

# **THE PROSPECT OF DEEP FREE TRADE BETWEEN THE EUROPEAN UNION AND UKRAINE**

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## PREFACE

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This study of the feasibility of free trade between the EU and Ukraine was undertaken from September 2004 to January 2005, under contract from the European Commission. Extensive consultations were held in Brussels with the European Commission, first with the Directorates-General for Trade and External Relations, and subsequently with the several other directorates-general concerned with sectoral policy aspects of EU-Ukraine relations (transport, energy, enterprise, agriculture, information technology, health and safety, economics and finance, competition). Consultations were also held in Brussels with UNICE, the European Round Table, COPA and steel industry interests. In Kyiv consultations were held with Ukraine's presidential staff, the Ministry of Economy, Ministry of Foreign Affairs and the Ministry of Justice (with special thanks to Olena Zerkal), the National Bank of Ukraine, the Ukrainian Agrarian Confederation, the European Business Association, steel industry interests, the Delegation of the European Commission, several embassies of EU member states, the offices of USAID, the World Bank, the IMF, the EBRD and the UNDP, along with several policy research centres.

All the authors worked in an independent capacity. Valeriy Pyatnytskiy was appointed Deputy Minister of Economy when the report was at an advanced stage of preparation.

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Michael Emerson  
Project Director  
March 2006

# EXECUTIVE SUMMARY

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## 1. Mandate

Our mandate has been to report on the possible content, feasibility and economic implications of Ukraine and the EU undertaking a free trade agreement (FTA) to follow on from Ukraine's accession to the World Trade Organisation (WTO).

The authors are a group of EU and Ukrainian economists, all of whom worked on the project in an independent capacity.<sup>1</sup>

The study was commissioned by the European Commission as a step in the EU-Ukraine Action Plan jointly agreed with the government of Ukraine in December 2004, in the framework of the European Neighbourhood Policy (ENP).

## 2. Context

The present study is intended to update an earlier study on this subject undertaken in 1999. There are indeed major new developments that warrant a fresh look at the question:

- Ukraine's economic recovery from the deep recession of the 1990s, with fast economic growth over the last five years;
- Ukraine's forthcoming WTO accession;
- the EU's enlargement in 2004 up to Ukraine's borders;

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<sup>1</sup> Valeriy Pyatnytskiy participated fully in the larger part of the work of the group in an academic capacity, before his appointment as Deputy Minister of Economy in November 2005.

- the EU's new European Neighbourhood Policy and Action Plan with Ukraine; and
- the Orange Revolution in 2004, which marked the will of Ukraine to make the break from a phoney to a real democracy.

At the EU-Ukraine summit of 1 December 2005, EU leaders "reconfirmed the goal of promoting deep economic integration between the EU and Ukraine and, in order to achieve this, look forward to an early start of negotiations of a Free Trade Area once Ukraine has joined the WTO".<sup>2</sup>

### **3. Methodological approach**

A starting point for our work was the request to update an earlier study undertaken for the Commission on a possible free trade agreement (Brenton, 1999). We have approached the task of 'updating' in a more substantial way than just re-running model calculations quantifying the expected impact of free trade with more recent economic data. We took this decision because there have been important developments in the analytical methods of economists in recent years, reflecting better understanding of the processes of both the post-communist transition and contemporary European integration. We confirm the earlier conclusions that the simplest free trade agreement, merely removing customs tariffs, would have only a minor impact on Ukraine's macroeconomic performance, and even less on the EU's economy. On the other hand, deeper forms of market integration can have substantial impact, especially when they link to reforms of domestic economic governance in countries (such as Ukraine) where it is badly needed. We have thus drawn up two main scenarios for simple and deep free trade, and made quantified estimates for both. Whereas simple free trade is relatively straightforward to describe, a deep free trade agreement (FTA+) requires much more detailed specification of its possible contents, to which we therefore devote substantial attention.

