Chapter Six

Ukraine and European Integration

Péter Balázs[1]

The Economy

Ukraine was hit hard by the global economic and financial crisis. The combination of weaker demand from Ukraine's trading partners, falling export prices, rising import prices and reduced access to international financial markets led to a sharp drop of GDP in 2008 and 2009 (-14.8%). Import and export flows have been compressed and the trade deficit has also fallen sharply. Table 1 also shows that inflation slowed down in 2009 but remained in double digits (15.9%). Unemployment increased to 8.8% in 2009. The *hryvnia* lost almost half of its value against the U.S. dollar since July 2008.[2]

Table 1. Main Economic Indicators for Ukraine

	2007	2008	2009	2010**	2011**	2012**
Real GDP (%)*	7.9	1.9	-14.8	4.2	4.5	4.9
Inflation rate (%)*	12.8	25.2	15.9	9.4	9.2	8.3
Unemployment (% of total labor force)*	6.4	6.4	8.8	8.1	7.8	7.2
Current account balance (% of GDP)*	-3.7	-7.1	-1.5	-1.9	-3.6	-3.8

*Source: IMF (*World Economic Outlook, April 2011*).
**IMF estimations.

[1] This chapter was prepared by the Center for EU Enlargement Studies in Budapest and contains contributions from Péter Balázs, András Deák, Áron Szele and Antónia Molnárová.

[2] European Bank for Reconstruction and Development: Ukraine—Key Developments and Challenges: http://www.ebrd.com/pages/country/ukraine/key.shtml.

Table 2. GDP of Selected Countries

Real GDP (%)*

	2007	2008	2009	2010**	2011**	2012**
Ukraine	7.9	1.9	-14.8	4.2	4.5	4.9
Russia	8.5	5.2	-7.8	4	4.8	4.5
Germany	2.8	0.7	-4.7	3.5	2.5	2.1
Hungary	0.8	0.8	-6.7	1.2	2.8	2.8
Poland	6.8	5.1	1.7	3.8	3.8	3.6
Slovakia	10.5	5.8	-4.8	4	3.8	4.2
Czech Republic	6.1	2.5	-4.1	2.3	1.7	2.9

*Source: IMF (*World Economic Outlook Database*).
**IMF estimations.

To restore financial and economic stability in Ukraine, in November 2008 the IMF approved a two-year stand-by arrangement in the amount of a $16.5 billion loan.[3] Another agreement was signed with the IMF in July 2010.

However, the economic situation has improved since 2010. For 2011, the World Bank has raised its forecast for Ukraine's economic growth to 4.5% and GDP is expected to grow by 4.9% in 2012. The European Bank for Reconstruction and Development (EBRD) has also improved its assessment of the economy to grow by 5% in 2011. This reflects improving conditions in the Ukrainian economy and the country emerging from the 2008-2009 crisis.[4]

Table 2 shows economic growth in Ukraine since the outbreak of the global economic and financial crisis in comparative perspective with Russia, Germany and the Visegrad Group of countries. Table 2 shows that in 2009, when the global recession was deepest, GDP growth in all countries, except Poland, was negative but with the biggest decline in Ukraine that was almost twice that experienced by Russia.

[3] IMF press release No. 08/271: http://www.imf.org/external/np/sec/pr/2008/pr08271.htm.

[4] Centre for Eastern Studies OSW: A positive economic forecast for Ukraine, July 27, 2011: http://www.osw.waw.pl/en/publikacje/eastweek/2011-07-27/a-positive-economic-forecast-ukraine.

Trade and Foreign Investment

Ukrainian exports to the EU are to a very large extent liberalized due to the Generalized System of Preferences (GSP) granted by the EU to Ukraine since 1993. Following WTO membership in May 2008, the EU and Ukraine launched bilateral negotiations for a Deep and Comprehensive Free Trade Agreement (DCFTA) that would replace the Partnership and Cooperation Agreement signed in 1994 (going into effect following parliamentary ratification by EU members in 1998). The DCFTA is designed to deepen Ukraine's access to the European market, modernize the economy and encourage European investment in Ukraine. Negotiations between the EU and Ukraine were planned to be finalized under the Polish Presidency of the European Council in December 2011 but this could be suspended in retaliation for the trial and sentencing to imprisonment of opposition leader Yulia Tymoshenko on October 11, 2011.[5] The case will make ratification of the Association Agreement by the European Parliament and 27 EU member parliaments difficult.

