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THE UKRAINIAN ECONOMY IN EUROPE

Edited by

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# Contents

# FOREWORD

The Institute for World Economics of the Hungarian Academy of Sciences (IWE HAS) organized a workshop on November 24, 2006 entitled *The Ukrainian Economy in Europe* with the purpose of bringing together knowledge of the Ukrainian economy from Ukraine itself, Austria (an old EU member) and Hungary (a new EU member and neighbouring country to Ukraine). Researchers were invited from the Institute for Economy and Forecasting of the Ukrainian National Academy of Sciences (Valery Heyets and Volodymyr Sidenko), and the Vienna Institute for International Economic Studies (Vasily Astrov). Mihály Simai and András Inotai from the IWE HAS took part as session chairs, and Sándor Meisel and Zsuzsa Ludvig contributed papers.

The presentations covered a wide spectrum of challenging and relevant Ukrainian economic issues, including the general macroeconomic and sociological scene, the topical issue of energy, the process of WTO accession, and FDI flows. Special attention was paid to EU–Ukrainian relations, including up-to-date information on the EU–Ukraine ENP Action Plan and such challenging questions as the prospects of Ukrainian EU membership and the feasibility of parallel integration processes with the East (within the CIS area) and the West (within the EU).

Our choices of subject were approved by the rather wide audience. Lectures were followed by interesting discussions involving experts, students, officials and researchers from various institutions. This publication covers the essence of all the presentations and is intended to spread the professional value of the event more widely.

The event and the whole project were sponsored by the Austrian Science and Research Liaison Office (ASO) in Budapest.

*Zsuzsa Ludvig*
project leader and organizer

Budapest, March 10, 2007

# I. Ukrainian Macroeconomic Prospects

## Macroeconomic Prospects in the Light of Recent Political Events

*Valery Heyets*

### 1) The socioeconomic situation in Ukraine's economy in 2006, against the background of the political and economic problems of 2005

A dynamic rate of GDP growth of more than 8 per cent a year in five consecutive years (2000–4) fell sharply in 2005 to a mere 2.6 per cent, mainly due to tense political disputes around the presidential elections in late 2004 and early 2005. The political opposition dramatically affected business confidence in future macroeconomic stability, which in turn had an immediate impact on capital investment. The index of fixed investment (1990=100) rose from 122 in 1999 to 155.7 in 2004, *i.e.* 33.7 points, or 6.7 points per year. But in 2005 the increase was only 1.1 points or a sixth of that. Contributions to the loss of confidence were made by political rhetoric and by real moves to reprivatize assets, as well as higher pressure on the economy from an increase in the level of GDP redistribution through the consolidated budget to 33.4 per cent of GDP, or 4 percentage points higher than in 2004.

The rise in the minimum wage was higher than in 2004 (39.2 per cent as opposed to 15.4 per cent). Average wages in the economy grew by 36.7 per cent. Social transfers to the population increased 2.2 times over. So real growth in monetary incomes was 18.9 per cent, while GDP increased by only 2.6 per cent.

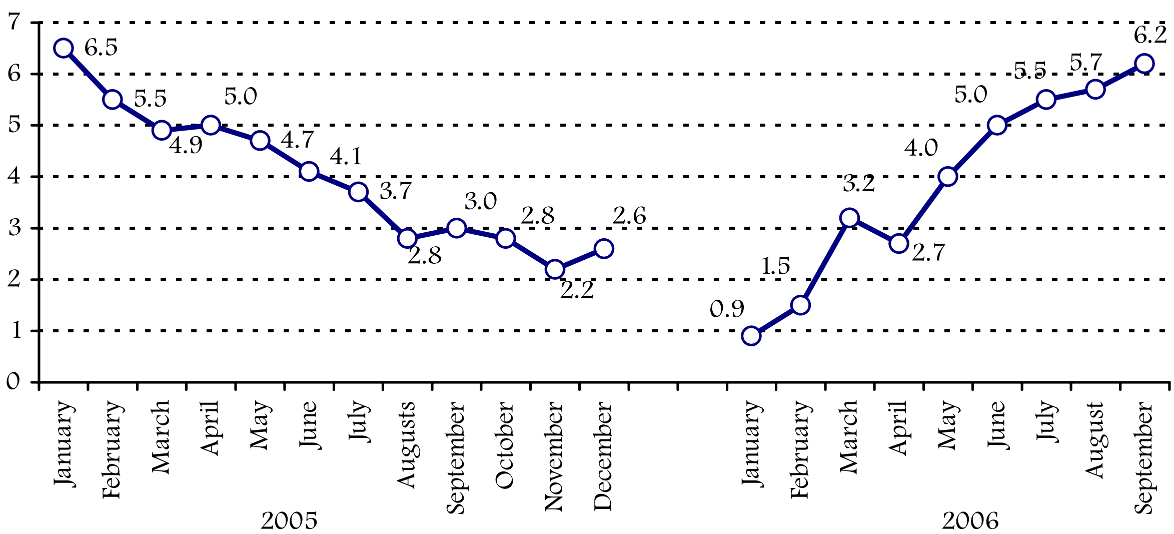
Many problems in the 2005 budget were solved not only by increased budget revenues relative to GDP, but by the resale of Ukraine's biggest steel corporation, Kryvorizhstal, and by certain measures to legalize export and import activities, which raised budget revenues from corresponding taxes. These factors meant that Ukraine's economy in 2005 suffered a number of serious shocks of the following character, of a political nature, and involving purchasing power, gasoline, sugar, meat, and revaluation of the currency.

The shortage of idle capacity to expand supply led to customs tariffs being lowered, with immediate effects on the export/import ratio. Imports in 2005 rose by 21.8 per cent, while exports fell by 4.8 per cent, compared with changes of 40 and 8 per cent in 2004. Factors included deterioration in commercial prospects, especially on metal markets, and trade disputes with Russia.

with USD 3.7 billion in 2004. The rate of export coverage of commodity imports in 2005 was -3.1 per cent (12.6 per cent in 2004). The budget was reorienting towards social programmes, which resulted in a reduction of the share of investment in the consolidated budget from 15.2 per cent in 2004 to 9.7 per cent in 2005. Rapid import growth kept inflation at a rather low 10.3 per cent from December to December.

The situation was stabilized at that level, although the government that came to power after the 2004–5 presidential elections was forced to resign. The new government showed a radically different attitude, first of all to the institution of property. The policy of reprivatization was abandoned. Much of the proceeds from the sale of Kryvorizhstal remained, and with some increase in the budget pressure on GDP in 2006 (the budget share of GDP was expected to reach 35 per cent) the situation was partly stabilized, mainly in relation to public finance. The expected budget deficit in

Figure 1
Real GDP in 2005 and 2006, as proportions
of same periods in the previous years, cumulative
(%)




For the first time in many years, Ukraine's balance of trade deteriorated, falling to USD -1.1 billion, as compared

2006 was 2.6 per cent of GDP, which with a comparatively low debt burden (as of August 2006, the national debt was 11.9 per cent of GDP, consisting of foreign debt [8.4 per cent] and domestic debt [3.5 per cent]) allowed macroeconomic stability to be maintained despite the gas shock of early 2006, which had economic and political consequences. In the event, the gas price of USD 95/1000 $m^3$ appears to allow many activities to be maintained at their previous output level and even improve *(Figure 1)*.