### **4. Current economic situation in Ukraine**

Ukraine has succeeded in the last five years to climb out of the deep recession of the early years of post-communist transition. But this burst of fast growth owed much to a cyclical boom for metallurgical products in

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<sup>2</sup> See the European Commission, Joint Statement, EU-Ukraine Summit held in Kyiv on 1 December 2005, 15222/05 (Presse 337), Brussels, 1.12.2005.

world markets, which has now come to an end, and to which is now added the rise in imported energy prices. Since Ukraine has only a moderate natural resource endowment, it has no option other than to become a highly open and internationally competitive economy in a diversified range of industrial and service sectors (the agricultural sector has a rich endowment of land, but will nonetheless be of declining importance in a growing economy).

To this end, Ukraine must establish a favourable business climate without delay, cutting out or streamlining a host of complicated, unpredictable and often corruptly administered business regulations, and so favour both domestic and foreign investment. Also, in the near future the government has to unwind the unsustainably populist fiscal policies of 2004. Yet Ukraine's capacity to attract strategically important foreign direct investments has recently been exemplified in the re-privatisation of its largest steel producer (Kryvorizhstal) and investment by an EU bank in one of its largest banks (Aval). Integration into European and international markets and supply chains, coupled with decisive measures to improve domestic economic governance and curb corruption, will have to be at the heart of an economic strategy to restore Ukraine to a fast-growth path.

## **5. From WTO accession to an FTA+: A continuum of possibilities**

WTO accession primarily means:

- abiding by the principles of non-discrimination and transparency among WTO partners;
- fixing tariffs, mostly at low levels, with the most-favoured nation clause;
- excluding quota restrictions;
- opening many service sectors to free trade;
- adopting rules for customs procedures; and
- observing rules for non-tariff barriers, with the principle of non-discriminatory 'national treatment'.

The simplest or minimalist FTA would add to these WTO conditions the move to zero tariffs for trade in goods, further liberalisation of services, but perhaps with only limited liberalisation in some sectors.

Deepening the free trade package could mean drawing on the following:



- extending the zero tariff principle to embrace the free movement of all goods, services, capital and (doubtless with longer transition periods) labour as well;
- for trade in goods, substantial elimination of non-tariff barriers through harmonisation or mutual recognition of technical standards with those of the EU (or both);
- for trade in services, complete sectoral coverage and convergence on internal market regulatory rules of the EU or best international standards;
- stronger commitments in competition policy, corporate governance and internal market regulation that are anchored to EU practices, and for selective elements of environmental standards; and
- adoption of accompanying policies, including technical assistance, infrastructure investment, education and training.

#### **6. Actual examples from the EU**

The continuum of theoretical possibilities is illustrated by the variety of the EU's existing free trade and association agreements:

- The EU's first free trade agreements were with the European Free Trade Area (EFTA), and initially only covered free trade in goods.
- The Euro-Mediterranean agreements initially only provided for shallow free trade in goods, but extension to free trade in services is now being discussed.
- The EU-Chile agreement is already more extensive in the coverage of service sectors and other provisions.
- The EU and Turkey share a customs union for industrial products.
- The European Economic Area (EEA), bringing the EU together with Norway, Iceland and Liechtenstein, covers all 'four freedoms' and entails complete compliance with EU internal market laws and standards, and full mutual recognition. This is the extreme model of complete inclusion in the EU's internal market, yet without political membership of the EU.
- The current EU-Swiss model comprises a large selection of sectoral agreements linked to EU internal market norms, but this model is less complete than the EEA.

## 7. Economic impacts of simple or deep free trade scenarios

For making quantitative estimates of the likely impact of free trade, the standard modelling (computable general equilibrium) technique is useful, but not fully adequate. This is because such models theoretically assume that trade barriers are separating otherwise competitive economies, which may be not too far from reality for the EU and US as trade partners, but is certainly not valid for Ukraine. In addition, the standard models generally fail to investigate the dynamic effects of improved institutional performance and economic governance or the curbing of corruption, which is now the most important deterrent to trade and investment for Ukraine.

