

EU-Ukraine Integration: What Lies Ahead?

Małgorzata Jakubiak

Recent events have called into question Ukraine's continued European orientation. If Ukraine is to develop a stronger economic relationship with the European Union, this will be based on a Free Trade Agreement. While a standard FTA in the manufacturing sector can benefit both the EU and Ukraine, deeper economic integration has the potential to significantly boost intra-industry trade between the two sides. This, if combined with other EU incentives, might yet draw Ukraine closer to the EU, but only if Ukraine is willing.

The main steps needed to bring Ukraine closer to the EU in economic terms have already been charted at the official level. These include Ukraine joining the WTO as well as gradually lowering barriers to trade in manufactured goods between Ukraine and the EU. However, it is difficult to estimate with any degree of certainty when or how these actions will be put into effect. In light of this, what are the best policy options for both Ukraine and the EU?

In the past several years, relations between the EU and Ukraine have evolved through the framework of European Neighbourhood Policy (ENP). ENP is intended to encourage stability, security and prosperity in neighbouring states without offering them the prospect of EU membership. To operationalise ENP, the EU has agreed on an individual action plan with each ENP country that specifies priorities for the short-to-medium term (three to five years).

To present, the implementation of the economic articles of the EU-Ukraine action plan shows that Ukraine has progressed substantially in areas connected with external liberalization, primarily trade and financial liberalisation. In other areas, such as those related to structural reforms, there has not been much success. In some extreme cases, domestic policies on structural reforms have even led to the deterioration of economic conditions. The situation now calls for concentrating efforts on domestic reforms, alongside finalising efforts aimed at WTO entry, which may happen as early as this year.

• **Benefits of Free Trade with Europe**

• When thinking about the exact form of economic integration that is going to take place between the EU and Ukraine during the next five to ten years, the most likely option is that a typical EU free trade agreement (FTA) in the manufacturing sector will be signed. Assuming that such an FTA goes into force in 2008, it can take as long as 10 years before trade in manufactured products is fully liberalised. However, it is in the interest of both the European Union and the Ukrainian authorities to make this transition period shorter.

• An EU-Ukraine FTA in manufactured goods is unlikely to result, however, in high welfare gains. Existing studies suggest that the gains for the EU would be rather negligible due to asymmetric economic relations. Ukraine accounts for only a tiny fraction of EU trade (in 2005 it accounted for 0.7% of EU imports and 1.2% of all exports of EU goods). Ukraine would gain more in comparison, although the positive effects would not be immediately felt across the whole economy. It is estimated that the welfare gains would be in the range of 1 -2% of GDP.

• While EU-Ukraine free trade in manufactured goods is unlikely to result in direct high welfare gains, it would help to change the structure of Ukraine's economy and facilitate its long-term development – thus making it more hospitable for foreign investment. As WTO membership is a precondition for Ukraine before it can sign an FTA with the EU, any actions that would support Ukraine's efforts to join the WTO are worth serious consideration.

• **FTA+**

• Greater gains will only be observed if deeper integration occurs between the EU and Ukraine, which could happen under an FTA+ agreement. The name reflects the idea that it would be in the interest

of both the EU and Ukraine to expand the coverage of the agreement. The concept was described in a recent feasibility study on a potential EU-Ukraine FTA conducted by the Centre for European Policy Studies (CEPS). If external circumstances fall into place, it may be worthwhile to promote this kind of more ambitious agenda even at the early stage of FTA negotiations, which are occurring at this time.

The FTA+ package should include:

- Support to the reform of the customs services (an ambitious agenda was set regarding this in the EU-Ukraine action plan; however the functioning of the customs service remains a huge barrier to trade)
- Harmonisation and mutual recognition of standards reducing non-tariff barriers to trade (this is likely to become an even greater barrier in the next few years)
- Adoption of agro-food standards (as complete integration in the sphere of agriculture is impossible, adopting these standards can lower barriers to trade, develop the internal agricultural market and reduce the scope for phyto-sanitary concerns)
- Removal of restrictions to capital mobility and the opening of Ukraine's financial services market
- Support for the improved implementation of competition policy – convergence with EU practices (currently, a relatively good competition law is not implemented in practice)
- Support for the implementation of good corporate governance in Ukraine (this is a major problem at present)

This kind of deeper free trade agreement would boost the development of processing industries in Ukraine and could lead to major growth of intra-industry trade with the EU, as Ukraine would gradually become incorporated into European supply chains.

Ukraine's EU Membership Perspective

Looking beyond the issue of liberalizing trade in manufactured goods, the main challenges at the

- moment are easing short-term capital mobility,
- removing restrictions on labour mobility and offering
- proper incentives on the part of the EU.

From the EU perspective, Ukraine is an important partner in the political dialogue and in the same category as other partner countries that are covered either within the Stabilisation and Association Process for the Western Balkans, European Neighbourhood Policy (ENP), or the accession process itself. In the next few years it appears unlikely that Ukraine will be offered a full membership perspective.

Future EU policy towards enlargement will develop based on how well the enlarged EU is able to function and how soon stable reforms occur in countries interested in membership. Ukraine has little influence over these processes. However, the ENP offers Ukraine a basis from which to shape bilateral relations with the EU. This can be seen as a major opportunity but also as a great challenge since much will depend on Ukrainian initiative and its ability to foster an ambitious reform agenda.

The European Neighbourhood and Partnership Instrument (ENP budget) can provide sufficient resources for financing projects that are important for both sides. Nevertheless, the extent to which Ukraine will be able to use the full potential of the ENP will be determined in a large part by the ability of the country to formulate its priorities and put them into action.

Read more about this topic in the CASE Report: Prospects for EU-Ukraine Economic Integration which can be found on www.case.com.pl.

Małgorzata Jakubiak is an expert on international trade and macroeconomics and has worked with CASE since 1997. She has published numerous texts on trade flows, exchange rates, savings and investments in CEE countries. She graduated from the University of Sussex (1997) and the Department of Economics at the University of Warsaw (1998). She is currently finishing her PhD thesis on „The Role of trade and foreign investment in the transmission of innovation into Poland.”

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E-Brief Series Editor: Paulina Szyrmer
Paulina.Szyrmer@case.com.pl