The GDP growth rate has been gradually increasing since the beginning of 2006. According to the ten-month data, it exceeds 6 per cent, with nominal GDP at UHR 300.8 billion. Although such a GDP increase rate may be associated with a low comparison base in the previous year and a rise in gross value added in trade and transport due to the increase in imports – not among the stable factors of economic development – the revival extended also to the basic sectors of industry, above all manufacturing and construction. The increase in gross value added in wholesaling and retailing came to 13.2 per cent, in transport to 8.7 per cent, in electricity generation and distribution and gas and water supply to 7.4 per cent, in construction to 7.1 per cent, in mining to 6.2 per cent, and in manufacturing to 5.2 per cent. During January-September 2006, industrial output increased over the same period of the previous year by 5.5 per cent. (*Table 1*)

Assessment of the country's political and economic situation based on sociological surveys with common, comparable methodological and informational bases reveals both progressive and negative tendencies. The latter need minimizing, to stabilize and improve the macroeconomic situation.

First the polls suggest that most people still rate the economic situation as quite bad: assessments of 0–5 points still exceed 90 per cent of the responses. Most people also have a negative attitude to privatization of land (52.8 per cent) and of big enterprises (67.2 per cent), so that the basis for further liberal reform is rather narrow, because its supporters have been steadily declining (for privatization of land from 23.8 to 42.1 per cent, and for big-enterprise privatization from 17.5 to 10.6 per cent). Meanwhile a growing number of people do not wish to work for private business, while support for socialism is over twice as great as support for capitalism.

Also negative is the assessment of the social situation, as the number who consider that organized crime plays an important role in Ukrainian life remains a high 33.6 per cent of respondents, although the proportion has eased by 3 percentage points over the last three years.

At the same time, the chance to express political opinions freely continues to be rated highly: 66.2 per cent, as compared with 54.9 per cent in 2004. There was a big increase (from 28.4 to 42.7 per cent in 2006) in those reporting parties and movements in which they could trust: from 25.5 per cent in 2004 to 42.9 per cent in 2006.

However, President Yuschenko's loss of support over the year has been considerable. In 2006, only 21.5 per cent respondents give him rather high assessment, while in 2005 the figure was 52.0 per cent. There are still many supporters of further development and consolidation of ties within East/Slavic Block (31.7 per cent), but their number has been easing (in 2004 the figure was 34.3 per cent). However, 61 per cent of Ukrainians favour accession to the EU, though 64.4 per cent oppose joining NATO.

Also high is the number declining to participate in meetings (45.8 per cent) and assessing the available methods of protecting their rights as inefficient, but 42.3 per cent are ready to defend themselves against any worsening in their material conditions. Confidence in government bodies is rather low: only 15 per cent, except that the country's president has a somewhat higher confidence rate (29.5 per cent in 2006). The mass media have the confidence of 31.4 per cent of respondents (35.5 per cent in 2005), and 49.5 per cent in the church.

Table 1
Survey results of assessments of ongoing economic and political developments by the public

| A. The economy | 2004 | 2005 | 2006 |
|---|---|---|---|
| 1. Assessment of economic situation on a ten-point scale (0– very bad, 10–very good) | | | |
| 0–5 | 94,5 | 89,6 | 93,1 |
| 6–10 | 5,7 | 10,4 | 6,9 |
| 2. Attitude to privatization of land | | | |
| Rather negative | 31,4 | 45,2 | 52,8 |
| Rather positive | 42,1 | 27,8 | 23,8 |
| 3. Attitude to privatization of big enterprises | | | |
| Rather negative | 56,1 | 60,9 | 67,2 |
| Rather positive | 17,5 | 13,3 | 10,6 |
| 4. Attitude to privatization of small enterprises | | | |
| Rather negative | 25,2 | 23,3 | 28,6 |
| Rather positive | 47,2 | 43,7 | 43,4 |
| 5. Would you agree to work for a private businessman | | | |
| “No” and “I would rather not” | 40,4 | 48,5 | 50,0 |
| “Yes” and “I would rather agree” | 39,7 | 36,4 | 36,8 |

| B. Politics | 2004 | 2005 | 2006 |
|---|---|---|---|
| 1. “I am in favour of socialism” | 25.2 | 23,7 | 26,7 |
| 2. “I am in favour of capitalism” | 11.7 | 11,1 | 12,0 |
| 3. “I support both providing there are no conflicts” | 19.9 | 26,0 | 21,7 |
| 4. What social groups play a marked role in Ukrainian society? | | | |
| Workers and peasants | 40.2 | 47,7 | 47,2 |
| Intellectuals | 13.2 | 18,1 | 18,8 |
| Business people and CEOs of public companies | 40.8 | 47,4 | 38,8 |
| Political leaders | 25.9 | 28,3 | 35,8 |
| Law and order protection bodies | 22.4 | 23,5 | 24,0 |
| Mafia | 40.2 | 30,7 | 33,9 |
| 5. Chance to express own political opinions freely | 54.9 | 58,4 | 66,2 |
| 6. Availability of leaders able to rule the country | 28.4 | 50,4 | 42,7 |
| 7. Availability of political parties and movements, to which power can be entrusted | 25.5 | 37,4 | 42,5 |
| 8. Assessment of activity on a ten-point scale | | | |
| L. Kuchma | | | |
| 0–5 | 92.7 | | |
| 6–10 | 7.3 | | |
| V. Yuschenko | | | |
| 0–5 | | 48,0 | 78,5 |
| 6–10 | | 52,0 | 21,5 |
| 9. Assessment of political situation in Ukraine | | | |
| Quiet and prosperous | 21.2 | 25,5 | 14,3 |
| Tense and critical | 66.4 | 65,9 | 77,3 |
| 10. What course do you prefer? | | | |
| Re-establishing ties mainly with developed Western countries | 14.4 | 17,9 | 15,2 |
| Consolidating ties in the East/Slavic Block | 34.3 | 29,3 | 31,7 |
| Relying mainly on own forces | 17.1 | 20,2 | 20,3 |
| 11. Attitude to Ukraine’s accession to the EU | | | |
| Rather positive | 47.9 | 47,2 | 61,0 |
| Rather negative | 11.7 | 19,9 | 24,7 |
| 12. Attitude to Ukraine’s accession to NATO | | | |
| Rather negative | 38.5 | 50,4 | 64,4 |
| Rather positive | 18.8 | 14,9 | 12,7 |

*(cont.)*

*(cont.)*

| C. Social protest and public confidence | 2004 | 2005 | 2006 |
|---|---|---|---|
| 1. Desire to participate in protest meetings and demonstrations | | | |
| "I would rather not" | 48.2 | 39.8 | 45.8 |
| "I would rather participate" | 28.0 | 35.2 | 30.7 |
| 2. Desire to defend own rights by way of: | | | |
| Signing petitions | 21.8 | 24.6 | 22.4 |
| Participating in election campaigns | | 23.7 | 20.3 |
| Meetings and demonstrations | 19.2 | 34.2 | 27.9 |
| None of above sufficiently efficient for me to participate | 36.6 | 25.2 | 31.2 |
| 3. Readiness for material hardships so long as law and order maintained | | | |
| Maintaining law and order | 34.2 | 35.2 | 35.1 |
| Protesting against worsening conditions | 42.1 | 45.1 | 42.3 |
| 4. Partial or full confidence in | | | |
| Church | 44.0 | 52.5 | 49.5 |
| Mass media | 27.9 | 35.5 | 31.4 |
| Tax authorities | 10.5 | 9.9 | 12.3 |
| Police | 14.2 | 12.3 | 13.5 |
| Public prosecutors | 14.7 | 12.3 | 12.1 |
| Judiciary | 15.6 | 13.2 | 13.7 |
| Pesident | 15.0* | 49.2 | 29.5 |
| Government | 10.2 | 36.6 | 15.7 |
| Legislature (Verkhovna Rada) | 9.1 | 28.5 | 15.2 |

* L. Kuchma's confidence rating was 33.3 per cent in 1995.