Ukraine is one of the biggest and, at the same time, poorest countries in Europe, although it possesses vast potential. As Table 3 shows, Ukraine has a relatively low per-capita GDP even among the Eastern Partnership countries. In comparison, Ukraine lags behind the Western Balkan countries (i.e. Albania, 3800 USD) or CEE countries at the time of their respective associate status.

Ukraine has an open economy, with total foreign trade accounting for 81% of GDP and exports/GDP ratio equal to 0.44. The geographic distribution of Ukraine's foreign trade is relatively balanced between East and West, with Russia taking a slightly bigger share both in exports and imports than the EU. Russian imports are mainly energy-related with the gas import bill 45% of total imports. Exports are heavily dominated (up to 60% by metallurgical and related products that are primarily exported to the EU. Energy imports do not impact directly and significantly on the performance of exports as the share of gas among inputs into metallurgy is low.

---

[5] European Commission, DG Trade, http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/ukraine/.

Table 3. Gross Domestic Product Per Capita in EaP and Some Selected Countries

Current prices, 2009 USD

Country	GDP/capita	Ratio in HU level
Armenia	2614.70	0.20
Azerbaijan	4798.24	0.37
Belarus	5190.79	0.40
Georgia	2455.37	0.19
Moldova	1524.23	0.12
Ukraine	**2568.65**	**0.20**
Czech Republic	18170.87	1.41
Germany	40831.66	3.17
Hungary	12893.96	1.00
Russia	8614.03	0.67
Turkey	8711.16	0.68

*Source: International Monetary Fund.

Table 4. Ukraine's Major Foreign Trade Partners, 2010

Billion USD

	Russia	EU	Other
Exports	13.43	13.05	19.62
Imports	22.2	19.1	14.94

Source: Ukranian Statistical Office.

Unlike foreign trade, the EU has a major role in foreign investments into Ukraine with 79% of foreign direct investments from the EU-27 (with 28% of this is from Cyprus). Net inflow was in a range of $5-10 billion during the last five years, a very high level for a CIS non-energy economy. Foreign investment is important because it sets the milestones for further DCFTA implementation and creates strategic corporate actors interested in Ukraine's further European integration. The banking and finance sector is almost completely under foreign ownership. Foreign investors have also moved into the foodstuffs sector, as in Russia and some other CIS states. Ukraine has a good record of integration into the world economy compared to other CIS countries and a big potential for growth due to its size, large population and low level of GDP.

Russia has lobbied for Ukraine's accession to the CIS Customs Union of Russia, Belarus and Kazakhstan. While free trade with Russia has an unambiguous rationale from Kyiv's perspective, the Custom Union—apart from its negative consequences for EU integration—would be beneficial only for some selected industries, such as machine-building. Understandably, the Yanukovych administration does not want to close this door and therefore has kept the discussion on Ukraine and the Custom Union alive in exchange for energy concessions. At the same time, Russia has not been ready to provide Ukraine with a free trade status without Ukraine also entering the CIS Customs Union. Such a step would further complicate negotiations between EU and Ukraine.

Energy

Ukraine's bargaining position in gas transit and imports issues vis-à-vis Russia has been gradually deteriorating. Transit volumes have been decreasing since the first pipe of the North European Gas Pipeline was commissioned (via the Baltic Sea) and since the 2009 gas war that produced a contract whereby Ukraine would be paying European prices (even with a Russian discount). Non-transparency in the Russian-Ukrainian energy relationship makes it difficult to analyze Ukraine's energy sector.

Nevertheless, the following four points should be considered.

First, Ukraine's current gas import bill (even at discounted prices) is an extremely heavy burden for the country as it comprises 7-8% of GDP in comparison, for Hungary it comprises around 3%). Sustainability of these price levels in the current macroeconomic situation is highly questionable.