In recent years, however, economists have progressed in analysing the impact of removing wider categories of trade barriers, such as incompatible technical standards, as well as the dynamics of deeper integration, especially between close neighbours where gravitational effects through proximity to large markets come into play. The recent experience of the enlargement of the EU into Central Europe, coinciding with the post-communist transition, has spurred research in these fields. There are now indications that deep free trade, of the kind discussed here for the EU and Ukraine, could have beneficial effects much greater than earlier estimates have suggested, including important benefits from both external liberalisation and domestic regulatory reforms in the main service sectors. Cuts in import tariffs on their own, such as in a simple FTA, will not lead to substantial income growth and welfare gains, although there would be significant changes in trade structure (which are detailed in chapter 4). Yet deeper free trade could deliver welfare gains of the order of 4-7% according to comparative static simulations; taking into account dynamic effects, welfare gains over time could be twice or three times as large. In addition, reductions in the cost of capital could lead to a further 4-5% welfare gain. Ukrainian exports to the EU could double, and EU exports to Ukraine could also grow very substantially.

Estimates of the impact of improved institutional quality for countries such as Ukraine are very large, with conceivable increases in GDP in the range of 20 to 30%. Fully opening the financial and other key service sectors such as telecommunications to foreign investment and best international practice would constitute a key element of such reforms, and could according to some new estimates alone raise the annual growth rate by 1.5%, compared with economies that have closed and unreformed markets. In interpreting these quantitative results it should be noted that they reflect different modelling approaches and are therefore not strictly comparable;

also, the reforms analysed are to some degree overlapping rather than strictly additional (the same is true for the estimated welfare effects).

Overall, a combination of opening the economy and transforming the quality of domestic economic governance could substantially raise the sustainable growth rate of the Ukrainian economy, possibly even approaching double digits for some time. This would mean a substantial catch up towards the GDP per capita levels of the new Central European member states of the EU. Ukraine has two key assets that could help to make this feasible, namely a well-educated human capital base and geographical proximity to the EU market – provided that the policy and institutional prerequisites are also satisfied. Furthermore, deep free trade may also lead to a more equal distribution of population income because enhanced competition will cut down monopoly profits.

The effects on the EU economy will be very minor at the macroeconomic level, even insignificant according to standard model calculations. But these simulations cannot take into account certain dynamic effects that could be of some importance to the EU economy. Notably there is the possibility that Ukraine's inclusion in the European supply chain could offer some EU industries, ranging from high-tech electronics to low-tech textiles, an opportunity to improve their competitiveness *vis-à-vis* the fast-growing Asian competitors by outsourcing labour- or resource-intensive parts of their production process. The example of the huge growth of US-Mexican trade and investment under the NAFTA agreement is suggestive here.

## 8. Concepts of feasibility

Feasibility, a key word in our terms of reference, is a complex concept. It is certainly not a static or purely technical matter, and it might be defined as having the following aspects in the present context:

- administrative capacity to legislate, implement and enforce requisite policy steps;
- political economy feasibility to undertake the requisite reform strategy;
- competitive capability of the economy to prosper under open market conditions; and
- educational capacity of the labour force for an advanced market economy.

In general terms, Ukraine's educational capacity is strong, its administrative capacity weak and its competitive capacity, with the exception of a few sectors, remains to be created. Political economy feasibility is surely a fluid and elastic matter, depending on the broad factor of political will, which is the product of political leadership, public understanding of the issues and perceptions of sectoral and national priorities on the part of different business and civil society interest groups. In this area, it is vital that the Ukrainian authorities invest more heavily in the normal processes of stakeholder consultation, for example for passing WTO-compliant legislation now, followed by that for an FTA. Given political will, administrative capacities can be strengthened, reform strategies implemented, and new competitive capacities created.

The broad picture is one of a trade-off, especially for Ukraine, between the ease of feasibility versus the scale of the benefits. Simple free trade is the most easily feasible, but its impact will be weak. Deep free trade is much more demanding in terms of feasibility, but offers the prospect of much larger economic advantages of strategic value.

#### **9. How far to go in convergence on EU regulatory rules and standards?**

How far or how fast the country should go in the direction of deep policy convergence on EU regulatory rules and technical standards requires detailed attention, i.e. to define the optimal package and time-path specifically for the case of Ukraine on the basis of cost-benefit analysis.

