figure prominently in the WBGI: human rights, participation, rule of law, effectiveness of government, and control of corruption. Therefore, the WBGI provide a good basis to analyse from a bird eyes view the institutional development in the countries in the Balkan and the Black Sea regions (the Black Sea aggregate includes Ukraine) and compare their progress with the standards set by old and new members of the EU.

Figure 4 shows the quality of overall, legislative, executive, and legal institutions calculated as simple averages of the six basic WBGI on institutional development. The country groups show groups of old and new member countries as well as the remaining accession countries and other Balkan and Black Sea countries. The country groups are ordered according to the average per capita income.

[15] Economic development shifts the values of a society from "survival" to "self expression" which, in turn, fosters the process of institution building, especially the demand for democratic structures. See Inglehart et al. (2001).

[16] On the technical level, one has to keep in mind that the data are based on interviews with local experts and thus include a strong subjective element. On the conceptual level, the problem is that despite a general consensus on the institutions that have to be analysed, a number of questions about details—e.g. finding the right balance between competition and regulation —do not have a unique answer. In an article, Stiglitz (1998) even argued that with respect to competition policy a consensus is neither possible nor desirable, because economic research will not be able to identify a competition policy that is optimal for all countries at all times.

Figure 4:
Institutional Development in the EU, Balkan, and Black Sea Europe, 2002 (population-weighted averages)



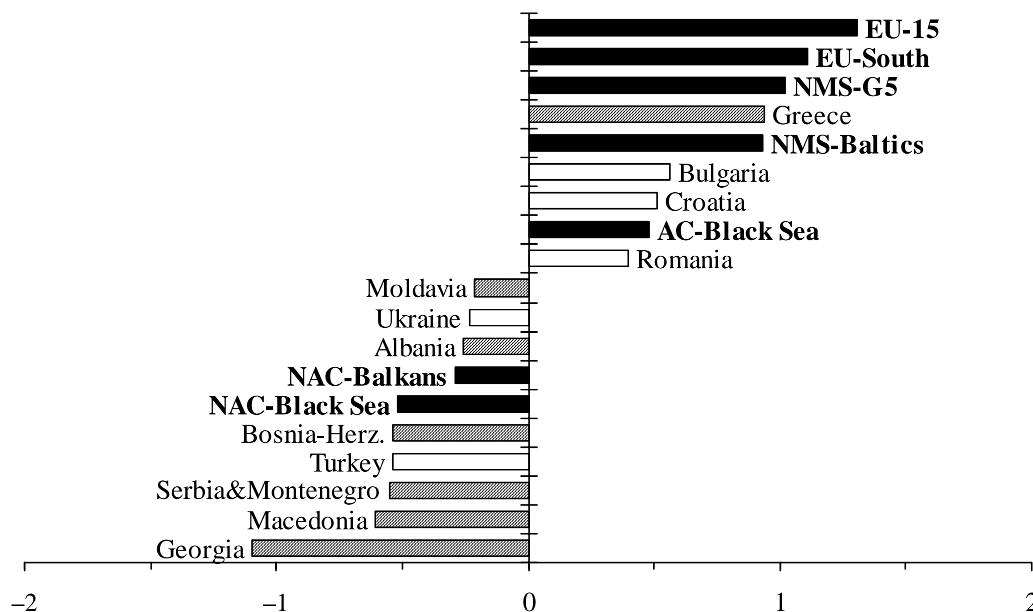
Source: WBGI; authors' calculations.

As predicted by the empirical literature, Figure 4 reveals a strong positive relationship between institutional and economic development. At the same time, it is evident that the current enlargement has already made the EU significantly more heterogeneous not to speak of future enlargement rounds ahead:

- While the southern European countries that joined the EU in the 1980s closed the institutional gap to the EU-15 considerably, the NMS reveal a significant institutional gap. This gap applies to all dimensions of institutions measured by the WBGI.
- For the remaining accession countries (AC), Bulgaria and Romania, institutional development is somewhat away from EU standards.
- Institutional development in the non-accession countries (NAC) in the Black Sea (including Ukraine) and Balkan regions is comparatively worse. Especially the Balkan countries, still suffering from disintegration and violent conflicts of the recent past and just beginning their nation building, urgently need institutional development.
- Figure 4 also shows a clear pattern of institutional development. Different to the old member states of the EU, the development of legislative institutions is far more advanced than executive and legal institutions.[17] To some extent this seems to be quite natural given the rather fast transformation from socialism to democracy and the integration into a community with internationally high democratic and economic standards. The formal introduction

[17] With the exception of administrative institutions in non-accession countries in the Black Sea region.

Figures 5:
Legislative Institutions in Europe, 2002



Source: WBGI; authors' calculations.

of laws has still to be backed up by their implementation. Neglecting the assessment of actual implementation implies that problems of integration may show up in the next years with potential negative implications for the willingness of EU member states to allow for further enlargements.

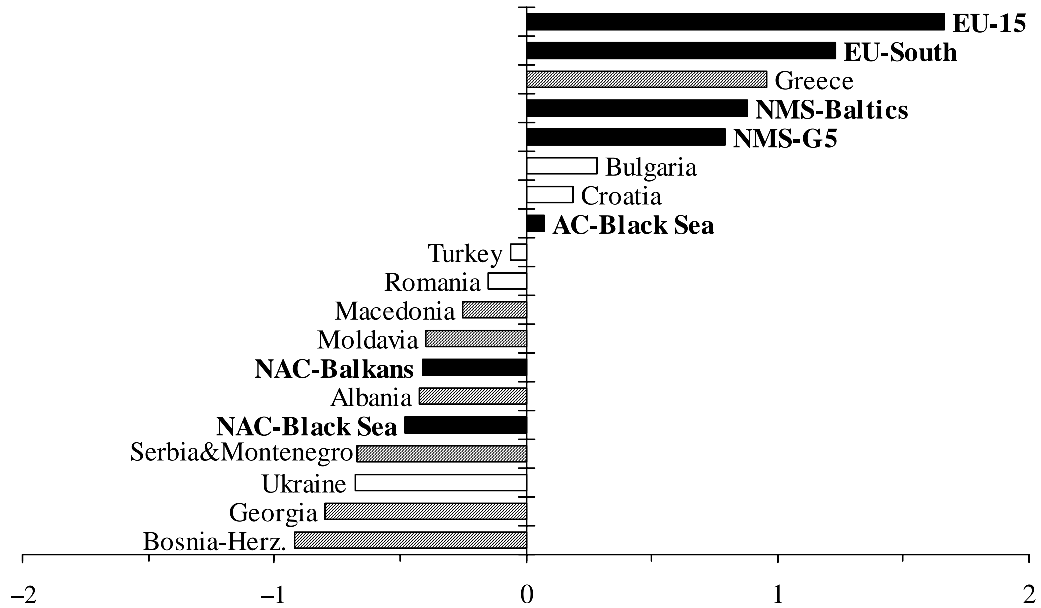
Comparing the results for Ukraine and the four countries which are next in the queue for entry, Bulgaria, Romania, Croatia, and Turkey, reveals that these countries are significantly less developed institutionally when measured by EU standards. Additionally, there are pronounced differences between these five countries. With respect to legislative institutions Bulgaria, Romania, and Croatia perform far better than Ukraine and Turkey (Figure 5).

This result is interesting for two reasons. First, Croatia, notwithstanding its initial difficulties, almost matches Bulgaria, which shows that progress with institutional reforms is possible even in a short time period. To the contrary, Turkey ranges even *below* Ukraine. Although the progress made in Turkey during recent years is not yet fully reflected in the WBGI, the fact that Turkey, according to the EU, has already fulfilled the political criteria demonstrates that the start of accession negotiations primarily depends on the political will of EU member states.

A different picture is drawn by the indicator on administrative institutions (Figure 6). As was to be expected on the basis of the comparison of country groups, the development of administrative institutions lags behind the development of legislative ones in Bulgaria, Romania, Croatia, and Ukraine. Turkey is an exception because administrative institutions clearly perform better than legislative ones. Although the difference from the EU standards is significant in all cases, Turkey together with Bulgaria, Croatia, and Romania form a group of countries that comes closest. Ukraine is here clearly still far behind, albeit, of course, the data relate to the situation in 2002.

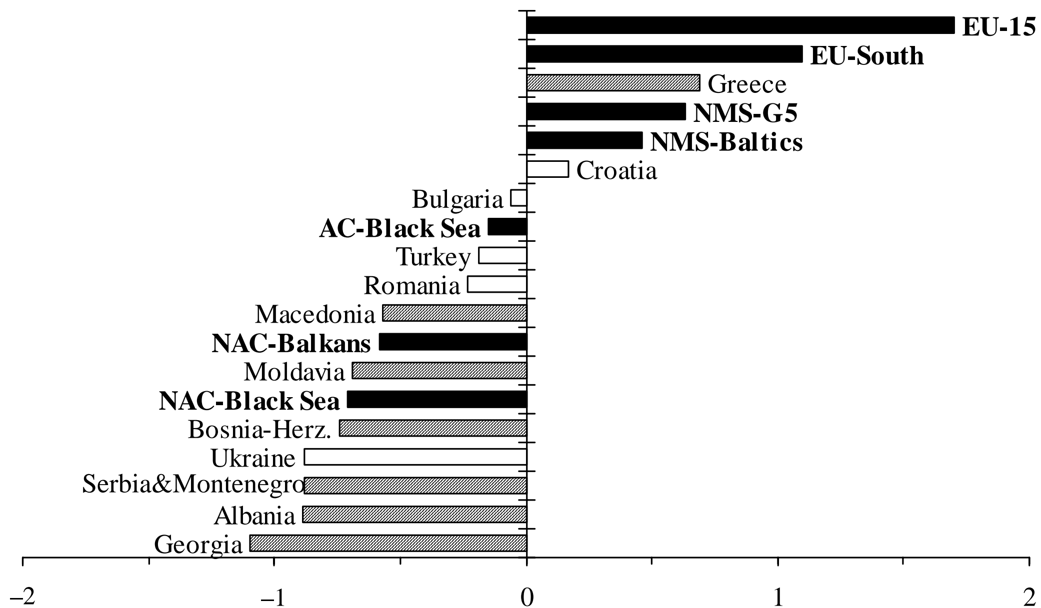
Finally, the indicator on legal institutions (Figure 7) reveals that Croatia outperforms the other countries that, again, perform worse with respect to the other institutional indicators. This result should have an impact on the prospects of Croatia to join the EU. It is at least difficult to

Figures 6:
Administrative Institutions in Europe, 2002



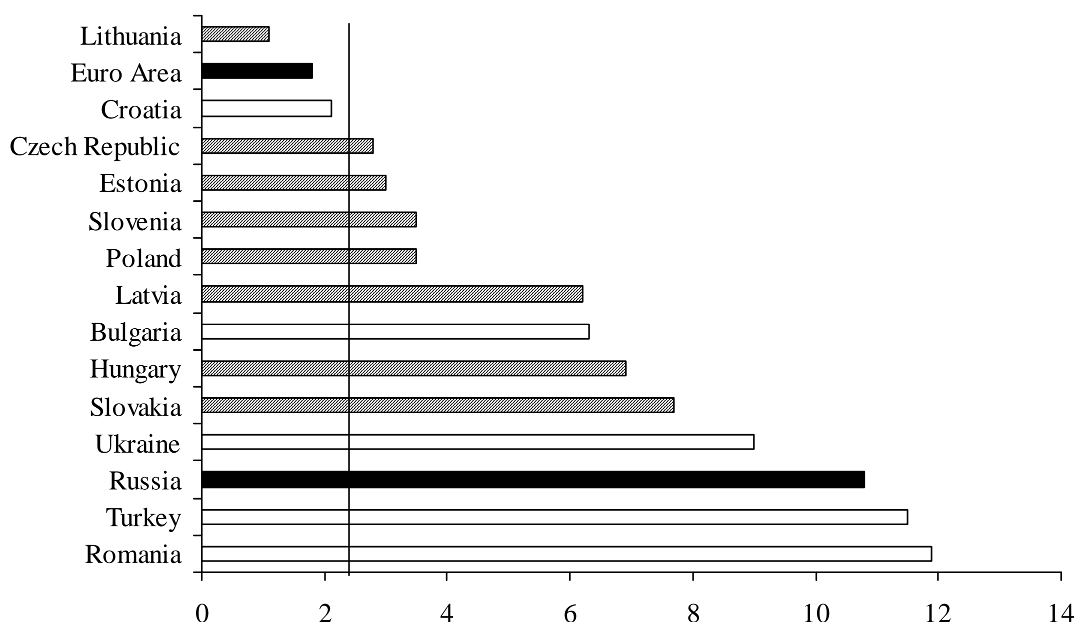
Source: WBGI; authors' calculations.