Thus state and social institutes influencing society and social life have a relatively low and a low confidence rate, respectively. The development of social life in this country is following its own rules, which is worth thinking about before we advance any further, not least in economic strategy, which we should in many aspects reconcile with the most influential social forces, notably the workers and the peasants, or convince them to accept. According to the assessment, their level of influence amounts to 47.2 per cent, while for the intellectuals it is 18.8 per cent, for businessmen and CEOs of public companies 39.8 per cent, for political leaders 35.8 per cent and for law and order protection bodies 24.0 per cent.

It is against that background that a new government came to power in mid-2006, declaring as its priority an innovative and investment-based course of economic development, coupled with retaining macroeconomic stability.

## 2) Ukraine's economy in 2007 and in the medium term

The overall situation in Ukraine began to change for the better in 2006, especially in the second half of the year. This tendency is not apparent only in statistics that are often difficult for the public to understand and interpret. It is very important for a scenario to include not only general economic trends, but analysis based on surveys. Before describing the scenarios and analysing the forecasts, mention must be made of surveys conducted by the Alexander Razumkov Ukrainian Centre of Economic and Political Reform, whose data, used in this study, has high public prestige as an independent centre that adheres to liberal and democratic concepts.

According to the Centre's data, the proportion of citizens who thought that the situation had changed for the worse after the first 100 days of the Yanukovych government was 34.7 per cent, as opposed to 46.2 per cent in December 2005. That is due to an increase in the proportion of respondents who believed that the economic situation was unchanged, from 32.5 per cent in December 2005 to 46 per cent in November 2006, although the proportion of those who notice some improvement declined to 11.1 per cent from 12.6 per cent in December 2005. While Tymoshenko's government in October 2005 received a grade of 2.54 points out of 5 and Yekhanurov's one of 2.51 points in December 2005, the Yanukovych government in November 2006 received 2.73 points, even though the social assessment of the government was not the best of the three (2.63 points, as opposed to 2.87 and 2.68 respectively). For the whole period, the Yanukovych government scored 2.76 points, which was higher than the grades of the previous governments (2.68 and 2.69 points respectively). However, the populist policies of the Tymoshenko government in April 2005 took its grades above 3 points, although the advantage had been lost again by October 2005, as we have seen.

There are grounds for saying that the most realistic of the scenarios of future development for Ukraine and its economy in 2007 is the optimistic one. The same applies to medium-term prospects. But a pessimistic variant has been included and come true if there are tensions in the political and social spheres, and on energy markets, one of the main risks to the economy. Section IV of this paper discusses in more detail the country's energy problems and their influence on the economy as a whole.

The most important medium and long-term task of national macroeconomic policy is to ensure stability, openness and justice in financial relations between the state and society, so as to create a basis for a new social contract and dynamic development based on innovation, investment, and structural and technological modernization. The policy of accelerating growth in human potential by increasing in labour quality and simultaneously encouraging work efficiency has top priority among the factors for ensuring innovation-based dynamic development.

The state's structural policy has to be oriented to developing the infrastructure and reforming enterprises, raising the level of control over the natural monopolies, and restricting the manipulation of markets for corporate interests. The state also has to encourage export diversification, to bring a gradual increase in the share of manufacturing produce, especially high-tech items.

The government's financial solvency has to be maintained mainly by reforming budget-funded state institutions and minimizing the practice of non-return funding, instead of funding based on the results. An improved investment climate will reduce capital outflow and provide conditions for repatriating capital previously taken abroad.

Social change should also provide needed social stability and reproduction of intellectual capital, and overcome excessive social inequality, which will help to lower business risks and promote overall development.

The basic stages of government reform must be accomplished in the years to come, to ensure efficiency of economy policy-making. On the whole, we expect national policy in 2006–2011 to follow the priorities of the "The Universal of National Unity": high living standards, a competitive, knowledge-based economy, just and efficient power, and a globally integrated and respected state. In particular, "The Universal of National Unity" shows that national economic policy should be oriented to:

* Raising the wellbeing of Ukrainian citizens, overcoming poverty by means

of efficient and beneficiary-oriented social protection, guaranteeing decent work compensation, and just pension provisions.

* Formation of a middle class through transformation of income policy, development of business, and encouragement for creating new jobs.
* A more accessible, higher -quality education, popularization of a healthy way of life, reorientation of the health system towards human development, and the creation of national centres to fight tuberculosis and HIV/AIDS.
* Introduction of the principles of innovation-based scientific and technological development, maintaining annual GDP growth rates at no less than 5 per cent, and encouraging the creation of at least one million jobs a year.
* Economic restructuring.
* Tax reform that relieves the tax burden by expanding the taxation base, including gradual introduction of realty tax (wealth tax) and a single social contribution from the work compensation fund.
* Ensuring Ukraine's energy security, higher efficiency in the use of natural resources and energy materials, and introduction of energy-saving technologies.
* Raising the efficiency of agriculture and of state care of the peasantry; establishing no later than 1 January 2008, a fully-fledged land market with a corresponding legal base (legislation on the land registry, land price, *etc.*)
* State guarantees and protection of property rights.
* Increasing accessibility and quality of public-utility services by developing competition in the housing sector and in public utilities.

# 3) Forecast summary

The basic scenario predicts that the slowdown in 2005 and early 2006 will be followed by higher growth rates in late 2006 and overall continuation of this tendency until 2011, through economic restructuring, new innovative investment, growing competition on domestic and foreign markets, and transformation of the mechanisms of capital and labour flow, which will promote greater efficiency in productive factors.

## 3.1. External assumptions

The new tendencies in the world economic system will include mounting pressure on international policy from the developed nations and increasingly strong international competition. There will possibly be further increases in the price of Ukraine's imported natural gas and continuing high oil prices in 2006–8, causing Ukraine's energy-intensive economy considerable loss of competitive advantage. This may lead to lower exports and a consequent decline in the GDP growth rate along with an increase in the domestic price level. Meanwhile Ukraine's negotiations towards accession to the WTO will continue, but there will be instability and probable worsening of world demand for its exports, which will restrict the economy's growth prospects.

## 3.2. Internal assumptions

In the *real sector*, the dynamics of real GDP, inflation, and key indicators of the foreign sector in Ukraine are estimated somewhat pessimistically, based on expectations of a considerable increase in the price of natural gas and further increases in international oil prices. The latter will be supported on the demand side by retention of extremely high development rates in such vast economies as China and India, and on supply side, by uncertainty about the political situation around Iran, overall aggravation of politico-ideological antagonism with the Muslim world, and anti-American (anti-Western in a broader context) policy conducted by Venezuela. In this context, there can be expected a marked rise in production costs, causing a relative decline of price competitiveness in Ukraine's energy-intensive products, which are still the core of its export potential. That will obviously encourage massive introduction of new energy-saving technologies, as well as some structural adjustment of Ukrainian industry towards accelerated development of its non-energy intensive components. Both directions will require considerable expansion of investment and imports of investment goods. These tendencies coupled with slow export increases (due to some loss of price competitiveness) will cause a considerable increase in the trade deficit and so the deficit on the current account.

