UKRAINE'S ECONOMY AND EU INTEGRATION[1]

IGOR BURAKOVSKY
Kyiv Mohyla Academy

ANDRII GONCHARUK
Ministry of the Economy, Kyiv

ALAN MAYHEW
Sussex European Institute

Background

Ukraine's Economy and EU Integration

The current economic relationship between Ukraine and the European Union – trade and integration

Contractual economic relations between Ukraine and the EU are at present determined by the terms of the **Partnership and Cooperation Agreement (PCA), which entered into force in 1998**. The PCA establishes trade between the parties on a Most Favoured Nation basis (MFN), with the possibility of establishing a free trade area (FTA) when Ukraine has completed its accession to the World Trade Organisation (WTO). Ukraine also benefits from the EU's Generalised System of Preferences (GSP), although many agricultural products do not benefit from GSP.

Sectoral agreements have been made in textiles and steel. The textile agreement eliminates quantitative restrictions, while the steel agreement, though not eliminating quotas, does allow certain types of steel to enter the Union relatively freely.

The EU has already signed off on its bilateral agreement with Ukraine in the context of WTO entry. This will commit Ukraine to eliminating most controls on exports and to binding its tariffs. **Together with the conclusion of the agreement with the United States in March 2006, and subsequently with Australia, this makes Ukraine's entry into the WTO more likely this year**, but the problem of harmonisation of legislation of Ukraine in accordance with WTO rules and procedures is still outstanding and depends on the Parliament of Ukraine. Considering the experience of the events of summer 2005 when discussion prior to voting on the laws related to WTO accession resembled a battlefield, and in the context of the general elections held on March 26, 2006, **it is difficult to predict whether the accession process can be concluded this year**, though recent progress leads one to be optimistic.

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The granting of market economy status by the EU (and the USA) is above all a political boost for exporters. A positive decision could also have been expected in the current investigation against the Ukrainian producers of seamless pipes and tubes but hopes have not been realised. Proposed duties have reached 26% and are in practice prohibitive for exports estimated at $100 mln. EU trade defence policies have also been applied to Ukrainian chemicals, fertilizers and grain. Such measures have a negative impact on Ukraine's major exporting sectors. In this context, Commissioner Mandelson's intention to reconsider the way the EU uses its trade defence mechanisms is a good message for Ukraine.

The current situation of trade relations between the EU and Ukraine is nevertheless far more liberal than a decade ago. Ukraine now trades with the Union on much the same basis as other countries, a far cry from the regime of autonomous measures, which prevailed before the trade articles of the PCA became binding. **As a result, trade has expanded and the EU now makes up around 35% of Ukraine's foreign trade**.

- **European Neighbourhood Policy (ENP) and the Action Plan (AP)**

Economic relations have moved on to a different plane with the introduction of ENP and the agreement in February 2005 of the Action Plan between the EU and Ukraine.

The headlines of ENP promise greater trade liberalisation and a stake in the internal market of the Union through increased regulatory harmonisation. Participation in Community programmes and additional financial assistance through a new European Neighbourhood and Partnership Instrument (ENPI) are also promised.

ENP operates essentially as a bilateral policy – differentiation is the key expression. Bilateral relations are organised around Action Plans agreed between the Union and participating states in ENP. The Ukrainian AP has been agreed for a period of three years and will end at the same time as the initial phase of the PCA in 2008. **Thus the design of 'an enhanced agreement' to replace these existing arrangements is an urgent task**.

In the economic sphere, the AP emphasises actions to liberalise trade and improve the business environment. It underlines the objective of negotiating a FTA once WTO accession has been completed. The integration of Ukraine into the internal market of the Union is to be achieved by a high level of regulatory harmonisation, leading eventually to the negotiation of an Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA) in key sectors. Measures in the Action Plan are also designed to create a more predictable and stable business environment.

Although Ukraine has accepted ENP conditions and requirements, the government has stressed on many occasions that Ukraine is aiming for a different relationship with the EU. Ukraine is prepared to take additional commitments and to comply with EU standards and requirements, even if the EU remains unwilling to reconsider its position regarding Ukraine.

- **WTO accession and the Free Trade Agreement**

The first priority of Ukraine's international economic policy must be membership of the WTO. This will not only ensure that Ukraine can be part of fair and open trading on world markets, strengthening the country's position against trade protectionism, but it will also open up the way to negotiate a free trade area with the

Union and, more importantly, will lead to 'an enhanced agreement' to follow on from the PCA and Action Plan.

A free trade agreement with the Union would be a significant boost to the Ukrainian economy, but the extent will depend on the range of products covered by the Agreement. In the past the Union has frequently excluded agriculture and some heavy industry from the agreement. Such actions now would of course reduce the value of the agreement to Ukraine. Nevertheless opening up the possibility of trade should encourage both domestic and foreign investment and help with the modernisation of the economy.