Figures 7:
Judicative Institutions in Europe, 2002



Source: WBGI; authors' calculations.

Figure 8:
CPI Inflation Rate (2004 estimate)[a]



[a]Vertical line shows Maastricht criteria.
Source: DekaBank, DCRI January 2005. Frankfurt/Main.

argue that Croatia should wait longer than Bulgaria and Romania if negotiations start soon and the chapters could be closed quickly. Again, Ukraine still has a long way to go, with legal institutions behind Turkey.

Overall, benchmarking the institutional development in EU neighbouring countries reveals the need for continued assistance from the side of the EU for institution building. This is an urgent requirement should Ukraine go for accession negotiations and for the medium-term goal of joining Turkey in this process. However, the case of Croatia shows that it can be done and in a comparatively speedy manner.

2.3 Maastricht Criteria: Macro/Nominal Convergence

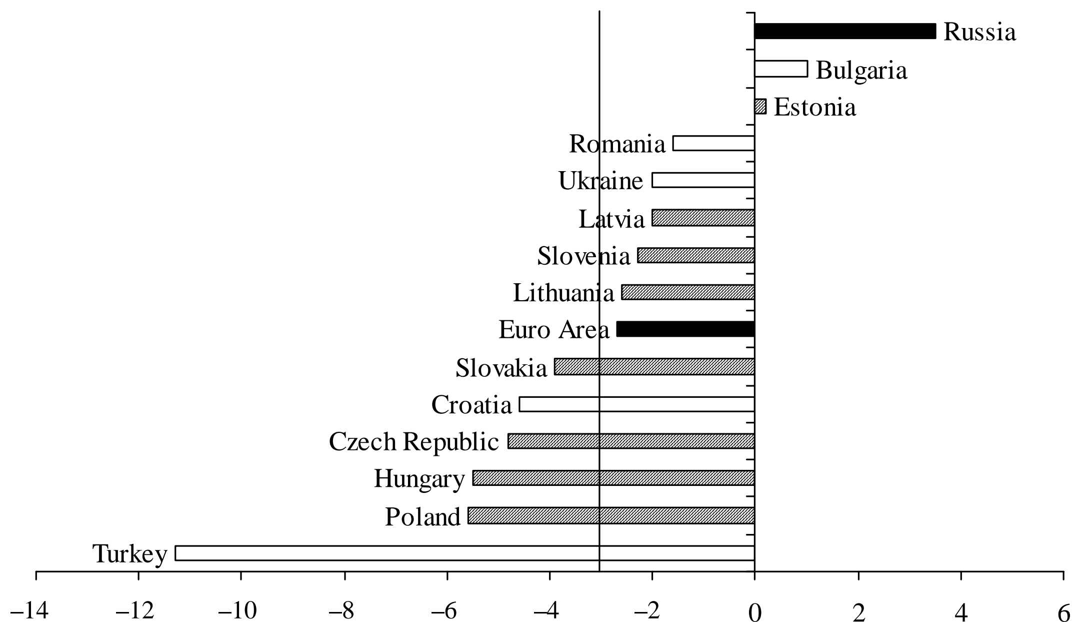
The Copenhagen criteria for entry into the EU do not only set institutional standards but also require macroeconomic stability as measured by the Maastricht indicators. Comparing inflation rates, budget balance, and public debt, the following figures again display the relative performance of Ukraine, Turkey, Croatia, Bulgaria, and Romania against the standards currently set by EU members. Different to the figures on institutions, the old members are represented by the euro area. Additionally, the performance of Russia is included because the EU and Russia are the two poles between which macroeconomic management in Ukraine takes place.

Figure 8 on inflation rates shows that among the five non-member countries only Croatia already meets the inflation criterion. As can also be seen, *all* NMS except Lithuania fail to meet this criterion. Ukraine is close to Russia, only slightly better than Turkey and Romania.[18]

Ukraine's performance with respect to fiscal data is much better. As revealed by Figure 9, the fiscal deficit is lower than the 3 percent criterion. Together with Russia, the Baltic countries and Bulgaria, Romania, and Slovenia, Ukraine even outperforms the euro area. Again, Turkey shows

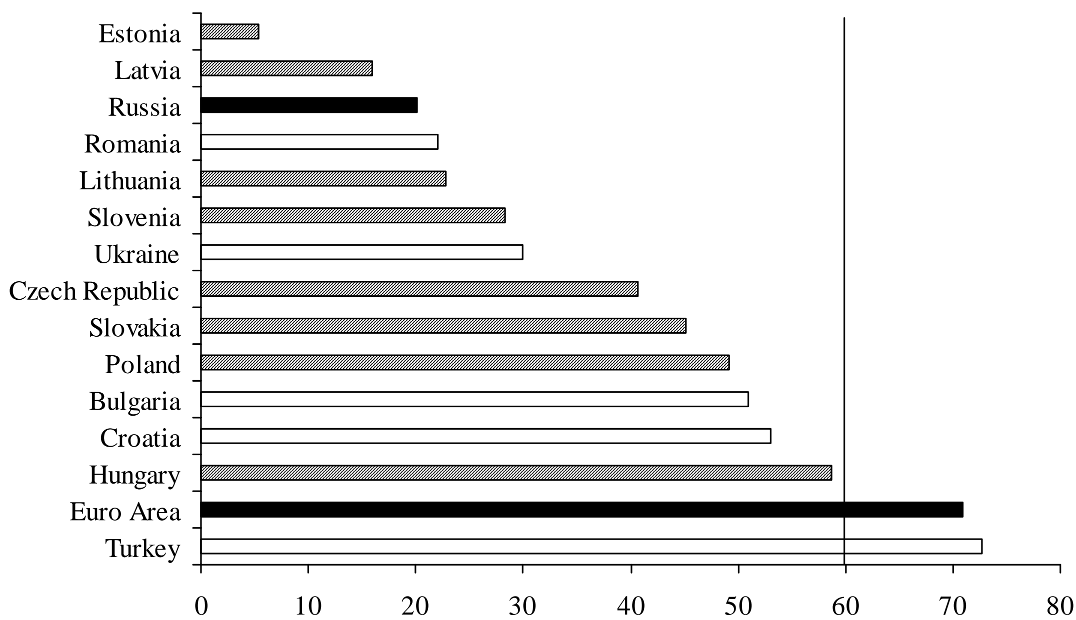
[18] Albeit the results would vary greatly with the year chosen as a benchmark: for instance, Ukraine experienced an inflation rate of –0.6 per cent in 2002, which would have made it comfortably respect the inflation criterion.

Figure 9:
Budget Balance as GDP Percentage (2004 estimate)[a]



[a]Vertical line shows Maastricht criteria.
Source: DekaBank, DCRI January 2005. Frankfurt/Main.

Figure 10:
Public Debt as GDP Percentage (2004 estimate)[a]



[a]Vertical line shows Maastricht criteria.
Source: DekaBank, DCRI January 2005. Frankfurt/Main.

up at the end of the scale, with a fiscal deficit more than double that of Poland, the NMS with the highest fiscal deficit.

A similar picture is shown in Figure 10 with respect to public debt. Here, Turkey is the only country that shows a higher indebtedness, together with the euro area, which currently does not meet its own standards. Except for Bulgaria, which started with a very high level of indebtedness, the same group as before—among them Russia—shows the best fiscal performance. All in all, the macro picture on the basis of inflation and fiscal data reveals that Ukraine still needs to undergo some additional nominal convergence. This is only in absolute terms, as in relative terms Ukraine and other non-member countries perform quite well when compared to the NMS. The exception is Turkey: this is the only country in the sample that fails to meet any of the three criteria discussed here. Hence, according to the Maastricht criteria, Ukraine is considerably closer to Brussels than Turkey is.

The Copenhagen criteria on macroeconomic stability do not only focus on the Maastricht criteria but also explicitly mention a sustainable external position. Table 1 shows some indicators on the external position comparing the five non-member countries with the new member countries in this respect. The following stylized facts can be summarized:

- Average external debt figures are generally most favourable in the accession group. However, a lot of heterogeneity is hidden behind these average figures. While Ukraine shows the lowest debt and short-term debt ratios of the total sample, Croatia (together with Estonia) has the highest ratio of external debt, and debt service is the highest for Turkey. Generally, Ukraine performs very well in this respect, both compared to all countries in the sample, but especially when compared to Turkey and Croatia.
- A similar picture is revealed with respect to the current account deficits adjusted for FDI inflows and the reserve ratio. Again, the two non-accession countries outperform the other groups; with Ukraine benefiting from a high current account surplus while FDI inflows are rather moderate. Looking at the non-member countries in total, only the low reserve ratio in the case of Turkey gives some reason for concerns.
- The situation with respect to exchange rate stability is different. Here, all countries show either stable or appreciating currencies. Ukraine is the only country where the real exchange rate depreciated strongly. This fits the high monetary expansion and increasing inflation rates in recent years. It also explains the high current account surplus.

Summarizing the evidence for the relative performance of Ukraine when compared to Croatia and Turkey, only the real exchange rate instability is on the negative side, while especially the figures on external debt are favourable for external stability. For the other two countries, a high external debt ratio in the case of Croatia and a high debt service ratio as well as a low reserve ratio in the case of Turkey may endanger external stability.

Based on the relative indicators analysed in this chapter, Ukraine performs quite well when compared to the other countries in the queue for entry into the EU. Especially the fiscal and external debt figures are better than in other countries. On the negative side, there is a considerable backlog with respect to the development of administrative and judicial institutional capacities, and a *potential* for macroeconomic instability due to monetary expansion, rising inflation rates, and real exchange rate instability. While strong real depreciation was favourable for the current account, real exchange rate instability as well as the institutional problems may be the main reasons why FDI inflows have remained moderate. This leads to the conclusion that Ukraine urgently needs to develop its institutions and stabilize its inflation and exchange rates in order to improve its European perspective and to move closer to Brussels.