According to pessimistic estimates, inflation may reach 15 per cent by late 2007, due to expectations of increased production costs in the current year (due to higher energy prices in 2006–7 and higher wage expenditure), introduction of strict limits on gas consumption, a rise in rail and public-utility tariffs, and development of a corresponding multiplier effect, if the waves of price increases are prolonged.

In *monetary policy*, the NBU will follow a reserved and flexible course to balance money supply and demand and ensure stability of the hryvnia:

* The money supply will grow at a slower rate (due to slower increases in household incomes and to the NBU's measures to curb inflation).
* There will be a lower rate of increase in household savings (due to lower rates of increase in incomes and continued high rates of consumption).
* There will be lower interest rates on credits (as a result of lower inflation rates and revival of competition between the commercial banks).
* The NBU will maintain a stable hryvnia exchange rate with insignificant devaluation and increased fluctuation due to NBU measures to curb inflation.

In *fiscal policy* in 2007 (based on the draft Act on the State Budget of Ukraine for 2007), there is no prediction of fiscal pressure on the real sector (although the state budget will adopted with a package with fiscal amendments), but tax collection will be become stricter. The rules on VAT returns established since 2005, if they remain in the forecasting period, will create conditions for further increases in receivables and payables, and induce reduction of circulating assets of economic agents. Repayments of foreign and domestic debt (despite a recent reduction) may cause cuts in budgetary expenditures on economic development (due to a fall in the investment budget), which may have a detrimental impact on corporate profits in 2007 and later years (through underfunding and growth of domestic debt associated with under-investment in innovation, economic development and qualitative restructuring.)

Turning to *social policy*, the increase rates in disposable incomes and average monthly wages will be no lower than in July–August 2006. Most of the increase in nominal and real average monthly wages is likely to come through a rise in the minimum wage, and secondarily, from adjustment of the single-tariff schedule for some worker categories in the budget-funded sector. A rise in the nominal average monthly wage of 32.3

per cent (37.2 per cent in the budget-funded sector) was expected in 2006, along with a real wage increase of at 21.9. According to the draft state budget for 2007, the minimum wage was to be at 76.2–82.1 per cent of subsistence level. With these assumptions, a considerable shortfall in the rates of increase in real average wages and in disposable incomes was expected in 2007, as compared with previous forecasts, which posed a threat to further stable economic development. The increase in real average monthly wages in the corporate and budget-funded sectors would be lower than in 2006, so that the increase in nominal wages would exceed that in the consumer price index, but not that of nominal GDP, while approaching the growth rate of disposable incomes. Increases in disposable incomes and average monthly wages in 2008–11 will gradually converge on that of real GDP, with insignificant deviations, as a sign of a stable economic development and a promise of reduced income differentiation among the employed and the population as a whole.

The basic scenario assumes overall preservation of the current investment-oriented development model, based mainly on companies' own funds. There will be a revival of investment demand starting in 2006–8, at the expense of borrowed funds *(Table 2)*. Under such conditions, the growth rates of gross investments are forecasted at a high level, (9,3–11.1 per cent as annual average).

Assessing the impact of these factors yielded a forecast GDP growth in 2006 of 5.8–6.5 per cent and in 2007 of 5.0–5.8 per cent. But such figures are too low for a country that lost half its GDP during the years of the transformation crisis. Considering the positive changes in Ukraine's economy over the last four years, the relatively favourable business climate on foreign markets, and a considerably improved situation in export-oriented sectors, this country's real GDP in 2008–11 is expected to grown by an annual average of 6.9 per cent. High GDP growth will be supported by higher growth rates in domestic and external demand.

The forecast for the period is slower price growth together with a considerable inflation rate caused by an increase in available incomes of households (demand-pushed inflation) and inflationary expectations by producers, due to higher government social payments.

It is projected that moderate activities of the government on the market for external borrowing will bring concentration of credit activities in the private sector and reflect in lower average weighted interest rate on credits.

## 4) Policy issues and uncertainties

The forecast risks in policy on the *development of the real sector* are these:

* Retention of high costs in the production will have a negative impact on company profitability and reduce incentives for business activity, through higher tariffs from natural monopolies (electricity, communications, transports, utilities) and costs in related activities, and higher inflation pushed by production costs, due to rises in company spending on energy and materials (higher prices), wages and other factors.
* A sharp speculative increase in housing prices could lead to collapse in the realty market.
* A rise in consumer prices due to the inability of government and business to balance commodity and financial flows.

Table 2
A forecast of the main macro indicators of the economy in 2006–2011

| Macro indicators | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| Change in real macro indicators: | | | | | | | | | |
| GDP, % | 9.6 | 12.1 | 2.6 | 6.2 | 5.8 | 6.5 | 7.1 | 7.5 | 6.5 |
| Final consumption expenditure, % | 12.8 | 13.0 | 13.2 | 7.1 | 6.9 | 6.8 | 7.8 | 5.4 | 5.1 |
| • Government consumption, % | 14.8 | 4.7 | 2.7 | 2.2 | 2.1 | 2.6 | 3.2 | 2.7 | 2.1 |
| • Private consumption, % | 12.4 | 16.3 | 16.6 | 8.5 | 8.2 | 8.1 | 9.2 | 6.5 | 5.9 |
| Gross fixed investment, % | 15.8 | 10.2 | -0.3 | 6.8 | 8.0 | 8.9 | 10.2 | 12.2 | 11.1 |
| Exports, % | 10.3 | 18.1 | -11.2 | 5.6 | 3.8 | 5.6 | 7.2 | 7.4 | 6.5 |
| Imports, % | 16.4 | 13.6 | 2.1 | 11.8 | 4.5 | 6.2 | 6.8 | 5.5 | 5.7 |
| Prices and exchange rate: | | | | | | | | | |
| Consumer price index, year-on average, % | 5.2 | 9.1 | 13.5 | 8.5 | 10.5 | 9.3 | 8.5 | 6.8 | 5.5 |
| December to December, % | 8.2 | 12.3 | 10.3 | 10.5 | - | - | - | - | - |
| Producer price index, year-on average, % | 7.8 | 20.4 | 16.8 | 9.7 | 8.9 | 11.6 | 10.2 | 8.2 | 6.8 |
| December to December, % | 11.1 | 24.1 | 9.5 | 16.2 | - | - | - | - | - |
| Exchange rate, average for period, UHR/USD | 5.33 | 5.31 | 5.14 | 5.05 | 5.1 | 5.2 | 5.23 | 5.27 | 5.3 |
| Money and credit: | | | | | | | | | |
| NBU discount rate, % | 7.0 | 9.0 | 9.3 | 8.7 | 8.5 | 8.2 | 8.0 | 7.5 | 7.0 |
| Credit interest rate, % | 18.0 | 17.8 | 16.0 | 15.5 | 15.0 | 14.5 | 14.0 | 13.5 | 13.0 |
| Deposit interest rate, % | 6.5 | 6.3 | 6.5 | 6.3 | 6.2 | 6.1 | 6.1 | 6.0 | 6.0 |
| Monetary base, % | 30.1 | 34.2 | 54.2 | 30.5 | 29.5 | 26.0 | 24.0 | 22.0 | 21.0 |
| Money supply (M3), % | 46.5 | 32.1 | 54.3 | 36.2 | 34.5 | 30.5 | 28.0 | 26.0 | 25.0 |
| Budget: | | | | | | | | | |
| Total revenues, % to GDP | 28.2 | 26.5 | 31.6 | 32.5 | 31.2 | 29.4 | 28.6 | 28.0 | 27.5 |
| Total expenditures, % of GDP | 28.4 | 29.4 | 33.4 | 34.5 | 33.3 | 31.4 | 30.3 | 29.5 | 28.3 |
| Balance, % to GDP | -0.2 | -2.9 | -1.8 | -2.0 | -2.1 | -2.0 | -1.7 | -1.5 | -0.8 |
| Social indicators: | | | | | | | | | |
| Real average monthly wages, % | 15.2 | 23.8 | 20.3 | 18.8 | 9.5 | 10.0 | 10.2 | 10.8 | 11.2 |
| Real unemployment rate, % | 9.3 | 9.2 | 8.9 | 8.5 | 8.0 | 7.6 | 7.2 | 6.8 | 6.5 |
| Foreign trade | | | | | | | | | |
| Exports of goods and services, USD billion | 28.95 | 41.29 | 44.38 | 48.90 | 50.81 | 54.11 | 58.82 | 62.82 | 66.28 |
| Imports of goods and services, USD billion | 27.67 | 36.31 | 43.71 | 51.53 | 53.59 | 55.84 | 58.58 | 62.33 | 65.69 |
| Foreign trade balance, USD billion | 1.28 | 4.98 | 0.67 | -2.63 | -2.78 | -1.73 | 0.24 | 0.50 | 0.59 |
| Exports, USD billion: SITC 0–1 | 1.92 | 2.91 | 3.22 | 3.94 | 4.60 | 5.00 | 5.54 | 6.08 | 6.51 |
| SITC 2+4 | 2.40 | 3.41 | 3.33 | 3.62 | 3.55 | 3.60 | 3.71 | 3.84 | 4.08 |
| SITC 3 | 2.83 | 3.47 | 3.50 | 3.74 | 3.64 | 3.15 | 2.97 | 3.20 | 3.23 |
| SITC 5–9 | 16.59 | 23.64 | 24.97 | 28.06 | 30.02 | 33.28 | 37.22 | 40.22 | 42.78 |
| All goods | 23.74 | 33.43 | 35.02 | 39.36 | 41.81 | 45.03 | 49.44 | 53.34 | 56.60 |
| Imports, USD billion: SITC 0–1 | 2.11 | 2.45 | 2.57 | 2.47 | 2.51 | 2.61 | 2.68 | 2.87 | 3.03 |
| SITC 2+4 | 1.03 | 2.25 | 1.52 | 1.67 | 1.72 | 1.74 | 1.85 | 1.99 | 2.10 |
| SITC3 | 8.19 | 10.40 | 12.69 | 14.49 | 14.71 | 15.26 | 15.57 | 16.72 | 16.96 |
| SITC 5–9 | 12.68 | 15.59 | 19.38 | 23.24 | 25.11 | 26.20 | 28.55 | 30.67 | 33.14 |
| All goods | 24.01 | 29.69 | 36.16 | 41.87 | 44.05 | 45.81 | 48.65 | 52.25 | 55.23 |
| Trade balance, USD billion | -0.27 | 3.74 | -1.14 | -2.51 | -2.24 | -0.78 | 0.79 | 1.09 | 1.37 |