Second, Russia does not want to give any further price concessions. The Russian state gas company Gazprom publicly stated that price cuts are only possible in exchange for control over property Ukrainian energy assets, such the state as company Naftohaz Ukrainy or the pipeline system (that is, the Belarusian and Armenian models).

Third, EU companies do not want to control energy assets or provide financial assistance to the modernization of the Ukrainian pipeline system. Gazprom is not very supportive and profits will decline in coming years. The energy sector is corrupt and heavily regulated by the Ukrainian authorities. Without a clear positive signal from Russia, an idea of future plans and readiness to welcome Western partners and Ukrainian guarantees on regulation, Western investors will not invest into Ukraine's energy sector. Despite public announcements, there are no prospects for large-scale Western investment into, or assistance for, the Ukrainian pipeline system, except for symbolic aid and loans from the European Commission (that were bundled with certain conditionality requirements).

Fourth, Ukrainian adoption of EU regulation practices will generate conflicts in the Ukraine-Russian energy relationship. Gazprom very much relies on long-term contracts on pipeline capacities while the philosophy of EU regulations is based on third-party access and short–term capacity allocations. Kyiv may prefer to adopt EU-regulations and, at the same time, seek to "overwrite" past contracts with Gazprom. Russia is very much against dividing Naftogaz according to the European unbundling model or providing third-party access, suspecting Ukraine of undermining existing trade and transit patterns unfavorable to its position.

Thus, the key question is the manner in which the Ukrainian authorities will implement the EU *acquis* in the field of energy. A possible solution could be the Central-Eastern European model where long-term Russian contracts enjoyed temporary derogation from EU-regulation following these countries EU accession. Another alternative could be a shallower implementation of European regulatory practices. However, it is reasonable to assume that for Kyiv one of the main benefits of adopting EU regulations is to counterbalance Russia, while patience and tolerance is scarce in Moscow. The threat for the European Commission and EU members is that they involved in any energy conflict where Western actors do not have real influence, while at least one of the parties will refer to existing agreements with the EU.

On the basis of the factors mentioned above, the Ukraine-Russia gas dispute will continue. Yanukovych refused to follow Belarus and Armenia in bowing to Russian demands even if negotiations still cushion the tensions. However, there is a Rubicon that Russia would like to cross; namely obtaining majority control over the Ukrainian

Figure 1. Global View of International Student Origins, 2009/10

Source: http://www.iie.org/Research-and-Publications/Open-Doors/Data/International-Students.

pipeline system. Such an objective might cause further large-scale conflicts between both sides.

Education

Ukraine is not well connected to the European or American educational systems. Such networks are normally at the level of higher education through a number of scholarly networks and funding, such as scholarship opportunities. Improved networks would improve the social and psychological attitudes of Ukraine's younger generation and improve the academic level at Ukrainian academic institutes.

Statistically, Ukrainian students are present in the United States in low numbers—under 5,000 in 2010 (see figure 1).

Similarly, enrollment in EU higher education institutions is very small. A case-study for this is the UK where Ukraine is not among the top ten donor countries, being again in the sub-4000 sender category (see table 5).

Ukrainian higher education institutions are also not members of the Erasmus Mundus network. Establishing a connection to this academic network of exchange scholarships would be important for student mobility and improvement of teaching methodology.

Table 5. Top 10 Non-EU countries That Send Students Abroad

Top 10 non-EU senders	2009-10	2008-09
China (PRC)	56.990	47.035
India	38.500	34.065
Nigeria	16.680	14.380
United States of America	15.060	14.345
Malaysia	14.060	12.695
Hong Kong (Special Administrative Region)	9.945	9.600
Pakistan	9.815	9.610
Saudi Arabia	8.340	5.205
Canada	5.575	5.350
Thailand	5.505	4.675

Source: UK Council for international Student Affairs, http://www.ukcisa.org.uk/about/statistics_he.php#table4).

Table 6. Gross Enrollment Ratios in Tertiary Education by Sex, 1991–2009

Percent

	1991	1999	2002	2009	2009 regional average
Male/Female	47	47	57	81	65**
Male	—	44	52*	72	57**
Female	—	50	62*	91	73**

Source: UNESCO Institute for Statistics, http://stats.uis.unesco.org/unesco/TableViewer/document.aspx?ReportId=121&IF_Language=eng&BR_Country=8070&BR_Region=40530).