Table 1:
External Balances in the NMS, Accession Countries, Croatia and Ukraine (2004 estimates)

	External debt/GDP	Short-term debt/exports	Debt service/ exports	Current account/GDP	FDI/GDP	(CA+FDI)/ GDP	Reserves/ M2	Change in real effective exchange rate
Czech Republic	35.5	21.8	6.2	–4.6	4.6	–0.0	36.8	–0.2
Estonia	80.3	36.6	13.5	–14.5	5.5	–9.0	34.8	0.9
Hungary	57.2	14.2	24.5	–9.1	2.3	–6.8	27.6	3.8
Lithuania	46.0	29.9	14.4	–8.5	3.0	–5.5	53.3	–0.9
Latria	74.4	112.5	14.8	–10.9	3.8	–7.1	34.4	–0.4
Poland	41.7	20.0	16.0	–1.4	1.7	0.2	36.8	–2.1
Slovenia	45.5	0.8	14.7	–0.3	–0.5	–0.8	44.6	0.0
Slovakia	46.1	20.5	8.0	–3.6	3.9	0.3	52.4	9.0
NMS-8	**53.3**	**32.0**	**14.0**	**–6.6**	**3.0**	**–3.6**	**40.1**	**1.3**
Bulgaria	61.9	23.1	12.4	–7.0	9.7	2.7	60.0	3.0
Romania	35.5	6.0	14.4	–6.0	5.5	–0.4	71.5	2.2
Turkey	51.1	32.0	36.9	–3.6	0.7	–3.0	24.7	–0.1
AC-3	**32.5**	**9.7**	**8.9**	**–4.3**	**5.1**	**0.8**	**43.8**	**1.7**
Croatia	78.9	3.3	20.4	–5.3	2.4	–2.9	37.5	–0.4
Ukraine	27.3	1.2	12.9	10.2	2.3	12.5	38.7	–7.5
NAC-2	**53.1**	**2.3**	**16.7**	**2.4**	**2.3**	**4.8**	**38.1**	**–4.0**

Source: DekaBank, DCRI January 2005. Frankfurt/Main.

3 The Current Status of Reforms in Ukraine

3.1 The Macroeconomic Framework

A robust macroeconomic framework is indeed necessary for a successful EU membership process. Since 1998, truly great strides have been made in terms of the macro stabilization framework in Ukraine.[19] The budgetary procedure is much more consolidated—albeit further progress is necessary—the inflation rate has decreased substantially, economic growth is not only positive, but high, and the current account is in surplus. Most notably, the NBU has, since 1998, proved itself as a credible and independent monetary authority, eliminating the monetary financing of budget deficits.

From a budgetary perspective, the full development of a formal medium-term budgetary framework would be of great assistance for the government in assessing its medium-term commitments and resources, given the need of eventual increases of expenditure in areas that imply multiyear programmes in Ukraine (for instance, in investment on the improvement of infrastructure or in the—implicit and explicit—pension and retirement commitments: see IMF 2005). From an EU integration perspective, these would also be useful, as they would enable a medium-term evaluation of accession-related expenditures and revenues. Additionally, from an even longer-run perspective, they would be compatible with the Stability and Growth Pact (SGP)[20] and its medium-term framework for fiscal policies, the national multi-year "Programs for Stability and Growth".

[19] As just one example of this, the quasi-fiscal deficit of the energy sector in Ukraine dropped from 4 per cent of GDP in 2000 to 0.2 per cent in 2004 (IMF 2005), by a combination of increased tax collection and reduction of barter arrangements.

[20] The SGP aims to assure the continuous compliance with the fiscal criteria of the Maastricht Treaty, and to assure medium-term budgetary positions in surplus or close to balance for the euro area member states. To try to impose a more binding constraint on the fiscal behaviour of the member countries of EMU, a system of punitive pecuniary fines was introduced by it, through which—after a lengthy joint political decision process, with ultimate decision placed on an unanimous vote by the Council—individual EU member countries that incur deficits that are deemed to be "excessive"—namely, over the 3 per cent benchmark—would transfer up to 0.5 per cent of their GDP to the Union. The SGP also aims to create a medium-term framework for fiscal policies, through the national multi-year "Programs for Stability and Growth". After several member states repeatedly broke the limits during the early 2000s, many reform proposals led to give the SGP a more "flexible" interpretation.

Nevertheless, from a macro framework perspective, the most pressing issue is likely to be the effects of the USD exchange rate targeting policy, in an environment of strong external surpluses. In the absence of sterilization policies, this led to double-digit increases in money supply, with, so far, rather limited inflationary effects, due to a remonetization process common to most transition economies and to the substantial reduction of "barter" payment procedures.

It is advisable that Ukraine gradually moves towards more exchange rate flexibility, in order to gain greater control over monetary aggregates, to avoid the buildup of financial vulnerabilities and any loss of external competitiveness. Unfortunately, whereas there is a broad agreement on the need of such a change, there is much less agreement on the best alternatives (Yushchenko 2000), given the practical difficulties that remain in implementing monetary policy in the Ukraine (as they do in other CIS countries; see Esanov et al. 2004): to mention but two, the monetary transmission mechanism is still unstable (Bilan 2004, Golodniuk 2004, Leheyda 2004), and there is a potential—and growing—"fear of floating" problem, when one looks at the level of dollarization of liabilities in the financial system (IMF 2005).

Among the alternative frameworks available to Ukraine, continuing with the current exchange rate anchor is one, as it can be made more flexible by the relatively simple targeting of a basket made of the USD and the EUR: this would reduce depreciation pressures, inflows, and the need to sterilize those. Such exchange rate anchor frameworks also provide a clear indication to the public about monetary policy and act to discipline fiscal policy, beyond being relatively easy to manage. Additionally, a clearer link to the euro may be useful for a greater integration with the EU.

Other potential alternatives are money or interest rate rules coupled with a floating exchange rate, but it is clear that Ukraine has neither the stable structural relationships nor the deep financial markets that will enable their successful implementation in the short run (van Aarle et al. 2004).

3.2 The Microeconomic Framework

It is necessary to recognize that the progress in terms of microeconomic reforms (or what could be called "second generation issues", i.e., those issues that arise when macroeconomic stabilization has been achieved) necessary for membership has been limited so far in Ukraine, albeit its level is relatively high when compared with other CIS and SEE countries (see previous section).

We, therefore, define here by "microeconomic framework" the regulatory framework necessary for long-run growth, once macro stabilization has been achieved. Many aspects need to be dealt with in Ukraine, from wholesale improvement of the enforcement of legislation to judiciary reform, in what will necessarily be an effort for many years. Therefore, in this section we will only briefly deal with two specific questions, tax and regulatory/competition reform, that we consider to be essential not only for a successful EU integration, but, much more importantly, for a sustained increase in the Ukrainian population's welfare (Blue Ribbon Commission for Ukraine 2004).

3.2.1 Tax Reforms

Since independence (the State Tax Administration was created only in 1996), Ukraine's tax system has developed by stages and somewhat inconsistently. As a result, Ukraine does not yet have a unified tax code. Additionally, Ukraine shares a similar feature with the Central European NMS: the tax ratio to GDP is higher (at roughly 40 per cent, including payroll taxes) than in countries with comparable GDP per capita levels.

Ukraine's tax revenues basically rely on four taxes (value-added tax, tax on corporate profits, personal income tax, and excise duties), which together accounted for 87 per cent of all revenues in 2003. The system is unstable, complex, and inconsistent, with continuous legal changes since independence and persistent discriminatory tax exemptions to certain sectors (mostly state-owned and energy-related or energy-intensive enterprises). A possible solution would be an ef-

fort to simplify and unify the code, while reducing overall taxation (by, for instance, reducing the tax on corporate profits—as was done by other NMS like Estonia and Slovakia—and the VAT, but without running into conflict with EU's minimum VAT levels, and reducing tax exemptions).

3.2.2 Privatization and Regulatory Reform

Ukraine's private sector is now reasonably developed, as an early mass privatization ensured the development and predominance of the non-state sector of the economy. However, the transformation of the state production sector remains far from complete. About 15,000 enterprises, 350 controlling interests of the largest production joint-stock companies and holdings, and 1,500 blocks of minority shareholdings remain in state hands, at the State Property Fund. The state continues to control the most capital-intensive enterprises: two-thirds of the capital assets of the real sector remain in state ownership. Thus far, privatization has been rather limited in the following sectors:

- Energy industry (including electric power generation and distribution);
- Transport industry (including pipelines);
- Post and communication: telecommunications (infrastructure, maintenance, and services);
- Public utilities;
- Military-industrial sectors (defence, space, aviation, and shipbuilding).

Given the systemic nature of these industries, with complex questions related to competition, their privatisation should probably avoid the "mass privatization" process and instead opt for IPOs (Initial Public Offers), probably with the preselection of strategic partners or consortiums that include foreign members.

In addition to completing privatization, a more robust and consistent competition policy should be developed. Competition policy is crucial for a functioning market economy and for sustainable economic growth.

The Ukrainian institutional framework for competition policy is currently made up of an Anti-Monopoly Committee (AMC), created in 1994, and some industry regulatory bodies (like the National Electricity Regulatory Commission (NERC) and the National Communication Regulatory Commission (NCRC)). Further reforms are needed to improve competition and the enforcement of competition legislation. Extensive state subsidies and regulatory capture by business groups result in unequal treatment of market participants and distort the allocation of resources. Inefficient regulation and delays in bankrupting insolvent firms prevent enterprise restructuring and preserve outdated industrial structures. Among the necessary reforms are the institutional and technical reforms (for instance, tariff setting by the regulatory bodies sometimes does not follow a clear economic logic), the strengthening of the AMC and the industry regulatory bodies, plus the effective separation of them from government. Also, some industries still lack independent regulatory bodies, for instance such as public utilities (water supply, sewerage, and heating) and transportation; before privatizing such industries, regulatory bodies will have to be created. The legal framework for providing state aid also needs to be improved significantly. The linkages and consistency between these components can be seen in practical terms in the way that they enabled greater FDI inflows in the NMS, and, consequently, reform of productive structures and a greater degree of international integration.

The financial sector of the NMS provides an example. It has some features that make them distinct both from advanced industrial economies and "transition" economies (Vinhas de Souza 2004). The main characteristics are the generally low (compared with advanced economies) level of financial intermediation, strong dominance of the banking sector within financial intermediation, *very* high degree of foreign (mostly EU) involvement in the newly privatized banking sector—foreign companies now hold the majority of the assets of the banking system in virtually all of the NMS bar Slovenia.[21] The overall health in

[21] In Bulgaria, around 80 per cent of the assets of the banking system are foreign-owned, 95 per cent in the Czech Republic, 63 per cent in Hungary, 70 per cent in Poland, 55 per cent in Romania, and 83 per cent in Slovakia. In the Baltic republics, around 98 per cent of assets in Estonia, 68 per

the financial systems in the NMS, regardless of their "starting conditions", seem to be very robust, with good capitalization levels and a continuous decrease of non-performing loans (Reininger et al. 2002), which is especially important in an environment of fast financial deepening, with double-digit rates of real growth of private credit.

Ukraine shares some similarities with the NMS, but also some dissimilarities, mainly linked to the sheer fact that it is, in spite of its much improved macroeconomic situation since the 1998 financial crisis, still in a *substantially lower liberalization and reform level than those countries*. For instance, of the 158 banks (June 2004 data) in Ukraine (Ukraine has a bank-centred financial system; a rather marginal share of financial assets is held by non-banking institutions), only 6 are wholly foreign-owned, and with a marginal share of assets.[22] Following the NMS, building the necessary legal/institutional framework and allowing EU financial institutions to service the domestic market would generate substantial benefits for Ukraine, especially in the current environment of strong credit growth.

cent in Latvia, and 87 per cent in Lithuania are foreign-owned. Slovenia is the "laggard", with 25.3 per cent of its banking system still state-owned (Romania has the highest share of state ownership, with 42 per cent), and only 28 per cent foreign-owned—which, nevertheless, was almost a doubling of the share, just between 2001 and 2002 (Vinhas de Souza 2004).