* Absence of a well-defined state strategy for energy provision, low efficiency of national purpose-oriented programmes in the real sector, and lack of efficient mechanisms and methods for realizing budget-funded programs and for control over their implementation all create a danger

that the budget funds allocated for introducing energy-saving technologies will not be fully used (*e.g.* some may be spent on public utilities due to their critical condition) or used efficiently.

* Absence of radical measures for improving trade relations with the main trade partner, Russia, may lead to further reduction in import quotas on the Russian market, increase the number of anti-dumping investigations of Ukrainian exports, reduce those exports, bring higher prices for imported energy materials and corresponding increases in electricity charges, and cause greater resource intensity in companies. These will worsen company financial indicators, causing further decline in investment and lower budget revenues.

The forecast risks in *monetary policy* are these:

* Uncontrolled increases in foreign borrowing (medium and long-term non-guaranteed credits) may lead to higher demand for foreign currency from economic agents with limited scope for earning it, which will place additional pressure on the domestic market. That will also promote "imports" of external factors related to instability on international exchange and financial markets, with a negative impact on the domestic exchange market.
* Worsening of the trade balance with a limited inflow of foreign exchange within the country's balance of payments (due to deterioration in the investment climate) may create considerable pressure to devalue the national currency.
* Deterioration in company financial indicators (due to the marked increase in the natural gas price and continuing "trade wars" with Russia) may reduce bank deposits by companies' and organizations.
* The public finance situation may be worsened by government subsidies for consumers of natural gas, to cover the price difference.
* Government may prove unable to apply market mechanisms of price regulation.
* Corporate debt may increase.
* Deterioration of macroeconomic relations through big volumes of consumer credit from banks, notably increases in the foreign trade deficit (as imported durables are bought on credit) and a gap between the rise in household real incomes and bank credit, which could jeopardize banking stability.

The forecast risks for *budget policy* are these:

* There may be populist decisions on additional benefits that increase social or other expenditures without regard for budget constraints, and insufficient financing of government investment in innovation, economic development and qualitative restructuring in the economy (as a result of limited budget funds).
* A higher share of the state sector in domestic credit (mainly to finance the deficit on the state budget) may reduce credit supply to the real sector, which, in turn, may damage the circulating assets of companies and organizations and reduce their investment and profit-making capabilities.

The forecast risks concerning *social policy* are these:

* There are major risks expected to the balance of commodity and financial flows on the consumer market in 2007, against a background of low increases in real average monthly wages and disposable incomes, due to a considerable gap between the minimum wage and subsistence level, coupled with failure to carry out the second and third stages in introducing the single tariff schedule.

* Subsistence level in 2007, after adjustment for the increase in consumer prices, will reach UHR 550–600, so that the minimum wage should equal that. The risk may be offset either by accumulating resources to raise the minimum wage to UHR 500 and bring it closer to subsistence level, or by improving in justice terms the system of social protection of low-income citizens through housing and public utility subsidies.
* The further decline in economic growth is expected to slow increases in real average monthly wages and disposable incomes, which may reduce the potential for endogenous economic growth, causing lower effective demand and consumption and saving propensities.

The forecast risks for *trade policy* are these:

* Protracted deterioration in the balance of the foreign economy will oblige the NBU to abandon its current policy of maintaining a stable nominal exchange rate for the hryvnia and shift to moderate devaluation, to support a stable real effective exchange rate. The negative factors in the external sector will peak in 2007–8, and 2009 will initiate some improvement in the external economic balance, if the structural corrections are successful.
* Ensuring a stable long-term rate of economic development means resolving some fundamental problems: accelerated investment of the real sector through government measures to introduce efficient mechanisms for the use of household funds, privatization revenues, and domestic and foreign direct investment; government implementation of efficient institutional reforms of property institutions, creation of market infrastructure, development of the cooperative movement, increased efficiency of production and exchange, and a programme of energy saving; strict budget policy, through tighter budget discipline, better control over expenditures, and reduction of tax exemptions – with simultaneous easing of the tax burden for producers, and introduction of a competition-based system of state procurement; and use of efficient monetary instruments to stabilize monetary and macroeconomic indicators.

## 5) Energy problems, investment prospects, and efficiency of socioeconomic development

The most urgent problem for Ukraine's economy is to ensure rapid growth of fixed investment, as the available fixed capital is ageing, technological renewal is weak, and without annual economic growth exceeding 6 per cent, the problems in public consumption will worsen further.