Among existing funding and scholarship opportunities, there is DAAD (German Academic Exchange Service), The Fulbright Program and Visegrad Fund,[6] that has taken an active role in regional collaboration. The Visegrad Fund's activities aim to improve regional collaboration and extend influence under the EU's Eastern Partnership. A component of the Visegrad Fund's educational opportunities offered to Ukraine is the Central European University and multiple educational and research programs.

The number of students remains very small, when compared to the number of students in tertiary education, which was 2,296,221 in the same year. The Ukrainian government spends approximately 5.4% of

[6] http://visegradfund.org/scholarships/.

GDP on education, about 20%, which in comparison with other countries is very good, but still small when compared to the actual country's GDP.

We may therefore conclude that Ukrainian higher education lacks sufficient interconnection and networks with international educational facilities.

Ukraine and the Visegrad Group

Ukraine's relations with the Visegrad countries are of unique importance due to geographical and historical reasons. In the 1990s the four countries had close economic ties with Ukraine in the Soviet Union and was their major foreign trade partner (links with Romania also show similarities to the V4–Ukrainian relations). The Visegrad countries remain important trading partners for Ukraine.

The share of the V4 in Ukrainian exports and imports of goods from and to the EU 27 is between 25-30%, with Poland in first place. The figures in Table 7 show that the share of the V4 and Poland's leading role have remained stable. The Hungarian share of Ukrainian exports and imports is rather modest, but interestingly, Ukraine's trade balance in goods with Hungary has recently changed from positive to negative. The share of Slovakia and Czech Republic is marginal and surprisingly, exports from the Czech Republic, a non-neighboring country with Ukraine, surpassed exports from Slovakia in 2010.

Overall, the share of the V4 in total Ukrainian foreign trade turnover is significant. Nevertheless, Ukraine's major trading partners from the EU-27 remain in Western Europe, such as Germany and Italy. However, it must be noted that Ukrainian customs statistics should be treated with caution because they may not always reflect the real state of affairs. Official counterpart statistics from the Visegrad countries are contradictory and there are cases when Ukrainian data is higher or vice versa, probably due to tax-avoidance schemes on the Ukrainian side.[7]

---

[7] Ludvig Zsuzsa, "What may the Visegrad countries offer to Ukraine with special regard to Hungary," in Gábor Fóti and Zsuzsa Ludvig, eds., *Eurointegration Challenges in Hungarian-Ukrainian Economic Relations* (Budapest: Institute for World Economics of the Hungarian Academy of Sciences, 2005), pp. 225-248.

Table 7. Ukraine's Foreign Trade in Goods with the Visegrad Countries

Million USD

	Export 2010	Import 2010	Balance	Export 2009	Import 2009	Balance	Export 2008	Import 2008	Balance
EU 27 total	13051.9	19101.2	-6049	9499.3	15392.7	-5893	18129.5	28868.4	-10739
Italy	2412.4	1390.3	1022.1	1227.6	1139.8	87.8	2911.7	2432.1	479.6
Germany	1499.5	4605.3	-3106	1248.1	3852.1	-2604	1837.1	7165.3	-5328.2
Poland	1787.2	2788.8	-1002	1208	2170.3	-962.3	2338.3	4280.3	-1942
Hungary	860.1	1214.6	-354.5	730.2	678.3	51.9	1367.1	1282.7	84.4
Czech Rep.	626.2	747.9	-121.7	340.7	622.2	-281.5	670.8	1376	-705.2
Slovakia	568.2	442.6	125.6	433.7	306	127.7	910.2	742.5	167.7
V4 total	3841.7	5193.9		2712.6	3776.8		5286.4	7681.5	
in % of EU 27	29.4	27.2		28.6	24.5		29.1	26.6	

Source: Ukrainian Statistical Office (www.ukrstat.gov.ua).

Economic ties are also reflected through foreign capital movements. The share of the Visegrad countries in total FDI invested into Ukraine has been marginal, lower than their share in trade flows. The main foreign investors in Ukraine are Russia, the U.S. and Western European countries (the list also includes some offshore tax havens such as Cyprus and the Virgin Islands, with Russian and Ukrainian capital re-entering Ukraine through them).