[22] The banking system in Ukraine is dominated by seven large banks, usually called "system banks", that have slightly more than 55 per cent of total banking system assets (end of 2003). Among these banks two are state banks (Oshchadbank and UkrEximbank) and two former state banks (Prominvestbank and Ukrsotsbank), which have a generally low efficiency level and high costs relative to other banks. Inherited close links with the government allow these banks to enjoy loose supervision and enforcement of prudential norms by the central bank. Often, the government grants them exclusive rights to service various government accounts and projects (servicing of budget accounts, state pension funds, etc.), which explains their large asset size. They have a low capitalization and the highest proportion of the delinquent loans.

4 "Sandwiched" between Russia and the EU: Costs and Benefits for Ukraine

Trade is very important for Ukraine (the openness index for it—as measured by the sum of exports and imports over GDP—exceeds 100 per cent) and, as indicated in Section 1, it has been one of the main recent drivers of growth. As some of the recent very impressive increase in trade flows is linked to temporary factors[23] (the devaluations of the hryvnia and increase in world ferrous metal prices), it is necessary to consider elements that will enable Ukraine to sustain such a trend growth in the long run. Among those elements are the entry into the World Trade Organization (WTO) and a free trade agreement (FTA) with the EU.

4.1 Regional Peculiarities of Ukraine's Trade Regime: The Institutional Aspect

4.1.1 Ukraine–Russia

Regarding institutional arrangements with Russia one can say that Ukraine's trade regime is determined by both CIS-wide arrangements and bilateral agreements. Numerous CIS-wide agreements (like the CIS Economic Union, CIS Free Trade Zone, CIS Common Agricultural Market, etc.) have failed so far to be implemented in full.

In this respect we should mention one agreement, which generated many discussions in Ukraine and outside. In September 2003, the Presidents of Belarus, Kazakhstan, Russia, and Ukraine signed two documents—an Agreement on the establishment of a Single Economic Space (SES) and the Concept (Guidelines) of Single Economic Space formation among the four countries. Agreement and Concept (Guidelines) defined the SES as "an area consisting of the customs territories of the participants, where the mechanisms of economic regulation are intended to ensure the free movement of goods, services,

[23] Others are "structural", like the lower costs of Ukrainian labour.

capital, and labour; where a common foreign-trade policy is carried out, and fiscal, monetary, and foreign-exchange policies are coordinated to the extent needed in securing fair competition and macroeconomic stability".

The main intentions of the SES were to establish an FTA between the four countries, to implement common policies for trade, competition, regulation, and standardization, to ensure free movement of production factors, and to harmonize macroeconomic policy and network regulation. It was envisioned that all of these ambitious objectives are to be implemented gradually, each country determining its speed of integration independently (so-called 'multi-level and multi-speed integration'). Eventually, a single commission in which each member state will have a voting weight proportional to its economic size would govern all policies.[24] Hence, the concept of the SES foresees the immediate implementation of an FTA with the intention of eventually creating a customs union that may even include some elements of higher integration levels.

Moreover, according to the Guidelines, the first step is the creation of a free trade zone without exceptions or limitations. It seeks to establish a unified policy on tariff and non-tariff regulations, unified rules for competition, the use of subsidies, and other forms of state support, while eliminating anti-dumping, compensatory, and other special defensive measures in mutual trade. In other words, already at this first stage the creation of a customs union was envisaged, that is, a form of union requiring a unified customs policy.

In one essential aspect, these agreements are distinct from other agreements signed by Ukraine: they anticipate the coordination of national positions in negotiating membership in the WTO. The Guidelines, in particular, specifies that, if one member enters the WTO before others, it will promote the earliest entry into the WTO of other SES members and, once WTO negotiations are underway, to refrain from advancing demands of their own. Thus, for the first time, a kind of "non-aggression principle" in negotiations with the WTO would have been officially set.

At the moment it seems that the feasibility of this project is rather low and probably any activities related to it will be limited to an attempt to create an FTA among the partners. The creation of any such deep regional arrangements would effectively mean a rejection of the EU membership intentions for Ukraine.

Bilateral trade relations between Ukraine and Russia are regulated by a free trade agreement signed in June 24, 1993. This agreement covers all goods except sugar, tobacco goods, certain spirits, chocolate, and candies. Ukraine–Russia steel trade is regulated by a special agreement envisaging quotas on Ukraine's steel products exported to Russia.

4.1.2 Ukraine–EU

As far as Ukraine's relations with EU are concerned, they are based upon the following agreements:

- Agreement between Ukraine and European Community on Trade in Textile Products (signed in 1993, new Agreement signed in 2000);
- Agreement between the Government of Ukraine and the Commission of the European Communities on the Establishment and the Privileges and Immunities of the Delegation of the Commission of the European Communities in Ukraine (signed in 1993);
- Agreement between the Commission of the European Communities and the Government of Ukraine setting up a Contact Group on Coal and Steel (signed in 1994);
- Partnership and Cooperation Agreement between the European Communities and their member states, and Ukraine (signed in 1994);
- Agreement between the Government of Ukraine and the European Coal and Steel Community on Trade in Certain Steel Products (signed in 1997);
- Agreement for Cooperation between the European Atomic Energy Community and the Cabinet of Ministers of Ukraine in the Field of Controlled Nuclear Fusion (signed in 1999).

[24] Assuming that economic weight of a country is determined by its GDP, Russia would get a dominant position in the commission governing the SES, as in the old Soviet Union.

It should also be mentioned that in March 2003 Ukraine and the EU signed a bilateral protocol for market access in goods and services in the framework of Ukraine's WTO accession.

Since 1 January 1993, Ukraine has become a beneficiary of the Generalized Scheme of Preferences (GSP).[25] These preferences are differentiated between two product categories: non-sensitive and sensitive products. Tariff duties on non-sensitive products continue to be suspended, while duties on sensitive products enjoy a tariff reduction. One must note that EU GSP benefits are not granted to the commodities accounting for a considerable part of Ukrainian exports (iron and steel, fertilizers, fishery products, grain, seeds, fruits, and plants). Still, the GSP should be considered as a tool for facilitating the access of Ukrainian goods to the EU market. Trade regulation in the steel and textiles sectors should be mentioned specifically:

Concerning steel the Partnership and Cooperation Agreement between the EU and Ukraine provides in Article 22(1) that trade in some steel products is to be the subject of a special agreement. The previous bilateral agreement between the European Coal and Steel Community (ECSC) and the Government of Ukraine on trade for certain steel products expired on 31 December 2001. The European Community has taken over the international obligations of the ECSC since the expiry of the ECSC Treaty, and measures relating to trade in steel products with third countries now fall under the competence of the Community in the field of trade policy. The Parties agreed to conclude a new agreement and the negotiations of this new agreement have not yet been completed. Pending the signature and the entry into force of the new agreement, quantitative limits for the year 2004 were determined. Given that the tax of 30 euros/tonne on exports of ferrous scrap Ukraine applied as of 1 January 2003 has not been lifted nor diminished, the EU found it appropriate to set the quantitative limits for the year 2004 at the same level as for the year 2003. Later on November 22, 2004 the Agreement between the Government of Ukraine and the European Community on trade in certain steel products for 2004 was signed envisaging a certain increase in steel quotas. At that time the Parties have also proclaimed their readiness to start the negotiations on new steel agreement to regulate their steel trade starting from 2005–2006. This new agreement has yet to be signed.

Concerning textiles, trade in textiles between the EU and Ukraine is regulated by a separate agreement, signed in December 2000 (replacing a previous agreement dating back to 1993), aimed at reciprocal liberalization of trade in textiles and clothing. The Parties agreed to refrain from adopting any non-tariff measures that could hinder trade in textile and clothing products if certain conditions are met by the Ukrainian side. Ukraine's commitments under this agreement were:

- First, to bound tariff rates applicable to EU textile imports from Ukraine to the level of tariffs as of July 2000, and
- Second, reduce them to the level not exceeding the rate EU has bound in WTO.[26]

One of the problems plaguing EU–Ukraine relations is granting Ukraine the market economy status, linked to anti-dumping investigations against Ukraine.[27] Anti-dumping measures are applied particularly frequently against steel and chemicals, two categories that comprise nearly half of Ukraine's total exports. According to the WTO, Ukraine ranked 13th in the world as a target of anti-dumping measures between January 1995 and June 2004, with 51 anti-dumping measures concluded by various countries (a share

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[25] The last time the Council Regulation No 2501/2001 of 10 December 2001 extended the application of the scheme of generalized tariff preferences was for the period from 1 January 2002 to 31 December 2004 (COUNCIL REGULATION (EC) No 2501/2001 of 10 December 2001; *Official Journal of the European Union*, L 346, 31.12. 2001, pp. 1–59).

[26] Agreement in the form of an exchange of letters between the European Community and Ukraine concerning the extension and amendment of the Agreement between the European Economic Community and Ukraine on trade in textile products initiated on 5 May 1993, at last amended by the Agreement in the form of an Exchange of Letters initiated on 15 October 1999 (*Official Journal of the European Communities*, L 16, 18.1. 2001, pp. 3–34).

[27] One must remember the granting of "market economy" status by the EU to Russia, an economy with a liberalization level similar to Ukraine's, in 2002.

of anti-dumping measures about *ten times greater* than Ukraine's share of world trade). From those, 8 originated from the EU-25.

In October 2000, the EU Council of Ministers passed a decision allowing a "market economy enterprise" status for particular Ukrainian firms that can substantiate that they operate under market economy conditions.[28] At the same time, the European Commission informed Ukraine that there are two unresolved issues, which are significant in the context of trade-defence investigations:

- Bankruptcy legislation: the EU Commission believes that current legislation prevents certain state-owned enterprises from going bankrupt under circumstances which are not sufficiently defined. There are also concerns that proper enforcement of bankruptcy law may not be ensured vis-à-vis "city-forming enterprises", which may have potential capacity to export whilst technically bankrupt;
- State interventions in price setting mechanism: the EU Commission believes that distorting state interference in the pricing of goods continues and appears to be on the increase in certain sectors, in particular fertilizers and metals, which are of key importance in the context of trade-defence measures.

Nevertheless, some of the main limitations in trade and thus in the FTA seem to be domestic (World Bank 2004), related to legislation, inadequate compatibility of standards, inefficiency of customs, and related tax procedures. An FTA with the EU that did explicitly incorporate the transposition of EU legislation (EU company legislation, EU rules on standardization and certification, EU competition rules, EU customs procedures, etc.) would not only help eliminate those internal limiting factors but would also strongly support the EU integration process.

An assumption present in some studies is that the process of WTO membership—Ukraine announced its intention to join the WTO as early as 1993—can be a stepping-stone for EU membership, given that some of the requirements are similar for both processes (Blue Ribbon Commission for Ukraine 2004, World Bank 2004) and that it should, therefore, precede it. Albeit true, in the sense that no country has ever entered the Union without having first entered the WTO, the connection between these two "options" is not so strong. As the experience of the last enlargement round shows, most of the applications for EU membership preceded WTO membership, and frequently by several years (Table 2).[29] The Baltic countries, whose economies most resemble the sort of problems faced by Ukraine, only entered the WTO as late as 1999. For most of the former EU candidate countries, the causality was actually the *reverse*: the fulfillment of WTO membership conditions arose as a *by-product* of the EU accession process.