The recent experience of the new member states has underlined the heavy costs in the short run, for both public administrations and the private sector, of achieving full compliance with EU economic rules and standards. This was in fact achieved only with very substantial financial and technical assistance, along with the political incentive of full membership. Ukraine, however, is under no pressure to define a deep FTA in terms of complete compliance with EU market laws and standards, and so selective prioritisation is both possible and desirable. The parties can focus on defining the content of an FTA in accordance with objective cost and benefit criteria for the two parties.

#### **10. A scenario for simple free trade (FTA)**

*Free trade in goods.* Various precedents would suggest the elimination of tariffs asymmetrically over five to ten years. The EU might front-load its tariff cuts, possibly eliminating them all on the day of entry into force of the

agreement, given its much greater competitive strengths. Ukraine would at the same time begin to reduce its tariffs. A long transition period, up to 10 years, has precedents in EU free trade agreements with Mediterranean countries. But the disadvantage of a long transition period is that the process may lose credibility and fail to energise the private sector, so we would suggest about five years.

WTO rules allow bilateral free trade agreements only on condition that substantially all products are included. Agriculture has been the main exception in many of the EU's free trade agreements. Particularly sensitive sectors could be handled with extended transition periods and limited partial exclusions.

*Free trade in services.* Ukraine's WTO offer already covers almost all service sectors, and will be one of the most liberal regimes of all WTO members. A few exclusions from the WTO offer, such as for road transport and civil aviation (see below), should be brought into the FTA.

*Freedom of capital movements.* Some restrictions remain at present for short-term capital movements, and these are understandable for a transitional period while the Ukrainian financial market is poorly developed, and while monetary policy is moving towards a floating exchange rate and inflation-targeting regime. Complete freedom for capital movements might be achieved by 2008.

## **11. A scenario for deep free trade and the reform of economic governance (FTA+)**

Under the current Partnership and Cooperative Agreement with the EU, Ukraine has already been progressively approximating many of its external trade and internal regulatory policies to EU standards. Although important as preliminary investments in legal infrastructure, Ukraine's performance in implementation and enforcement has been lagging far behind. Our summary of the priorities for Ukraine would see a scenario with the following points, along with those outlined in the simple free trade scenario, and are illustrative rather than exhaustive:

- i) *Customs services* have to make a double quantum leap, first to eliminate corruption, and then to introduce technically advanced procedures that would logistically support Ukraine's entry into the European supply chain.
- ii) For *industrial product standards*, compliance with EU standards is of primary importance, and the EU Commission has proposed an

ambitious plan to Ukraine for achieving a high level of harmonisation and mutual recognition by 2011.

- iii) For *agricultural and food products* major investment is needed to enable compliance with EU sanitary and phytosanitary standards so that Ukraine might be able to export a diversified range of products to the EU.
- iv) Ukrainian *competition policy* is being comprehensively aligned at the legislative level on EU practice, but major reinforcement of the political independence of the executive authority for controlling monopolies and state aid is needed, possibly with some external anchorage.
- v) A *government procurement agreement* could be negotiated with the EU, taking into account whether Ukraine would first negotiate an agreement in this domain in the WTO.
- vi) The *financial sector* is now being opened for foreign investment, and this is the crucial step at this stage towards improved resource allocation – by disconnecting the financial system from both government and domestic monopolistic power. Nevertheless, there should not be a premature attempt at total compliance with EU regulatory norms, which would be too costly.
- vii) The *transport sector*, especially air and road transport, needs multiple initiatives beyond free trade in services, with convergence on EU standards and investments in infrastructures. Since the civil aviation sector is excluded from the WTO, bilateral negotiations between the EU and Ukraine are already beginning in this sector, and should aim at full inclusion of Ukraine in the ‘Single European Sky’.
- viii) The *telecommunications sector* has also recently been opened for foreign investment and competition, and here it is appropriate to converge on the EU’s first generation of regulations of 1998 (rather than the more recent version, which relies on very advanced national regulatory authorities).
- ix) In the *energy sector* there are already limited possibilities for connections with the EU electricity grid in the south-west region. But the bigger question of linkage of the entire Ukraine grid with the EU and south-east European grid now becomes conceivable, which would require strict compliance with EU standards. The gas crisis of January 2006 highlights the inevitable convergence of Ukraine’s

energy prices on world market levels, and the resulting burden of adjustment for its energy-intensive industries.