From the V4, Poland is the biggest investor in Ukraine, followed by Hungary. However, Hungary no longer appears on the list of countries with the largest investment into the Ukrainian economy, even though data for Hungarian outward investment shows that Central-Eastern European countries (including the Western Balkans) are among its major destinations. The greatest Hungarian investment is into Hungarian small and medium enterprises in the Transcarpathian region, where there are partners within the Hungarian ethnic minority.[8]

[8] Ibid.

Table 8. Foreign Direct Investment in Ukraine

Million USD

	FDI as of 1.1.2011	in % of the total	FDI as of 1.1.2010	in % of the total
Total	44708	100	40026.8	100
Cyprus	9914.6	22.2	8593.2	21.5
Germany	7076.9	15.8	6613	16.5
Russia	3402.8	7.6	2674.6	6.7
Virgin Islands	1460.8	3.3	1371	3.4
USA	1192.4	2.7	1387.1	3.5
Italy	982.4	2.2	992.2	2.5
Poland	935.8	2.1	864.9	2.2
Hungary			675.1	1.7

Source: Ukrainian Statistical Office (www.ukrstat.gov.ua).

Towards an Open Ukraine

Energy

Despite controversy, Ukraine is one of the success stories in EU-CIS countries relations. Kyiv joined the WTO, has negotiated a DCFTA with the EU, is open to foreign investment and relatively democratic. Economic growth will be crucial to Ukraine's future Ukraine and low GDP per capita levels will set constraints for further co-operation and limits to integration capabilities.

There are no influential strategic actors in Ukraine fully committed to EU-integration; those that exist are politically weak. Domestic business groups should be interested in opening up exports and receiving access to EU-related funds and partners, although corporate actors and the general political culture of the Ukrainian population is protectionist. For political actors the gap between domestic conditions and ambition remains far too wide.

At the same time, EU-Ukraine relations are crucial for Kyiv even without the prospect for accession for three reasons that provide the EU with real influence over Ukrainian matters. First, the EU is a significant economic and political partner, which could provide real benefits. Second, counterbalance against Russian interests. Third, important source for domestic legitimization.

Russia is neither interested, nor capable of solving Ukraine's economic problems. There is a capacity constraint on both the Western and Russian side. Ukraine needed both IMF-loans and Russian gas price concessions in order to maintain its economic situation. Given the vulnerability of the Ukrainian economy it is reasonable to formulate policies based on three assumptions. The first is that Kyiv needs both Russia and Western support in order to sustain economic and political order. The second is that neither of the parties has enough potential, resources and ambitions to integrate Ukraine. The third is that even if it is not acknowledged, both sides are needed to sustain Ukraine's economic and political growth and stability.

Domestic policies in Ukraine will remain a perennial source of problems for EU-Ukraine relations because Ukrainian politics will continue to be characterized by a mixture of weak statehood, authoritarian reflexes and oligarchic corporate interests. Short-term improvements are unlikely and therefore the EU will need to formulate a medium to long-term strategy in the field of economic growth, energy, and democratic institutions.

Ukraine and the EU

Relations between the EU and Ukraine have intensified since the 2004 Orange Revolution which opened a new chapter in Ukraine's history as an independent state. Orange forces had set out to quickly integrate Ukraine into Euro-Atlantic structures, position the country as a regional leader and promoter of democracy and regional integrator in the post-Soviet space. Despite Ukraine's Western orientation the Orange Revolution failed to bring any changes in the EU policies (see chapters by Stephen Larrabee and Serhiy Kudelia).

Beside the general conditions set out in the EU's founding treaty in articles 6 and 49, which state any European country which respects the principles of liberty, democracy, respect for human rights and fundamental freedoms and the rule of law may apply to become a member of the Union, the EU has never offered any membership perspective to Ukraine. Unfortunately, Ukraine's 2004 democratic breakthrough came when the EU was enlarging into the post-communist world and going through an institutional crisis after rejection of the draft EU constitution by France and the Netherlands.