Additionally, the assumption that the WTO is an effective framework provider that will enhance *domestic* reforms—especially on the scale necessary for EU accession—seems to overestimate the "minimum common denominator" negotiation process that actually leads to WTO membership (which, among other things, is responsible for the usually disappointing trade increases after WTO accession). [30]

EU membership, by its very nature, is clearly a great deal more effective in exporting a much more robust and comprehensive regulatory framework than the WTO, and the process of implementing this framework (as again shown by the previous enlargement round) starts several years before actual accession. Therefore, if one assumes EU membership as the main objective, the EU integration process includes all the necessary reforms for WTO entry. This is especially

[28] Council Regulation (EC) No 2238/200 amending Regulation (EC) No 384/96 on protection against dumped imports from countries not members of the European Community; *Official Journal of the European Communities*, L 257, 11.10. 2000.

[29] *The same does not apply to achieving some sort of FTA with the EU*: as again one can see from Table 2 that FTAs with the EU usually preceded both WTO entry and the official EU application membership by several years.

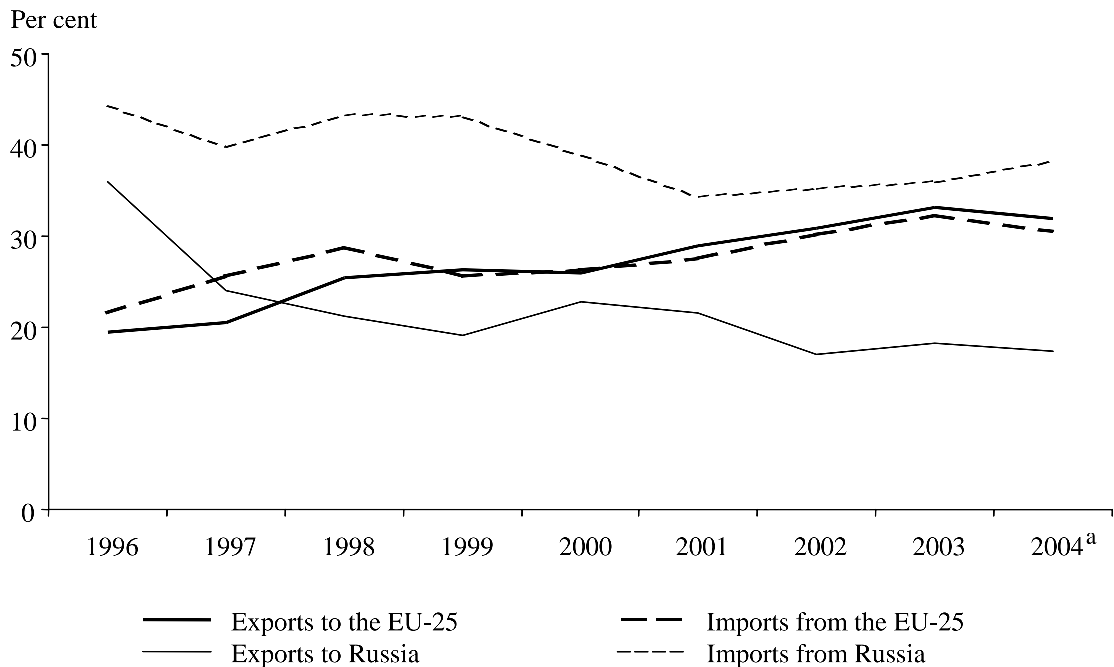
[30] Rose (2003) estimated that WTO accession has non-significant trade-creating effects, contrary to regional FTAs, which have strong significantly positive trade-creating effects, possibly due to the "lowest common denominator" constraints of the WTO accession negotiation process, while regional/bilateral FTAs usually go much deeper towards liberalization amongst its members (like, for instance, the EU itself). This conclusion is also backed for Ukraine by Eremenko et al. (2004).

Table 2:
Membership of International Organizations by EU Applicant Countries

Countries	EU Association Agreements: Date of entry into force	OECD membership	WTO membership	IMF Article VIII Compatibility
Bulgaria	– Europe Agreement: 2/95 (signed 3/93). A "Europe" Trade Agreement also signed in 3/93. – Application for EU membership: 12/95 – EU Entry: 2007		1 December 1996	–IMF entry: 25/9/90. Article VIII: 24/9/98.
Croatia	– Independence: 6/91 – Stabilization & Association Agreement: 10/01. – Application for EU membership: 2/03. – EU Entry: ?		30 November 2000	–IMF entry: 14/12/92.Article VIII: 29/5/95.
Czech Rep.	– Czechoslovakia break-up: 1/1/93. – (New) Europe Agreement: 2/95 (old one signed in 12/91, new in 10/93). A "Europe" Trade Agreement since 3/92 (signed in 12/91). – Application for EU membership: 1/96. – EU Entry: May 2004	–12/95: OECD membership.	1 January 1995	–IMF entry: 20/9/90 (as the Czech and Slovak Federal Republic; since 1/93 as separate states). Article VIII: 1/10/95.
Estonia	– Independence: 20/8/91 – Europe Agreement: 2/98 (signed: 6/95). – Free Trade Agreement with the EU in 7/94. – Application for EU membership: 11/95. – EU Entry: May 2004		13 November 1999	–IMF entry: 25/5/92. Article VIII: 15/8/94.
Hungary	– Europe Agreement: 2/94 (signed: 12/91). A "Europe" Trade Agreement since 3/92 (also signed in 12/91). – Application for EU membership: 3/94. – EU Entry: May 2004	–5/96: OECD Membership.	1 January 1995	–IMF entry: 05/06/1982. Article VIII: 1/1/96.
Latvia	– Independence: 21/8/91. – Europe Agreement: 2/98 (signed: 6/95). – Free Trade Agreement with the EU in 7/94. – Application for EU membership: 10/95. – EU Entry: May 2004		10 February 1999	–IMF entry: 19/5/92. Article VIII: 10/6/94.
Lithuania	– Independence: declared in 11/3/90, only accepted by URSS in 6/9/91. – Europe Agreement: 2/98 (signed: 6/95). – Free Trade Agreement with the EU in 7/94. – Application for EU membership: 12/95 – EU Entry: May 2004		31 May 2001	–IMF entry: 29/4/92. Article VIII: 3/5/94.
Poland	– Europe Agreement: 2/94 (signed: 12/91). A "Europe" Trade Agreement since 3/92 (also signed in 12/91). – Application for EU membership: 4/94. – EU Entry: May 2004	–11/96: OECD Membership.	1 July 1995	–IMF entry: 06/12/86. Article VIII: 1/6/95.
Romania	– Europe Agreement: 2/95 (signed in 2/93). A "Europe" Trade Agreement (also signed in 2/93). – Application for EU membership: 6/95 – EU Entry (expected): 2007		1 January 1995	–IMF entry: 15/12/72. Article VIII: 25/3/1998.
Slovakia	– Czechoslovakia break-up: 1/1/93. – (New) Europe Agreement: 2/95 (signed: 10/93). A Trade Agreement since 3/92 (signed: 12/91). – Application for EU membership: 6/95 – EU Entry: May 2004	–8/00: OECD Membership.	1 January 1995	–IMF entry: 20/9/90 (as the Czech and Slovak Federal Republic; since 1/93, as separate states). Article VIII: 1/10/95.
Slovenia	– Independence: 25/6/91. – Europe Agreement: 2/99 (signed 6/96). – Application for EU membership: 6/96 – EU Entry: May 2004		30 July 1995	–IMF entry: 14/12/92. Article VIII: 1/9/95.
Ukraine	– Independence: 24/8/91. – EU Entry: ?			–IMF entry: 3/9/92. Article VIII: 24/9/96.

Source: Vinhas de Souza (2004), modified by the authors.

Figure 11:
Merchandise Trade Shares with the EU-25 vs. Russia



[a]First half.
Source: National Bank of Ukraine.

true within the framework of a pre-accession FTA, as was the case with the last enlargement wave.

4.1.3 The Level of Economic Integration with the EU

After the enlargement in May 2004, the EU became the largest trade partner of Ukraine. Trade with the EU-25 is estimated to account for approximately one-third for merchandise exports and imports in 2004, with total trade turnover at almost 15 billion euros. In spite of this fact, it is still substantially below the share from the eight new EU member states from Eastern Europe several years before their EU accession (one must also note that the only EU neighbouring countries *without* free trade agreements with the EU are Moldova, Belarus, Russia, and Ukraine).

The role of Russia—although it is still the largest single country trade partner for Ukraine—has gradually and substantially diminished. The most significant decline is registered for Ukraine's exports to Russia, which halved their share in total Ukraine's exports from 36 per cent in 1996 to 17 per cent in 2004 (Figure 11). Export flows were redirected towards both the EU-25 and to the rest of the world, in particular Asia.

As regards imports, the decrease in trade with Russia was far less significant, primarily because of its importance as a source of energy products for Ukraine. While during the last nine years the share of imports from Russia declined by 6 percentage points to approximately 38 per cent in 2004, in nominal terms imports have even slightly increased.

The structure of Ukraine's trade with the EU-25 and with Russia differs quite significantly. In the most simplified terms, Ukrainian trade flows include westward movement of raw materials and semi-processed goods, and the eastward (opposite) movement of final products, primarily investment goods. These counter-movements characterize both Ukraine–EU and Ukraine–Russia trade relations.

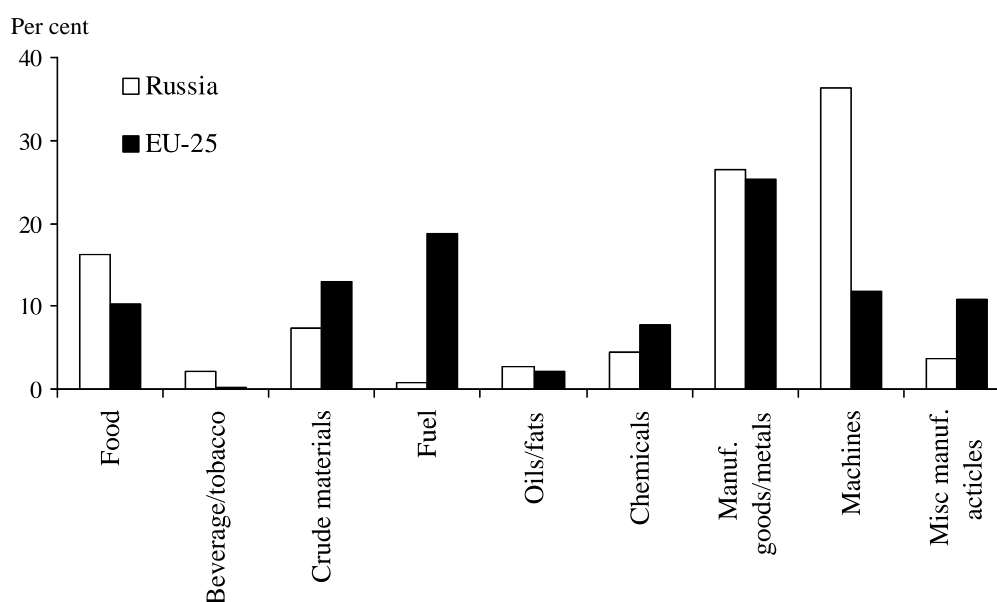
Table 3:
Structure of Ukraine's Exports by the Level of Processing in 1996 and 2002 (percent)[a]

	EU-25		EU-15		NMS		Russia	
	1996	2002	1996	2002	1996	2002	1996	2002
Raw materials	29	20	20	16	41	26	4	3
Semi-processed products	32	31	32	29	32	35	45	31
Final goods	33	45	39	49	27	38	52	66

[a]Applied methodology does not allow classifying all traded items, thus the sum of proposed categories does not always sum up to 100 per cent.

Source: UN ComTrade; authors' calculations on the basis of Multilateral Trade Negotiations categories (WTO).