A liberalisation of Ukraine's trade regime vis a vis the EU and the rest of the world will encourage Ukrainian business to diversify exports and will also lead to a broader use of GSP. It will also stimulate trade in services.

<u>The modernisation of Ukraine's economy</u>

Typically, the basis for increased investment and thus higher sustained economic growth is a macro-economic policy predicated on long-term economic stability. Part of this policy should be the establishment of a mid-term financial framework for government expenditure, which would go some way to ensuring financial stability.

However, the government should not ignore the micro-economic aspect.

Ukraine's economy has suffered from an insider economy and the ensuing lack of competition. The result is an economy heavily dependent on a few low value-added sectors, with poor productivity and high sensitivity to small movements in prices and exchange rates and to external shocks.

An example of this sensitivity to external shocks was the reaction of Ukraine's industry to the sudden rise in gas prices – a sector that has been cosseted by low energy import prices. While Ukraine's economy is heavily dependent on cheap energy, it is one of the least efficient producers of energy because of an outdated energy industry.

The modernisation of Ukraine's economy will rely on heavy investment in modern equipment, especially in the manufacturing and energy sectors. Much of this investment will come from foreign sources.

Foreign direct investment (FDI) has played a significant role in the modernisation of the economies of the new member states of the Union.

FDI brings not only capital into the country, but perhaps more importantly new management and technical skills as well as new technology and production methods. Through its requirement of high quality production from its suppliers, FDI leads to a modernisation of local business, which will now have to work to internationally acceptable quality standards. Foreign acquisitions in the banking sector, which are now progressing rapidly in Ukraine, also lead to more competitive credit offerings and will improve the supply of bank finance to small and medium size business.

The factors which attract FDI include the size of the market, the business regulatory environment, the absence of corruption and non-transparent business relations and the relative cost of production factors. In Ukraine a market exists, albeit with a low purchasing power, though this may accelerate rapidly in the coming years. The relative cost of production factors is very attractive to EU and American companies.

In order to attract substantial FDI, Ukraine must overcome the widespread perception among foreign investors that the country suffers from an inconsistent regulatory environment and corruption.

The government has been trying to tackle these issues over the last 18 months with some success though there is a long way to go before the quality of the business environment reaches the levels of the new member states.

The need to improve the business regulatory environment is evident from business surveys carried out with domestic and foreign companies. Despite Ukraine's advantages in terms of lower production costs and proximity to markets, a number of factors discourage foreign investors from investing in Ukraine. They include: the complexity of dealing with the national and regional public authorities; difficult and sometimes corrupt customs procedures; the low security of property rights; the lax enforcement of contracts; and the lack of mechanisms to protect minority shareholders.

The EBRD notes that, of all the countries in central and eastern Europe, Ukraine's Administration is one of the most difficult to deal with. Overall, Ukraine is classed by the EBRD in the lowest category in terms of compliance with international standards of corporate governance, together with Tajikistan and Belarus.

Another important aspect of the regulatory environment is the predictability of government actions. If government policy is continually changing, investors, domestic and foreign, cannot be sure of the profitability of their investment and they are liable to stay away. Part of the problem is that different authorities in Ukraine have not necessarily been saying the same thing and this has caused confusion. Recently there were several contradictory statements on the number of companies likely to be taken back into state ownership in order to be reprivatised. Another example was the sudden change in the law regarding Special Economic Zones, through which honest and serious companies, which had established plants in the Zones, suddenly found themselves in a completely different financial environment from the one they had been attracted to invest in.

The modernisation of Ukraine's economy has been held back by isolation from external competition and by the power of the 'insider economy'. The insider economy is especially well developed in Ukraine, where large financial industrial groups (FIGs) dominate industrial output. These groups maintain strong connections with government and other state institutions, allowing them to circumvent the normal operating rules of the market economy.

Many operators in Ukraine are thriving from the economic rents they derive from the lack of a transparent and competitive environment. They make super-normal profits and have little incentive to change the system. This, together with investments in local facilities, often leads to public appreciation even though in the medium-term the public is being condemned to work in low quality jobs and have a very poor standard of living. The status quo seems less risky than change.

The existence of these negative factors has led foreign investors to shy away from investing in Ukraine. Between 1989 and 2004 cumulated foreign direct investment averaged \$3,700 per capita in Hungary, \$1,500 in Poland but only \$170 in Ukraine (source: EBRD). **The new government should continue to tackle the problems of the "insider economy" and corruption and introduce a realistic programme to simplify the legal business environment and to give more protection to investors.**

The decision to integrate with the European Union will also be an important step in the struggle to attract more foreign investment.