The EU developed the European Neighborhood Policy (ENP) as a framework policy for relations with the entire EU neighborhood, including Ukraine. The "carrot" of the ENP, defined as a stake in the EU's internal market, brought countries such as Syria, Libya and Belarus into the same policy group as Ukraine which disappointed the pro-European sectors of Ukrainian elites and society.

In 2009, the EU launched the Eastern Partnership, the Eastern dimension of the ENP framework, which provided Ukraine with an opportunity to become a regional leader on European integration as the most advanced of the six Eastern Partnership states. Ukraine became a pioneer country within the post-Soviet space for the DCFTA as part of an Association Agreement.[9] The Association Agreement would replace the Partnership and Cooperation Agreement and the EU–Ukraine Association Agenda replaces the Action Plan as an instrument of the European Neighborhood Policy. However, while the Association Agreement is symbolically important, it will not represent a breakthrough unless it mentions a membership perspective.

Even though Ukraine's ties to the EU have considerably strengthened over the past decade, the issue of Ukraine's EU membership remains a remote and uncertain perspective. The EU does not have any clear vision concerning the sequencing of its further enlargement. The 2011 Enlargement Strategy and Progress Report lists the countries with a perspective of accession in the future as Iceland, the Western Balkans and Turkey—but not Ukraine. The EU could not offer membership prospects to only Ukraine within the Eastern Partnership which is another stumbling block for Kyiv. Realistically Ukraine therefore does not have the possibility of receiving EU membership in the foreseeable future. Nevertheless, in order to facilitate and continue with the reform processes and strengthen pro-EU forces in Ukraine, it will be crucial to provide Ukraine with a clear European perspective through the attainment of realistic objectives.

---

[9] See L. Zsuzsa, "Troublesome triangle: The European Union, Russia and Their Common Post-Soviet Neighbourhood. The European Union's Eastern Partnership," *East European Studies*, No. 3. 2011, pp. 93-111.

Macro-Regional Integration

Ukraine has received new perspectives in its cooperation with the EU through macro-regional strategies that represent a new and promising answer by the EU to the growing number and diversity of member states. The Baltic Sea Strategy is a pilot project establishing the blueprint with the 'three no's' of no new institutions, no new legislation and no new funds. The new framework for regional cooperation could become popular with other member states not directly involved in the Baltic Sea region.

The next step was the Danube Strategy, which was adopted by the European Council at its June 2011 meeting at the end of the Hungarian Presidency. The Danube Strategy follows in the footprints of the Baltic Sea Strategy and unites eight EU member states and six regional neighbors of the EU, including Ukraine.

There is a potential third macro-region for the EU of the Adriatic Sea area that could include most of the Balkan states together with Italy and Greece. However, most of its potential members are, for the time being, not members of the EU.

All three macro-regions are located around important internal EU waterways: the Baltic Sea, the Danube River and Adriatic Sea and include most of the medium-sized and small EU member states. The 'circle of the big' and three macro-regions cover almost the entire territory of the EU (except Ireland and Portugal), together with countries that are within future enlargements and immediate neighborhood.

In the spirit of this new, macro-regional approach, Ukraine has two further opportunities for deepening and enriching its relations with the EU. Following the accession of Romania and Bulgaria and the launch of accession negotiations with Turkey, the EU has gained a potential dominant position in the Black Sea area. Two other 'giants'—Russia and Ukraine—are present and highly interested in that region. Furthermore, the Black Sea is directly connected with the South Caucasian area that possesses strategic importance for energy supplies to Europe. Instead of multi-vectoring between Russia and the EU, Ukraine should promote a complex 'win-win' strategy for the Black Sea region.

The second macro-regional opportunity for Ukraine is the economic potential of its Western region, Transcarpathia, which is surrounded by four EU member states, Poland, Slovakia, Hungary and Romania. All four countries and EU members are linked to Transcarpathia and each other through cultural, historical and ethnic ties. The Transcarpathian region could be developed into an EU bridgehead into Ukraine that would promote its integration into continental Europe. The region is already linked by broad-gauge railway to Hungary (Záhony) and Slovakia (Kosice) and its geographic location and multi-ethnic traditions are convenient as potential a offshore zone and for factories assembling products for the EU market.