Figure 12:
Structure of Ukrainian Exports, 2002

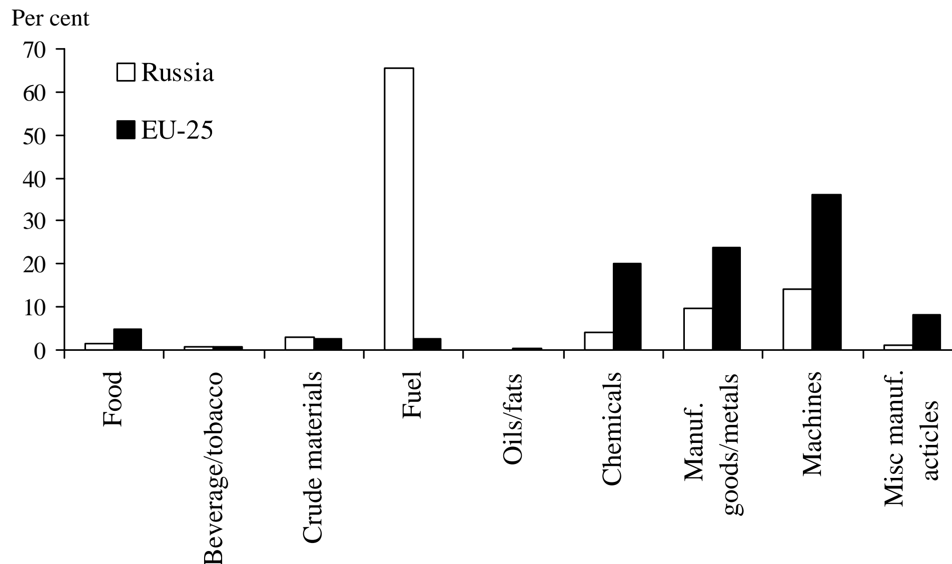


Source: UN ComTrade; authors' calculations.

Ukraine exports to the EU-25 metals (including ores), fuel,[31] crude materials, and agro-food products. Around 20 per cent of these products are raw materials, other 30 per cent are semi-processed goods, and the rest are final products (Table 3 and Figure 12). Although the structure of Ukraine's exports to the EU approximately corresponds to the general structure of the country's exports, Ukraine still supplies to the EU-25 relatively more fuels and relatively less metals (manufactured products). The latter could be explained by the structure of the EU protectionism, especially in relation to trade of metals. Although Ukraine is a beneficiary under the EU's General System of Preferences (GSP), iron and steel are excluded from this scheme, thus are subject to the MFN tariff rate. Moreover, quotas established by the EU further restrict the supply of Ukraine's metal products. However, despite the high protection of the EU market of agro-food products reflected in the limited GSP preferences, the exemption of selected products from the GSP for Ukraine, as well as in the introduction of quotas in grain trade, the share of Ukraine's exports of these products to the EU

[31] Exports of fuel have recently intensified, linked to Russia's investments in Ukraine's petroleum refinery plants that were built in the Soviet Union time for processing Russian oil.

Figure13:
Structure of Ukrainian Imports, 2002



Source: UN ComTrade; authors' calculations.

Table4:
Structure of Ukraine's Imports by the Level of Processing in 1996 and 2002 (per cent)[a]

	EU-25		EU-15		NMS		Russia	
	1996	2002	1996	2002	1996	2002	1996	2002
Raw materials	11	4	5	4	21	7	66	66
Semi-processed products	17	23	17	22	17	24	10	11
Final goods	69	69	73	70	61	69	25	23

[a]Applied methodology does not allow classifying all traded items, thus the sum of proposed categories does not always sum up to 100 per cent.

Source: UN ComTrade; authors' calculations on the basis of Multilateral Trade Negotiations categories (WTO).

market is quite similar to the share of agro-food products in its total trade.

Machinery and equipment, in particular railway tank cars and gas turbines, occupy the largest share of Ukraine's exports to Russia, followed by metals and food products. Thus, the level of aggregated value of Ukraine's eastward exports is higher: the share of raw materials is only 3 per cent, while the share of final products is 66 per cent. Still, this structure of trade exists to a large extent not because of competitive advantage of Ukraine's machinery, but because of the preservation of Soviet Union links. Russia purchases in Ukraine machines and equipment serving as spare parts for capacities that were installed in the country during the Soviet Union period.

The structure of Ukraine's imports from the EU-25 and Russia to a certain extent mirrors the structure of exports (Figure 13). Imports from Russia are dominated by oil and gas, that is, raw materials, while imports from the EU-25 is mostly final goods, first and foremost machinery and equipment (Table 4).

The structure of trade by factor intensity, as shown in Tables 5 and 6, supports the previous story. Indeed, Ukraine exports to the EU-25 raw material-intensive products (mainly fuel and agro-food products), while one-third of its exports to Russia are of capital goods. In imports

the situation is just the opposite: Ukraine imports capital-intensive goods from the EU-25, and raw material-intensive goods from Russia.

The study of Ukraine's competitive position in world trade on the basis of the revealed comparative advantage index (RCA)[32] shows that Ukraine has a comparative advantage in metals, agro-food products, including vegetable and animal oils and fats, and inedible crude materials (Table 7). Ukraine has still a small comparative advantage in chemical products. Exports of these products face more trade restrictions in the case of the EU market (anti-dumping cases against metal and chemical products, limitations of the GSP scheme, etc.) than in the case of Russia's markets. Although Ukraine also meets these anti-dumping and safeguard measures against Ukraine's metals and other products, the existing free trade agreement and similar trade regulations inherited from the past and still partially functioning make Russia's markets more open than the EU's markets.[33]

By factor intensity, Ukraine has a comparative advantage in exports of capital-, labour- and raw material-intensive goods, while no advantage in research-oriented goods (Table 8).

Summarizing the above discussion, Ukraine depends on Russia's fuels and the EU-25 machinery and equipment. The former is a heritage of the Soviet Union, and the extremely inefficient structure of energy consumption in the country makes Ukraine—a net importer of energy products—the most energy-consuming economy in the region. The introduction of energy-saving technologies as well as the diversification of energy suppliers and types of energy used is expected to reduce Ukraine's dependence upon Russia.

In terms of exports, the EU markets seem potentially much more attractive, being the largest neighbour market both in terms of population and GDP. Moreover, they are more demanding, thus increasing export shares in these markets will mean meeting very high demand standards, allowing entering other world markets with a considerable markup for quality. However, Russia's markets are still relevant for Ukraine. As the trade regime of the EU towards Russia is rather liberal, there is no contradiction between the aim of preserving the access to Russian markets and EU accession.

Another indicator of regional integration is capital movements between the regions concerned and, in particular, flows of foreign direct investment (FDI). Despite all the benefits FDI may bring to a transition economy, Ukraine failed to attract a significant amount of capital from abroad. The comparison of FDI volumes per capita across "transition" economies reported in Figure 14 shows that Ukraine is at the end of the list, surpassing only four countries. Although the country has managed to reach a relatively high level of economic development without substantial FDI, much of current economic growth is caused by an extremely favourable situation in world markets for the main Ukrainian export items. Thus, without new driving forces, growth may slow down as soon as world market conjuncture changes for worse. Numerous benefits for economic development brought by FDI such as technological upgrade, management improvement, know-how, and others may help sustaining current economic growth and promote regional integration.

Considering the origin of foreign investors present in Ukraine, we can distinguish four groups of countries. The European Union is by far the largest investor, with more than one-third of total FDI inflow (just for the EU-15, so the actual number is higher).[34] It is followed by the United States, a set of so-called "offshore zones" (Cyprus, an EU-25 member, and the Virgin Island, a British dependency), and CIS countries, mainly Russia (Figure 15). Altogether these four groups account for three-quarters of total FDI inflows.

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[32] Calculated as a ratio of sector shares in Ukraine's and world exports.

[33] Even so, of the two bilateral trades, Ukraine derives surpluses on its trade with the EU, but not on its trade with Russia.

[34] The figure of FDI flows from the EU-25 is not reported, since the enlarged Europe includes one very large offshore zone, Cyprus, that accounts for a substantial part of FDI into Ukraine. It is difficult to identify the true origin of capital coming from offshore zones. Potentially, investors of all countries (including Ukrainian) may use these regions for tax optimization schemes.

Table 5:
Structure of Ukraine's Exports by Factor Intensity in 1996 and 2002 (per cent)[a]

	EU-25		EU-15		NMS		Russia	
	1996	2002	1996	2002	1996	2002	1996	2002
Capital goods	36	34	33	32	42	40	55	55
Labour-intensive goods	12	18	18	20	5	14	7	12
Raw material-intensive goods	43	40	38	40	50	40	29	25

[a]Applied methodology does not allow classifying all traded items, thus the sum of proposed categories does not always sum up to 100 per cent.

Source: UN ComTrade; classification from Yilmaz and Ergun (2003); authors' calculations.

Table 6:
Structure of Ukraine's Imports by Factor Intensity in 1996 and 2002 (per cent)[a]

	EU-25		EU-15		NMS		Russia	
	1996	2002	1996	2002	1996	2002	1996	2002
Capital Goods	46	58	52	60	35	47	22	24
Labour-intensive goods	21	25	20	23	24	29	4	5
Raw material-intensive goods	22	9	15	6	36	17	72	69

[a]Applied methodology does not allow classifying all traded items, thus the sum of proposed categories does not always sum up to 100 per cent.

Source: UN ComTrade; classification from Yilmaz and Ergun (2003); authors' calculations.

Table 7:
Revealed Comparative Advantage Index (RCA) for Ukraine, 1996–2002[a]

		1996	1997	1998	1999	2000	2001	2002
0	Food and live animals	2.1	1.3	1.1	1.5	1.0	1.4	1.8
1	Beverages and tobacco	1.1	0.6	0.5	0.6	0.8	0.6	0.6
2	Crude materials, inedible, except fuels	2.5	3.2	4.0	3.8	4.1	3.0	2.7
3	Fuels, lubricants, etc.	0.6	0.7	0.7	0.9	0.6	0.8	1.1
4	Animal, veg. oils, fats, wax	2.7	1.7	2.0	2.2	5.3	4.4	4.7
5	Chemicals, related products	1.4	1.1	0.9	0.9	1.0	0.9	0.7
6	Manufactured goods	2.4	2.9	2.9	3.0	3.3	3.2	3.0
7	Machines, transport equipment	0.4	0.3	0.3	0.3	0.3	0.3	0.3
8	Misc. manufactured articles	0.3	0.3	0.4	0.4	0.4	0.4	0.4
9	Goods not classified by kind	0.4	0.8	0.9	1.4	0.9	0.8	0.5

[a]The RCA index ranges from 0 to infinity with 1 denoting the neutral position.

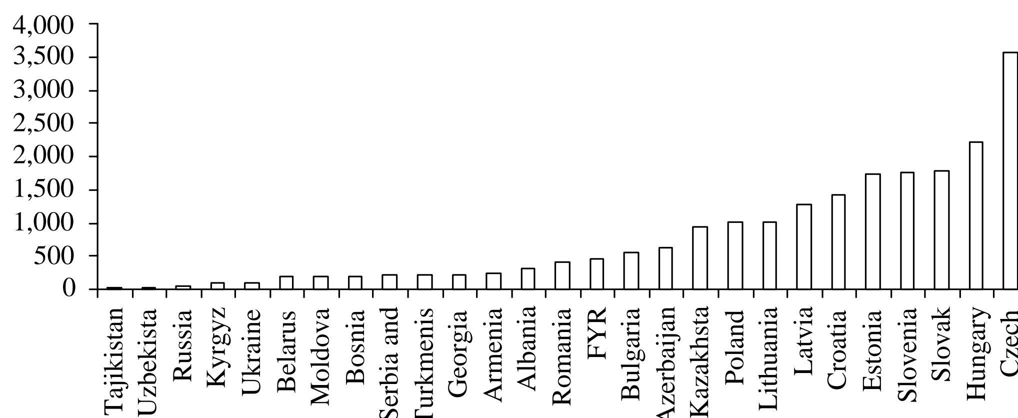
Source: UN ComTrade; authors' calculations.