There are however several hopeful signs. The government has done its best to reduce the scale of the insider economy over recent months, with some success. The World Bank reports that there has been a marked decrease in insider deals concerned with privatisation of state-owned firms and state contracts. The greatest success in this field was the privatisation at the end of 2005 of *Kryvorizhstal*, the largest steel plant in Ukraine for $4.8bn. The government had previously sold this company for only $800,000.

The other hopeful sign is that some of the FIGs are now beginning to transition to open, law-abiding companies, with international status. The most successful companies are beginning to realise that they will gain from the application of international standards of governance in Ukraine, as these will protect them from aggressive and shady companies. As these companies also begin to invest abroad, they will be compelled to abide by international standards of corporate governance.

<u>Energy policy and relations with Russia</u>

Ukraine today faces the danger of a serious external shock to its economy due to drastic price increases in Russian gas supplies.

The decisions taken by Russia were not entirely based on economics but were also based on political calculations. The solution to the short-term problem lies therefore also in the political/security sphere.

In the medium and longer term, economic policies which improve energy efficiency in Ukraine and impose hard budget constraints will be necessary as energy prices move towards world market prices.

On the domestic front Ukraine needs to improve its performance as an energy producer and as an energy transit country. There is considerable scope for improvement in the area of domestic gas extraction but it is in being a reliable and high quality transporter of energy that Ukraine will gain most. Higher returns from transit will help offset to some degree the rise in energy import prices.

Having experienced the first serious problems with Russian supplies and prices this January, the government of Ukraine has recently prepared a concept paper outlining the long-term development of the energy sector of Ukraine up to 2030. The document foresees a 5-fold decrease in energy dependency and a 3-fold increase in local energy production.

Reducing the inefficient consumption of energy of the economy will require the government to pursue policies which lead to full-cost recovery from consumers. This policy will need to be consistently pursued, while ensuring that domestic consumers are given time to adjust to higher prices.

Today the World Bank reports that Ukraine uses 22 times more energy to produce each unit of GDP than Germany. Reducing reliance on high levels of energy consumption is the most important longer-term challenge. It will only be met by hard budget constraints and considerable investment in industry.

<u>EU Integration as a channel for modernisation</u>

EU integration will help the modernisation of Ukraine's economy in a variety of ways:

- Deeper integration with the EU, and especially the negotiation of a new Treaty with clear obligations on both sides will reduce the perceived risk of investing in Ukraine. Better credit ratings will reduce the cost of borrowing and will therefore reduce the costs of operating in the country and of international loans.
- Implementation of the Action Plan will introduce a much improved business environment from a legal perspective; it will be difficult for Ukraine to roll this back.
- Integration leading to more liberal trading rules will allow domestic industry to develop further and attract FDI.
- Contractual relations with the EU will anchor reforms.
- The proposed European Neighbourhood and Partnership Instrument (ENPI) will provide a degree of financing for Ukrainian reforms. The Ukrainian authorities should carefully consider their priorities in the use of these funds.

The Action Plan is an ambitious programme of reform. Implementing the measures in the Action Plan would go a long way towards achieving the necessary reform objective of modernising the economy. If Ukraine makes good progress in Action Plan implementation, it could consider a very ambitious 'enhanced agreement' with the EU in 2008.

Ukraine should now concentrate on implementing the agreed Action Plan and preparing for 'an enhanced agreement' with the EU.

This 'enhanced agreement' could be an enhanced association agreement, going beyond the normal agreements by laying emphasis on integrating sectors of the economy with the EU's internal market.

Recommendations

Ukraine's Gross Domestic Product per capita is only 14% of that of its neighbour Hungary and 21% of that of Poland. The main aim of any Ukrainian government must therefore be to ensure that the economy expands rapidly in an environment of macroeconomic stability.

Ukraine has lost a decade of opportunity since the collapse of communism. The inconsistencies in economic policy over this decade have led to Ukraine falling far behind its neighbours.

However trade liberalisation and modernisation of the economy leading to higher productivity and economic growth can produce significant improvements in the standard of living.

The government should:

1. Pursue **trade liberalisation** with the aim of joining the WTO in 2006 and then proceed to negotiate **a free trade agreement with the EU**;
2. Continue **the fight against the 'insider' economy and corruption** at all levels: the government should concentrate on building interest groups in business and the state which have an interest in openness and transparency. Greater powers should be given to the competition authority and state aid should be made more transparent;

3. Implement measures to guarantee **'national' treatment to foreign investors and improve the quality of the business environment**. High standards of corporate governance are essential to the modernisation of the economy;
4. Take measures to **reduce the economy's dependence on energy** and impose hard budget constraints in the sector. Maximise the value of transit facilities;
5. Pursue EU integration through implementation of the EU-Ukraine Action Plan, with the aim of integrating with the internal market of the Union in those areas of specific value to the Ukrainian economy.