At the same time, the additional financial load that companies may face from higher prices for imported natural gas could seriously undermine their investment potential, and as their own resources are the main source of investment funds (over 61 per cent), this poses another serious risk for the country's economic prospects. Such tendencies are apparent in some data provided by the Ministry of the Economy:

the number of profit-making companies fell somewhat between February 2005 and January 2006:

* from 58.5 to 53.9 per cent in mechanical engineering and in metallurgy,
* and from 63.8 to 61.7 per cent in chemicals and petrochemicals.

The falls were still not drastic, although the gas price was 52.8 per cent higher than it had been in September 2000.

Expert calculations show that an end price of 1000 $m^3$ of natural gas at USD 135.50, would provide minimum profitability for Naftogaz Ukrainy and leave many producers making losses (Ekspert 3/2006, 13).

A considerable reduction of gas consumption may be attained by about 2015–20, depending on how well the situation develops. (See the Institute for Economics and Forecasting of the Ukrainian National Academy of Sciences calculations, *Table 3*).

Gas consumption will fall by 36 per cent to 49.5 $m^3$ billion, and the share of natural gas in energy imports from 32.3 to 3.6 per cent by 2030.

The Institute for Economics and Forecasting of the Ukrainian National Academy of Sciences has made projections of gas-price rises and assessment of their impact on corporate results (O. Bolkhovitinova). Our analysis and forecast calculations presented below are based on government statistics, and so in our opinion more reliable.

Table 3
The energy-cost pattern of companies by main energy materials, % of total energy costs

| | Total | Costs by individual energy carriers | | | | | |
|---|---|---|---|---|---|---|---|
| | | Coal | Oil | Natural gas | Coke and derivatives | Motor fuel | Diesel fuel |
| National economy total | 100.0 | 16.5 | 19.1 | 24.8 | 20.1 | 4.2 | 9.4 |
| Agriculture, hunting, forestry | 100.0 | 0.4 | | 3.8 | | 22.8 | 68.5 |
| Industry | 100.0 | 18.7 | 22.2 | 26.4 | 23.3 | 1.5 | 2.6 |
| Mining | 100.0 | 15.0 | 5.4 | 21.5 | 3.6 | 8.3 | 38.2 |
| Manufacturing | 100.0 | 29.9 | 25.8 | 23.1 | 27.1 | 1.1 | 1.8 |
| Food industry, processing of agricultural produce | 100.0 | 2.4 | | 48.4 | 0.6 | 21.8 | 18.4 |
| Light industry | 100.0 | 2.3 | 0.0 | 56.0 | | 21.7 | 16.3 |
| Lumber & wood | 100.0 | 0.3 | | 40.7 | | 10.8 | 18.6 |
| Pulp & paper, publishing | 100.0 | 0.1 | | 67.5 | | 1.9 | 2.4 |
| Coke & oil processing | 100.0 | 29.9 | 61.7 | 0.5 | | 0.1 | 0.1 |
| Chemicals and petrochemicals | 100.0 | 0.4 | | 91.7 | 1.3 | 1.6 | 2.1 |
| Metallurgy & metal working | 100.0 | 5.8 | | 30.4 | 58.2 | 0.3 | 1.3 |
| Mechanical engineering | 100.0 | 1.9 | | 58.8 | 3.0 | 5.6 | 8.7 |
| Energy generation & distribution, gas & water supplies | 100.0 | 43.5 | | 50.6 | | | 0.2 |
| Construction | 100.0 | 0.6 | 0.2 | 2.8 | | 22.4 | 50.6 |
| Trade | 100.0 | 1.7 | | 7.9 | 0.1 | 41.8 | 41.7 |
| Accommodation & catering | 100.0 | 3.5 | | 24.3 | | 48.0 | 16.8 |
| Transport | 100.0 | 1.3 | | 27.4 | | 10.6 | 51.2 |

* Calculated on the basis of statistical form 4–МТП (annual) “Report on residuals and use of energy materials and oil processing products”.

The Economic Strategy of Ukraine calculated and approved by the government assumes that imports of energy materials will fall by between 54.8 and 11.7 per cent (including gas, oil and uranium). Domestic gas extraction will fall from 23 to 28 $m^3$ billion, and extraction abroad to 11.6 $m^3$ billion. There will be some switching to nuclear energy and coal.

*Table 3* shows that most productions are quite sensitive to change in their spending on natural gas, not only in manufacturing, but in mining (where natural gas accounts for 21.5 per cent of total energy costs), light industry (56 per cent), wood working and pulp and paper (40.7 per cent and 67.5 per cent respectively), mechanical engineering

(58.8 per cent) and some services. However, the real scale of the effect can only be found by comparing such expenditure with total costs of energy materials, and estimating the corresponding increase in operational costs.

By our calculations, an increase in the gas price of the amount shown in *Table 4* would symmetrically raise total costs of energy materials in proportion, as shown. The biggest (almost synchronous) impact of gas price changes on energy costs is predicted for chemicals and for electricity, gas and water supplies, where the share of expenditure on natural gas exceeds 90 per cent of all energy expenditure. Then come construction materials, and in order of diminishing influence, non-ferrous metallurgy, mechanical engineering, pulp and paper, ferrous metallurgy, light industry, food processing, and wood working. The greatest impact outside industry is on accommodation and catering and on transport, especially land transport.

The increase in energy expenditure due to a higher average price for natural gas will produce the increases in operational costs shown in *Table 5*. Here the risks are presented in a different way than with the potential growth of energy spending alone. The biggest influence is characteristically on chemicals, construction materials, and pulp and paper industry.

The positive variant assumes a 5 per cent rise in sales since 2004 and takes into account exclusively the gas-related factor in the rise in operational costs, with other operating costs fixed at 2004 level. The profitability of most sectors then improves and profitability problems occur only in chemicals, metallurgy, construction materials, and pulp and paper, but in view of the high basic profitability of these industries, such problems seem quite solvable: industries will become loss-makers only against a 200 per cent annual increase in the gas price, which is hardly probable. If the positive fore-

Table 4
Share of natural gas in total energy costs; potential increases in costs of energy materials depending on rise in average price for natural gas*
(%)

| | Natural gas as % of total energy costs | Potential increase, as % of 2004 base level, in total costs of energy materials with a rise of average price for 1 m$^3$ of natural gas of: | | | |
|---|---|---|---|---|---|
| | | 75% | 100% | 150% | 200% |
| National economy total | 24.8 | 118.6 | 124.8 | 137.3 | 149.7 |
| Agriculture, hunting, forestry | 3.8 | 102.8 | 103.8 | 105.6 | 107.5 |
| Industry | 26.4 | 119.8 | 126.4 | 139.6 | 152.8 |
| Mining | 21.5 | 116.2 | 121.5 | 132.3 | 143.1 |
| Manufacturing | 23.1 | 117.4 | 123.1 | 134.7 | 146.3 |
| Food industry, processing of agricultural produce | 48.4 | 136.3 | 148.4 | 172.6 | 196.8 |
| Light industry | 56.0 | 142.0 | 156.0 | 184.0 | 212.0 |
| Lumber & wood | 40.7 | 130.5 | 140.7 | 161.1 | 181.4 |
| Pulp & paper, publishing | 67.5 | 150.6 | 167.5 | 201.3 | 235.0 |
| Coke & oil processing | 91.7 | 168.8 | 191.7 | 237.6 | 283.4 |
| Chemicals and petrochemicals | 30.4 | 122.8 | 130.4 | 145.6 | 160.8 |
| Metallurgy & metal working | 58.8 | 144.1 | 158.8 | 188.2 | 217.6 |
| Mechanical engineering | 50.6 | 138.0 | 150.6 | 175.9 | 201.2 |
| Energy generation & distribution, gas & water supplies | 2.8 | 102.1 | 102.8 | 104.1 | 105.5 |
| Construction | 7.9 | 105.9 | 107.9 | 111.9 | 115.8 |
| Trade | 24.3 | 118.2 | 124.3 | 136.4 | 148.6 |
| Accommodation & catering | 27.4 | 120.6 | 127.4 | 141.1 | 154.8 |

* Calculated as Table 3.