Table 8:
Revealed Comparative Advantage Index (RCA) for Ukraine by Factor Intensity, 1996–2002

	1996	1997	1998	1999	2000	2001	2002
Capital-intensive goods	3.2	3.3	3.1	3.2	3.5	3.1	2.7
Labour-intensive goods	1.4	1.7	1.7	1.7	1.9	1.8	1.7
Raw material-intensive goods	1.6	1.5	1.6	1.7	1.4	1.4	1.7

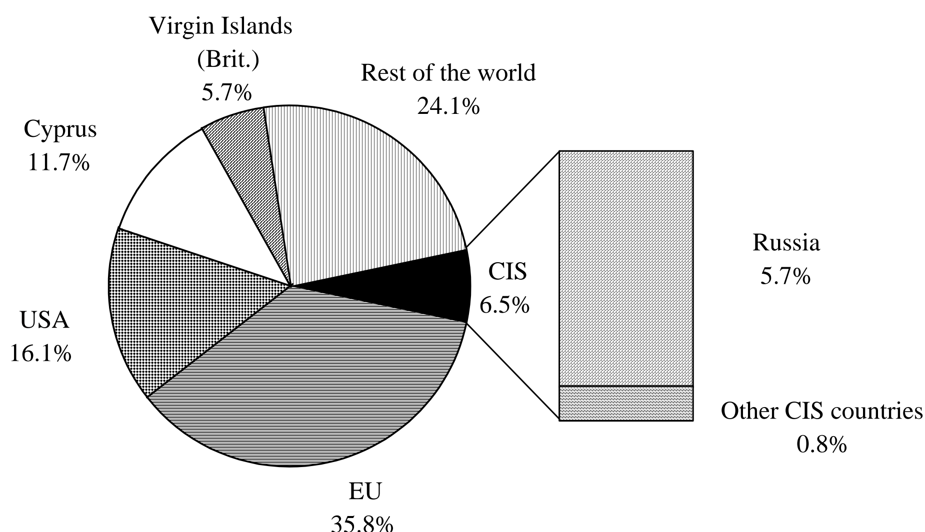
Source: UN ComTrade; classification from Yilmaz and Ergun (2003); authors' calculations.

Figure 14:
Cumulative FDI Inflows, 1992–2002 (USD per capita)



Source: EBRD (1999, 2003); authors' calculations.

Figure15:
Origins of FDI Inflows to Ukraine, 2003



Source: State Statistics Committee of Ukraine.

Capital coming to Ukraine from the west and from the east differs not only by volume, but also by investment motives and distribution of funds across industries. According to the survey results, conducted by Flemings/SARS Consortium, the main motive for western companies operating in Ukraine was the possibility to access a large domestic market (International Centre for Policy Studies 2000). Indeed, with its 48 million inhabitants, Ukraine represents one of the biggest markets in Europe, which, in addition, has a good potential for growth in terms of purchasing power. Relatively low labour costs are also reported as one of the motives for investment; however, this advantage is diminished by low productivity. On the contrary, investors from Russia and CIS came to Ukraine to regain lost markets and re-establish production links that had been formed during the Soviet era (Mankovska 2001).

Table 9:
Sectoral Distribution of FDI from EU-15 and Russia, 2003

	EU-15		Russia	
	USD m	%	USD m	%
All sectors	2,383.4	100.0	377.7	100.0
Agriculture	61.6	2.6	5.9	1.6
Industry (A+B+C)	1,340.2	56.2	159.4	42.2
(A) Mining	32.7	1.4	1.1	0.3
(B) Manufacturing	1,297.0	54.4	158.3	41.9
Food industry	581.0	24.4	10.6	2.8
Light industry	55.0	2.3	0.1	0.0
Wood-processing	45.2	1.9	0.5	0.1
Publishing	73.0	3.1	0.8	0.2
Coke and refined oil products	10.2	0.4	103.7	27.5
Chemical industry	141.1	*5.9*	0.6	*0.2*
Other non-metallic mineral products	109.4	4.6	2.3	0.6
Metallurgy and metal processing	46.0	1.9	20.0	5.3
Machine building	205.0	8.6	8.5	2.3
Other	29.5	1.2	11.1	2.9
(C) Production and distribution of electricity, gas and water supply	10.1	0.4	0.0	0.0
Construction	50.3	2.1	14.7	3.9
Wholesale & retail trade	373.3	15.7	26.9	7.1
Hotels and restaurants	24.9	1.0	6.3	1.7
Transport and telecommunications	174.9	7.3	39.4	10.4
Finance	186.1	7.8	28.5	7.5
Real estate	108.1	4.5	17.3	4.6
Education	1.2	0.1	0.0	0.0
Healthcare	5.2	0.2	77.9	20.6
Other community, social, and personal service	57.6	2.4	1.4	0.4

Source: State Statistics Committee of Ukraine.

FDI originated from different regions goes into different industries. As shown in Table 9, recipients of funds from Europe are mostly companies operating in food, chemical, and machine building industries. The wholesale and retail trade sectors have also received a significant part of the funds from the EU. At the same time, Russian capital is concentrated in the fuel and energy sector. To take a practical example, Russian oil companies have acquired almost all Ukrainian oil refineries, which in Soviet Union times were constructed specifically for processing Russian oil. Another object of interest for investors from the "northern neighbour" were healthcare complexes in the region of Crimea.

Stronger production links between Ukrainian and Russian enterprises in certain sectors would be beneficial for both countries. However, capital from the more advanced economies of the EU can bring benefits that are more relevant for the long-run growth and development of the Ukrainian economy. Factors such as new production, management and marketing technologies, better labour skills, improvement in risk management, etc. are linked to EU FDI and make firms more competitive and productive. Another important factor is that western companies tend to better comply with international standards of environmental protection. Thus, it would be advisable for the Ukrainian government to make efforts towards attracting more capital from the west.

After the 2004 elections, Ukraine finds itself in an extremely favourable position to attract foreign investors from advanced economies, as they are interested in an economy that has a large domestic market, low labour costs, and a poten-

tial to make considerable progress in market reforms. While the old member states of the EU are expected to be the main source of foreign capital flows into Ukraine, some funds may come from the NMS as well, as they are gradually losing their low labour cost comparative advantage as a result of economic convergence. Thus, increasing wages are likely to push investment further to the east (Economist Corporate Network 2002).

Despite its increasing attractiveness, Ukraine is not likely to be able to obtain more investment from abroad and, accordingly, promote its regional integration, unless the numerous statements about Ukrainian economic potential are supported by the practical implementation of reforms, specifically of those intended to eliminate major impediments that foreign firms face there. As indicated in the previous section, among them are instability of regulation, ambiguity of the legal system, discriminatory regulation, corruption, and the high tax burden (International Centre for Policy Studies 2000), unpredictability of the tax system, poor protection of rights of minority shareholders, ineffective bankruptcy procedure, and other impediments (European Business Association 2004).

5 The Road Ahead: "Tak dalshe zhit' nelzya"[35]. Initial Perspectives under Yushchenko's Government

So far, the development of the EU–Ukraine relationship can be split into two stages. The first stage, under the Kuchma governments, was characterized by a multiplicity of official documents declaring Ukraine's desire to move towards the EU, but little practical steps in this direction. There were a lot of complaints from the Ukrainian side that "the EU does not want to give a positive political signal by acknowledging the possibility of Ukraine's membership in the EU and readiness to start talks on this subject" as well as fears that the EU enlargement would result in negative consequences for Ukraine (fears so far disproved by the facts). In addition, actions like the agreement on Single Economic Space (SES) have raised doubts that Ukraine is seriously determined to move towards the EU. Further, they did not contribute to improving Ukraine's international reputation as a predictable and responsible partner. It should be acknowledged, however, that during Kuchma's Presidency a more or less coherent background for EU–Ukraine relations was at least formally established.

The 2004 Presidential elections can be considered as a turning point in Ukraine–EU relationships and the beginning of the second development stage. Many EU countries (including the NMS) actively participated in the settlement of the political crisis in Ukraine and explicitly demonstrated their support to Yushchenko as a new President. From his part, immediately after being sworn into office, he undertook an extensive foreign tour to Europe. He visited European institutions in Strasbourg and Warsaw, as well as World Economic Forum in Davos, actively mending international relations that were in stagnation for almost a decade. Definitely, Yushchenko is a more welcomed guest in the west than Kuchma was and, thus, can benefit from a more positive international environment. Nevertheless, there are still questions whether Yushchenko will transform the international trust he enjoys now into some more or less practical proposals from the EU side.

On February 4, 2005, Ukraine's Parliament voted for the new government headed by Yulia Timoshenko, and for the new Programme of the Cabinet of Ministers ("Towards People") that formulates the main strategic goals and directions of the government's activities, including its foreign policies' priorities.[36] While in many aspects the relevant programme provisions are very close to the intentions declared during the Kuchma period (Box 1), it contains one important element, an explicit intention "to develop together with the EU a new strategy of Ukraine–

[35] "We cannot go on living like this."

[36] http://www.kmu.gov.ua/control/uk/publish/article?art_id=11639687&cat_id=60142 (in Ukrainian).

Box 1:

Ukraine's Movement towards EU: Basic Official Documents

(I) The European choice: Annual Presidential Address to the Parliament "On the Internal and External State of Ukraine", May 31, 2002

According to the Address, Ukraine's gaining membership with the EU is a prospective foreign policy goal. Strategy for achieving this goal is the following:

2003–2004 : Ukraine is to sign an associated membership agreement with the EU and conduct talks on a free trade zone;

2004–2007 : Ukraine is to follow all necessary procedures needed to implement the associated membership agreement and become an associated member of the EU;

2005–2007 : Ukraine is to set up a customs union with the EU;

2007–2011 : Ukraine is to meet all the requirements for EU membership.

(II) Law "On National Program of Ukraine's Legislation Approximation to that of the EU", March 18, 2004.

According to the law, the adaptation of legislation is defined as the "process of bringing Ukrainian laws and other regulatory acts into compliance with "acquis communautaire". Chapter III of the Law explicitly states: "the state policy regarding adaptation of the legislation shall be formulated as a component of law reform in Ukraine". The Law also states "that draft Laws of Ukraine and drafts of other legislative acts, relating to the fields of legal relations regulated by the law of European Union, are subject to mandatory expertise to determine whether this draft comply with "acquis communautaire".

The Law confirms that the priority fields of legal approximation are those defined by the Article 51 of PCA: customs law, company law, banking law, company accounts and taxes, intellectual property, protection of workers at the workplace, financial services, rules on competition, public procurement, protection of health and life of humans, animals and plants, the environment, consumer protection, indirect taxation, technical rules and standards, nuclear laws and regulations, transport. This list shows that if implemented efficiently the process of legal approximation will result in substantial improvement of Ukraine's legal business environment and will contribute to integration of Ukraine into European legal space.

(III) Statement of the Ukrainian Party in Connection with Signing of the Protocol On accession of the New EU Member States to the PCA, April 29, 2004.