- x) In general, an essential requirement for the service sectors is for the *regulatory authorities* to have independence from both political and commercial interests, and to acquire state-of-the-art competence, for which twinning arrangements with European counterparts would be valuable.
- xi) Ukraine's *corporate governance* standards are extremely weak and basic laws for joint stock companies, the protection of minority rights and for mandatory accounting and audit standards in line with European/international standards are still lacking.
- xii) Regarding *environmental standards*, full compliance with EU standards would be extremely costly if implemented rapidly, although there are also the costs of non-action to consider, notably in the area of public health. The European Neighbourhood Policy (ENP) Action Plan therefore foresees step-by-step alignment with the environmental *acquis*, with EU financial support. Ukraine's accession to the Kyoto Protocol opens opportunities for accelerating the process in cooperation with the EU.
- xiii) Concerning *labour regulations* there are urgent needs in Ukraine to improve safety standards, but this requires above all modern re-equipment in industries such as coal mining. The introduction of liability insurance systems would also be helpful. In this area there is no need to harmonise with the EU's often very burdensome regulations, such as those for part-time work. Mutual recognition of professional qualifications and coordination of social security would be natural complements to the other three freedoms.
- xiv) With regard to the *movement of persons*, it is already highly positive for both parties that Ukraine has scrapped visa restrictions for EU citizens. Asymmetry is appropriate here in the interests of both parties for the next several years. Visa-free travel would be appropriate when Ukraine has achieved a higher level of prosperity and border control. Visa facilitation negotiations have now begun for Ukrainians travelling to the EU.
- xv) Ukraine's *human capital* is high, especially in the natural sciences, but has a huge need for modernisation in the social sciences and management studies. With the projected doubling of the EU's grant assistance from €50 to €100 million in the near future, we advocate scholarships in higher education as a major priority, with a rapid

build up from the few dozens per year of Ukrainian students in the EU as at present, to a thousand by 2008.

## **12. Benchmarks and checkpoints**

The negotiation and implementation of an FTA+ could be subject to a number of major benchmarks or checkpoints, for example from the entry into force and review after a number of years to moving towards an even more advanced relationship. The main strategic requirement, for an FTA+ to become strongly beneficial, is for Ukraine to switch to a transparent, consistent and largely de-corrupted regime of economic governance, and therefore to acquire a reputation for these qualities in the eyes of the international business community. Examples of conditional checkpoints could include some vital laws for creating conditions for sound economic governance that need to be passed, notably the current draft laws for joint stock companies, minority shareholder rights and competition policy for state aid, which have been rejected by the parliament during the last year, but have not been pre-conditions for WTO accession.

In any event, enforcement of EU-compliant legislation will be monitored under the ENP Action Plans, and this could link to the intention to make aid under the new European Neighbourhood Policy Instrument (ENPI) dependent on performance according to governance criteria. This could further link with and reinforce conditionalities set by the international financial institutions (IFIs). Indeed, classic trade policies are in general not suitable instruments for fine-tuning in relation to wider economic policy conditions. On the other hand, where an FTA+ forms part of a wider transition strategy and European integration process, there will be opportunities for attaching EU and other IFI finance to policy reforms that would be crucial for the success of an FTA+.

## **13. From sensitive sectors to a rebranded Ukrainian economy**

We have had a close look at certain sectors that are currently the most heavily protected in either or both the EU and Ukraine, and where the most lively opposition to free trade might be expected.

For both parties agriculture is a heavily protected and politically sensitive sector. In Ukraine this is because the modernisation of the agricultural sector has only recently begun, beyond the essential first step of privatisation. For the EU there are already major political difficulties in



agreeing conditions for opening the WTO's Doha Round agenda, especially for liberalisation of agricultural trade.

For the EU, steel and textiles have been sensitive industrial sectors for several years. In any case, the EU's quota for steel imports from Ukraine will have to be scrapped with Ukraine's accession to WTO, and an FTA will not add to this sector's challenges. It is already apparent that EU and Ukrainian steel producers are beginning to see opportunities for complementarity and mutual integration through investments. For textiles Ukraine is not at present a major player, but with an FTA+ there would be useful opportunities for intra-industry trade in textiles and clothing, with the proximity of low labour costs in Ukraine next to the high value-added parts of the supply chain in the EU.