Table 5
Share of natural gas spending in total operating costs; potential increases in operating costs depending on rise in average price for natural gas*
(%)

| | Energy materials as % of total operating costs | | Potential increase, as % of 2004 base level, in total operating costs with a rise of average price for 1 $m^3$ of natural gas of: | | | |
|---|---|---|---|---|---|---|
| | Total | Incl. nat'l gas | 75% | 100% | 150% | 200% |
| National economy total | 6.7 | 1.7 | 101.2 | 101.7 | 102.5 | 103.3 |
| Agriculture, hunting, forestry | 18.0 | 0.7 | 100.5 | 100.7 | 101.0 | 101.4 |
| Industry | 20.7 | 5.5 | 104.1 | 105.5 | 108.2 | 110.9 |
| Mining | 6.2 | 1.3 | 101.0 | 101.3 | 102.0 | 102.7 |
| Manufacturing | 23.5 | 5.4 | 104.1 | 105.4 | 108.2 | 110.9 |
| Food industry, processing of agricultural produce | 2.6 | 1.2 | 100.9 | 101.2 | 101.9 | 102.5 |
| Light industry | 1.3 | 0.7 | 100.5 | 100.7 | 101.1 | 101.4 |
| Lumber & wood | 5.1 | 2.1 | 101.6 | 102.1 | 103.1 | 104.2 |
| Pulp & paper, publishing | 8.3 | 5.6 | 104.2 | 105.6 | 108.4 | 111.2 |
| Coke & oil processing | 13.2 | 12.1 | 109.1 | 112.1 | 118.1 | 124.1 |
| Chemicals and petrochemicals | 37.8 | 11.5 | 108.6 | 111.5 | 117.3 | 123.0 |
| Metallurgy & metal working | 3.1 | 1.8 | 101.4 | 101.8 | 102.7 | 103.6 |
| Mechanical engineering | 14.7 | 7.4 | 105.6 | 107.4 | 111.2 | 114.9 |
| Energy generation & distribution, gas & water supplies | 3.1 | 0.1 | 100.1 | 100.1 | 100.1 | 100.2 |
| Construction | 0.1 | 0.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Trade | 0.4 | 0.1 | 100.1 | 100.1 | 100.1 | 100.2 |
| Accommodation & catering | 7.6 | 2.1 | 101.6 | 102.1 | 103.1 | 104.2 |

* Calculated as Table 3.

cast comes true, inflation can easily be kept within single digits. There will be no general decrease in the volume of own investment resources. For companies that try rapidly to overcome their energy dependence and modernize, there will be no additional problems with access to credit resources or foreign investment.

The variant with a 100 per cent increase almost corresponds to the price level industrial companies had in the first half of 2006. In the forecast context, it is advisable to consider the last two variants, with increases of 150 and 200% since 2004, increases by 150-200 per cent, and of operational costs in the economy of 2.5–3.3 per cent. In this case, chemicals will show a rise in operating costs of 24–32 per cent, ferrous metallurgy of 20–27 per cent, construction materials of 14–19 per cent, pulp and paper of 8–11 per cent, mechanical engineering of 6–9 per cent, wood working of 3.1–4.2 per cent, food processing of 2–2.7 per cent, and light industry of 1.1–1.4 per cent. Operational costs of the power sector will increase in this case by 11–15 per cent.

A worse, rather more realistic variant of the positive forecast uses similar assumptions, but a 2 per cent rise in sales. The general level of profitability then eases, but the most gas-dependent industries, like construction materials, chemicals, and metallurgy, become loss-making. The first of these will become loss-making even with a prospectively quite realistic 100 per cent rise in the natural-gas price, and the rest with a 150 per cent rise.

The results of the realistic forecast differ from the previous in not stipulating any possibility of a sales increase without a symmetrical increase in prices for other operational costs apart from natural gas. The impact of the inflation factor damages the finances of almost every industry so much that higher sales prices seem inevitable.

If the sales increase rate is lower (a worsened realistic forecast), the financial results of operations will raise the risks of a slowdown in Ukrainian investment development as a whole, in particular in the introduction of energy-saving technologies.

*Table 6* shows the expected increase in the sales prices of producers, assuming rising prices for natural gas and some other components of operating costs, as they try to maintain profitability at 2004 levels.

Table 6

Expected growth rate of sales prices needed to maintain 2004 profitability against forecast increases in the average price of natural gas of 75–200%

(%)

| | Profitability of operations in 2004 | Expected growth rates of sales prices needed to maintain profitability at 2004 level with a rise of average price for natural gas of: | | | |
|---|---|---|---|---|---|
| | | 75% | 100% | 150% | 200% |
| National economy total | 4.0 | 110.6 | 111.0 | 111.8 | 112.6 |
| Agriculture, hunting, forestry | 2.0 | 110.2 | 110.4 | 110.7 | 111.1 |
| Industry | 6.5 | 112.7 | 114.0 | 116.5 | 119.1 |
| Mining | 1.2 | 110.7 | 111.1 | 111.7 | 112.4 |
| Manufacturing | 7.8 | 112.5 | 113.7 | 116.3 | 118.8 |
| Food industry, processing of agricultural produce | 1.2 | 110.7 | 111.0 | 111.6 | 112.2 |
| Light industry | -1.8 | 110.7 | 110.8 | 111.2 | 111.6 |
| Lumber & wood | 2.8 | 111.0 | 111.5 | 112.5 | 113.6 |
| Pulp & paper, publishing | 6.4 | 112.8 | 114.1 | 116.7 | 119.3 |
| Coke & oil processing | 13.0 | 115.5 | 118.2 | 123.4 | 128.7 |
| Chemicals and petrochemicals | 13.0 | 115.2 | 117.7 | 122.7 | 127.7 |
| Metallurgy & metal working | 4.6 | 110.7 | 111.1 | 112.0 | 112.8 |
| Mechanical engineering | 2.9 | 114.4 | 116.2 | 119.8 | 123.4 |
| Energy generation & distribution, gas & water supplies | 2.2 | 109.8 | 109.9 | 109.9 | 109.9 |
| Construction | 1.4 | 109.9 | 109.9 | 109.9 | 109.9 |
| Trade | -7.9 | 110.9 | 110.9 | 110.9 | 111.0 |
| Accommodation & catering | 14.4 | 109.7 | 110.2 | 111.1 | 112.0 |

* Calculated as Table 3.