The Ukrainian Side expects that the dialogue with EU concerning enlargement issues will continue after May 1, 2004 and will concentrate on the following important issues of Ukraine–EU relations: granting Ukraine a full market economy status in the framework of the EU antidumping legislation; increase of the Ukrainian steel exports to the enlarged EU taking into account traditional steel exports to the 10 New Member States; granting Ukraine "social" preferences in the framework of the EU GSP; reaching settlement on the modalities of access of Ukrainian agricultural products to the EU market; ensuring significant simplification of the visa regime between Ukraine and the EU.[a]

[a]Statement of the Urkainian Party in Connection with Signing the Protocol On Accession of the New EU Member States to the PCA, April 29, 2004.

EU relationship that would envisage prospects of Ukraine's membership in the EU; to work in order to extend separate elements of pre-accession EU strategy to Ukraine". In addition, in the new government the special position of a Vice Prime Minister on European Integration (Oleg Rybachuk) was created, who is supposed to be responsible for the implementation of the "European course" of Ukraine. However, the scope of his responsibilities as well as the political role in

the process of Ukraine's regional integration has remained unclear so far.

As indicated in Section 2, Ukraine's EU membership is likely to be a long-run process, though the new Ukrainian leadership is very optimistic regarding the timing of accession.[37] Definitely Ukraine needs to elaborate a pragmatic approach to its relations with the EU in the post-enlargement period, in terms of expectations and possibilities, but also eliminate the impression that it is wavering undecided between the EU and the CIS. At the current stage the ideal European strategy for Ukraine would incorporate the following elements:

- Reconsidering the numerous programmes and other documents inherited from the Kuchma governance in order to identify real priorities;
- Harmonizing Ukraine's legislation with EU law;

If implemented effectively, the process of legal approximation will result in a substantial improvement of Ukraine's legal business environment and will contribute to integrate Ukraine into the European legal space. Currently Ukraine has more chances to speed up the harmonization process, since the struggle among its ruling groups is over and the Ukrainian Parliament is ready to cooperate with the new Cabinet of Ministers. At the same time there are grounds to believe that EU will put more emphasis on the issue of harmonization.

- Undertaking steps to get a market economy status from the EU;

As noted in a previous section, the receipt of market economy status by Ukraine is hampered by such domestic policy problems as inefficient bankruptcy legislation and state interventions in the price setting mechanism. The new government announced its intentions to overcome all obstacles and receive a market economy status this year. It is expected that the election of Viktor Yushchenko to the presidency will allow the EU to grant market economy status to Ukraine, as the new government resolves the EU's outstanding concerns.

- Accessing the WTO;

After more than a decade of negotiations upon Ukraine's WTO membership, it seems that the country is approaching the conclusion of the talks. As of February 2005, Ukraine signed 30 bilateral protocols on access to markets of goods and services, including protocols with such key partners as the EU, Canada, and Turkey. According to the Ministry of Economy and European Integration, Ukraine has agreed upon 95 per cent of all tariff lines, excluding tariffs on sensitive Ukrainian products (first of all, in agriculture). Also, talks on access to service markets is completed for 98 per cent of all service categories as defined by the WTO classification. Ukraine continues negotiations concerning access to financial and audiovisual services markets.

However, for the successful completion of the negotiation process in the near future, Ukraine has to fulfill several tasks. First, Ukraine has to sign bilateral protocols with the USA, Japan, China, Norway, Australia, and several other countries. It is expected that a successful conclusion of negotiations with the USA (as Ukraine and the EU have already signed a bilateral protocol for market access in goods and services in the framework of Ukraine's WTO accession) will intensify the overall process of signing bilateral agreements. Second, Ukraine has to complete multilateral talks and to finalize a Working Party Report. For this, Ukraine has to harmonize national legislations in accordance with the WTO requirements. Unsettled questions include harmonization of technical regulation; simplification of certification procedure; harmonization of sanitary, phyto-sanitary and veterinary measures; custom valuation; subsidies in car industry; export tariffs; quotas on exports and imports of sugar; estimation of agricultural domestic support.

Some Ukrainian officials forecast that Ukraine's increased coordination of activities between the

[37] According to Boris Tarasyuk, minister of foreign relations of Ukraine, in the case Ukraine successfully completes reforms envisaged in Ukraine–EU Action Plan, in 2007 Ukraine will be able to sign a "new-level" agreement with the EU that allows the country to look for a full EU membership in approximately 7 years. Ideally, according to Mr. Tarasyuk, a new bilateral document between Ukraine and the EU should be in the form of a "Europe Agreement or Association Agreement".

Government and the Parliament will allow completing harmonization of national legislation and bilateral talks in the first half of 2005. Shall these hopes come true, Ukraine might be able to become a WTO member in December 2005 during the Hong Kong Ministerial Conference.

- Preparing an agreement concerning the establishment of an FTA with the EU;

Although the PCA envisages the prospect of establishing a free trade area (FTA) with the EU as an "evolutionary" clause, so far no agenda for the fulfillment of this clause has been determined. The main requirement by the EU is that Ukraine becomes a WTO member before establishing an FTA with the EU. Thus, while for most of the NMS the fulfillment of WTO membership conditions was a by-product of the EU accession process, for Ukraine the WTO membership is a step towards EU integration.

It is worthwhile noting that the programme of government's activities entitled "Towards People" explicitly declares Ukraine's intention "to launch jointly with the EU work aimed at establishing a free trade area". Such negotiations, if seriously taken by both sides, could become an external anchor for internal institutional reforms.

Finally, it should not be overlooked that Russia and other CIS countries remain important economic partners for Ukraine. Therefore, it would be advisable for the country to preserve relationships with its eastern neighbours. Generally speaking, future cooperation between Ukraine and the CIS countries will be determined by the following factors:

- The political and economic agendas of the EU. In case Ukraine and the EU fail to find an appropriate "post-enlargement" scheme of bilateral relations, Ukraine may be forced to reconsider its European choice and come closer to Russia. At the same time a lot will depend upon how the EU will assess the integration prospects of Ukraine;
- The speed and scale of the continued trade reorientation away from the CIS space to third, mainly EU markets;
- The increase in FDI inflows from the enlarged EU;
- Ukrainian attempts to secure its positions on the CIS markets.

In sum, from Ukraine's perspective the way ahead in relations with the EU has two dimensions: economic and institutional. Success in the economic dimension will depend upon Ukraine's ability to penetrate more deeply into EU markets, to receive a greater share of EU FDI, and to compete successfully with EU companies. This ability will be determined, to the largest extent, by a domestic policy that should ensure the establishment of a viable market economy. Further developments in the institutional dimension will depend upon improving the framework of cooperation and removing obstacles in mutual economic relations.

This will also depend upon a clear decision from the Ukrainian side concerning its remaining relations with the CIS and prospective initiatives like the SES. A commitment towards the EU will necessarily imply a choice towards it, with all its rules and obligations. Relations with the CIS will not be severed, but Ukraine must realize that it will not be able to remain a member of this organization or of other sorts of regional groupings if those contradict the conditions for EU membership.[38]

This seemingly Ukrainian indecision between CIS and the EU was dispelled by a series of high level bilateral EU–Ukraine meetings held during February 2005: starting with the visit by EU External Relations Commissioner Ferrero-Waldner to Kiev during 16–18 February and followed by the 8th meeting of the EU–Ukraine Cooperation Council, held in Brussels on 21 February 2005, when the EU welcomed the appointment of a new government and expressed support for its programme of political and economic reforms. At this meeting, the EU formally acknowledged Ukraine's European ambitions and made clear that a new commitment to democracy and reforms opened new prospects for EU–Ukraine relations, and presented additional measures agreed by the European Council in order to

[38] One must stress here that, in spite of some proposals, the EU is *not* a "pick and choose" structure, and that there is no such halfway house towards membership. One is either inside the EU or not.

strengthen the Action Plan, some of which are listed below (one must note that they do incorporate many of the elements described above as the “ideal European strategy for Ukraine”):

- To initiate early consultations on an enhanced agreement between the EU and Ukraine, to replace the PCA at the end of its initial ten-year period;
- To explore possibilities for closer co-operation in the area of foreign and security policy, including European Security Defence Policy. Ukraine should be invited, on a case-by-case basis, to align itself with EU positions on regional and international issues;
- To deepen trade and economic relations between the EU and Ukraine. Work on agreements for steel and textile products for 2005 will be intensified. The review of the existing feasibility study on establishing an FTA between Ukraine and the EU will be accelerated with a view to enable an early start of negotiations once Ukraine has joined the WTO;
- To lend further support to Ukraine’s WTO accession and to offer Ukraine continued assistance in meeting the necessary requirements;
- To grant ‘Market Economy Status’ to Ukraine, as soon as the limited remaining issues have been satisfactorily resolved. The EU will intensify contacts with Ukraine in order to resolve theses issues;
- To step up support to the process of legislative approximation, including technical assistance and twinning to meet EU norms and standards and targeted advice and support legislative approximation through a mechanism such as the Technical Assistance and Information Exchange (TAIEX) unit of the Enlargement DG of the European Commission. Further efforts will be made to conclude bilateral agreements on the co-ordination of social security;
- To maximize access to funding from the European Investment Bank (EIB). After final endorsement of the ENP Action Plan, up to 250 million euros of EIB lending could be made available to Ukraine;
- To provide increased assistance to Ukraine through the relevant instruments in order to help Ukraine to pursue the reform process.

The culmination of those meetings happened on February 23, 2005, when the new Ukrainian President made a speech entitled “Ukraine’s Future is in the EU” at the European Parliament, in which a clear vision for EU membership was expressed, with his statement that “We hope that at the end of the Action Plan, in 2007, we will be in a position to begin EU membership negotiations. Ukraine is already a part of an integrated Europe. We are able to make an application under Article 49 and will aim to meet the Copenhagen criteria”, received with a standing ovation by the Parliament. In the same speech, he also stressed the non-exclusive nature of Ukraine’s EU links, by saying that “Moving closer to Europe does not prevent closer cooperation with Russia. Ukraine’s membership of the EU and NATO is not against Russian interests—on the contrary, a stable Ukraine could help bring Russia closer to Europe”. After this speech, President Yushchenko met in Brussels with the EU’s Council Secretary General, Javier Solana. These meetings happened one day after his visit to the NATO headquarters in Brussels, once again stressing the already existing links between this organization and Ukraine, and also opening the doors for a future NATO membership for Ukraine.

6 Conclusions

Under Yushchenko, Ukraine has an opportunity to engage in a series of reforms, including concerning its relations with the EU. Ukraine has experienced a remarkable macroeconomic stabilization and growth resumption in the last few years. Using relative institutional and economic indicators, the remaining deficits are obvious when compared to other countries in the queue for EU membership, but the case of other applicant countries, e.g., Croatia, has shown that institutional reforms can be quite fast, when supported by a clear EU entry perspective. Given the current economic links with the EU, Ukraine’s largest partner, the potential gains for Ukraine from membership are very substantial.

Ukraine should press for fast reforms and use the "honeymoon" period of the new government to open negotiations for EU membership, by submitting a formal application. This will, among other things, help to prevent a state recapture by vested interest groups and the further blocking of reforms. Nevertheless, EU membership is a long-term effort, and the Ukraine government should be aware of that.

The Ukrainian government should expect an initially sceptic reaction from some member states at the Council and also from the European Commission, as historically these institutions were sceptical about *all* previous enlargements. The New EU Member States and the European Parliament shall prove to be important allies for Ukraine in the application/negotiation process.

The EU, on its side, should weigh Ukraine's application on its merits, not taking into consideration the concerns of non-EU countries. To assure the successful achievement of Ukrainian membership, the EU should actively support the continuation of the reform process in the country, especially with respect to institution building. Finally, one must stress that the EU itself shall gain from this enlargement, as it has gained from all the previous ones.

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