The challenges are more heavily weighted on the Ukrainian side, where virtually every sector of the economy, including for example a poorly competitive automobile industry, still faces the prospect of deep restructuring and renewal. The extent of the poor international competitiveness of Ukrainian industry and service sectors makes it pointless to try and identify individual branches that might justify special protection. This is why a strategy of total commitment to openness and steady improvement of the business environment is indispensable. Once Ukraine achieves a reputation for such a strategy, which means a 're-branding' of the Ukrainian economy, there is every reason to expect a strong flow of domestic and foreign investment. Already there are signs that major industrial sectors, for example electronics manufacturers, are seriously considering the option of locating an important part of the European supply chain in Ukraine, which could also become a plus for the EU's global competitiveness, in light of the Asian challenge it faces.

#### **14. Implications for Ukrainian-Russian trade relations**

There will be many aspects of an EU FTA+ affecting relations between both parties and Russia. Both the EU and Ukraine would want an FTA+ to be compatible with positive and constructive relations with Russia, as illustrated in the following two examples:

- There could in principle be possibilities for free trade between all three parties. For Ukraine the main objective should be to have free trade with both the EU and Russia. Russia also advocates a customs union with Ukraine (and Belarus and Kazakhstan); however, this idea is being rejected by Ukraine since it would indeed be incompatible with free trade between Ukraine and the EU.

- For the highly complex domain of technical standards for industrial and agricultural goods, convergence on a single set of standards is desirable. Ukraine is converging on European standards. Here it would be helpful if Russia more clearly agreed to also converge on European standards in the framework of the (EU–Russia) Common European Economic Space.

#### 15. What is feasible? What is necessary?

Unfortunately, as noted earlier, the main policy options come in the form of a trade-off between the ease of feasibility and the scale of likely benefits.

The least ambitious and simplest free trade area, merely eliminating tariffs with the exception of agriculture, would be rather easily feasible, but of little benefit since the most important barriers to trade and investment in Ukraine remaining after WTO accession will be the well-known problems of economic governance (lack of transparency in business relations, lack of predictability in government policies and pervasive corruption).

It would clearly not be feasible, on the other hand, to seek within a five-year time horizon, full inclusion into the EU's internal market in the manner of Norway in the European Economic Area. The burden of full compliance with EU law for the legislature, government agencies and the private sector would certainly be excessive for Ukraine over such a short period.

An FTA+ along the lines set out above would fit with the needed reform agenda of Ukraine. Its feasibility would certainly be more difficult than for simple free trade, and would depend on the capacity of the Ukrainian government, parliament, business interests and civil society to find together the political will to work towards this end. This condition cannot be taken for granted at present, since the current parliament has refused to pass a number of laws required even for WTO accession, and which would be essential parts of a comprehensive strategy to improve economic governance. It remains to be seen therefore what will prove feasible with the next parliament following the elections of March 2006.

The ongoing experiences of the post-communist transition in wider Europe point to a model that is not as simple as the idea of a naturally continuous process. The picture seems rather to be one of two models emerging: the model of countries converging fast on advanced European standards of economic governance and democracy with law-abiding societies, versus a model of corrupt oligarchic governance, pseudo-

democracy and poor living standards. Regrettably, it seems that the second as well as the first of these models is self-sustaining. The Ukraine of the Orange Revolution was seen to be trying to break out of one to join the other. But the economic forces that sustain the vicious circle of corruption and poor living standards are formidable, which is why a strong and deep free trade formula, rather than a shallow one, is advisable.

At this stage the future of the Orange Revolution and Ukraine's European choice hang in the balance, and cannot be considered irreversible. A credible reform strategy needs to be anchored in the short run to a progression, beginning with the conditions for WTO accession and leading on to those for deep free trade, or an FTA+, with the EU. In the long run, Ukraine can only become a prosperous and stable democratic society with a diversified economy if as a general rule it converges on international standards of economic governance and competitiveness. Convergence on European standards fits as a strategic anchor both as a matter of the political 'European choice' and as proxy for general international standards.