* * * * *

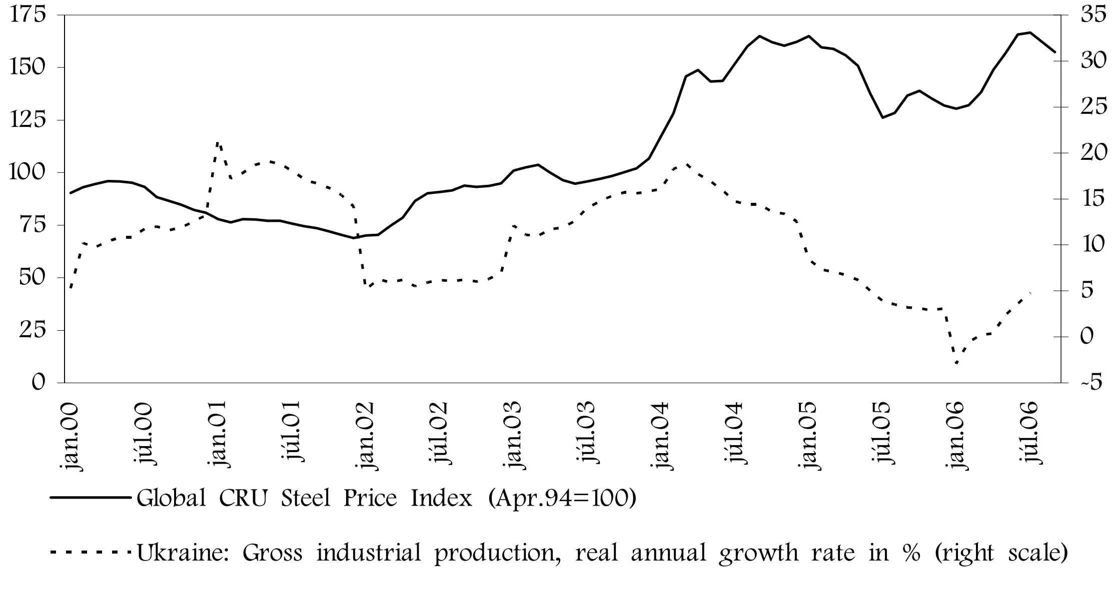
# SOURCES OF ECONOMIC GROWTH

*Vasily Astrov*

Ukraine's economic growth exceeded 5 per cent in 2000 and 2002, and 9 per cent in 2001 and 2003, and reached 12.1 per cent in 2004. However, these dynamic increases must be viewed against a very low base, resulting from a dramatic decline during the the 1990s. Even in 2004, after several consecutive years of high growth, GDP was still at only 61 per cent of its 1990 level. The main factors behind the impressive performance of the early 2000s were these:

* Devaluation of the hryvnia in 1999, in the aftermath of the Russian financial crisis, opened up a competitive advantage for producers, especially in food processing.
* Rapid growth in Russia and other CIS countries brought, among other things, rising demand for Ukrainian machinery and transport equipment on these markets.
* World prices of steel were mounting *(Figure 2)* and external demand for metals – Ukraine's major export commodity – was strong, particularly on Asian markets.
* There was an upswing in domestic demand for capital goods.

Figure 2
Steel prices and gross industrial production



The booming fixed investment reached its peak in 2003 and 2004, when it expanded by 31 and 28 per cent, respectively, financed primarily by the healthy profits of exporters, although access to bank credit generally improved as well. Private consumption was rising as well, although it was not until 2004 and especially 2005 that it became the major pillar of growth. On the production side, industry was leading the growth, while the performance of agriculture was much more volatile, due largely to the changing weather conditions for harvest.

However, the economic growth in 2005 slowed down to just 2.6 per cent, largely on account of weak investment demand and negative developments in foreign trade, while consumption picked up somewhat. Anecdotal evidence suggests the investment climate suffered massively from the policy steps undertaken by the new 'Orange' authorities. In particular, the 2005 budget amendments introduced a five-year moratorium on granting new and enhancing existing tax benefits, while the tax and customs benefits enjoyed by certain industries (including the automotive, aircraft and space industries) and the 'special economic zones' (SEZs) and the 'territories of priority development' (TPDs) were scrapped with retroactive effect. The latter move was aimed at closing 'loopholes' for smuggling, but it also hurt investment projects already implemented. Even more importantly, the new authorities launched a reprivatization campaign, revising some of the most controversial privatization deals concluded under former President Kuchma. On the one hand, the campaign was intended to raise privatization revenues to replenish the state budget, but it was also part of the fight by a new power elite against the financial and industrial groups that had benefited most under Kuchma. The government added to investors' worries by making a series of contradictory statements about the scope and particulars of the upcoming reprivatization scheme. Although large-scale reprivatization was never really implemented, several privatization deals were annulled in the courts, including that of the country's biggest steel producer, Kryvorizhstal', and of the Nikopol Ferroalloy Plant. Largely because of the new policy course, fixed capital investment increased in 2005 by a mere 1.9 per cent, and construction output declined by 6.6 per cent.

At the same time, negative trade developments could be seen on the export and import sides, only partly generated by domestic factors. On the export side, world steel prices plunged by some 30 per cent in the first half of 2005 alone (Figure 2), following an increase in China's steel-production capacity. Ukraine's steel exports, making up some 30 per cent of its total exports, suffered accordingly. Simultaneously, imports were fostered by increased social spending and a currency revaluation undertaken in April 2005. The resulting reversal of the country's trade balance was dramatic: the 2004 trade surplus in goods, which had reached €3 billion, turned into a €900 million deficit in 2005 (corresponding to 1.4 per cent of GDP).

That economic slowdown in 2005 and the early months of 2006 has recently been reversed again. For 2006 as a whole, real GDP growth of some 6.5 per cent is expected, driven primarily by services such as the retail and wholesale trade, but also by construction, benefiting from recovering investment. Since May 2006, industrial output has been generally picking up as well, largely through strong expansion of metal production, taking advantage of soaring steel prices and notwithstanding the "gas price shock". The recovery in metals has already translated into the rising exports. Finally, private consumption gained momentum again, backed by impressive growth of household incomes and expanding bank lending.

## INFLATION AND THE EXCHANGE RATE

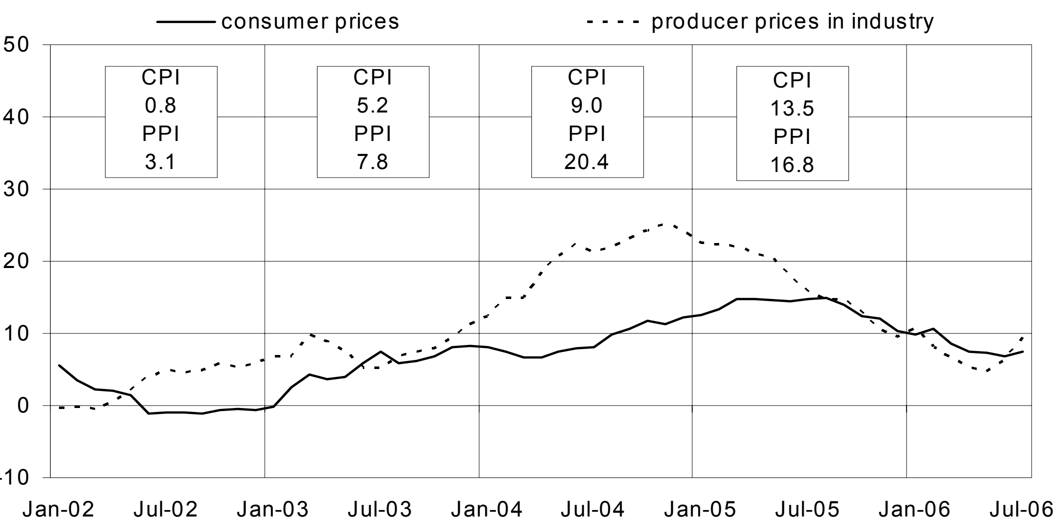
The unpleasant side of fast economic recovery in 2000–4 was rising inflation. After reaching a low of 0.8 per cent on annual average in 2002, consumer price inflation in subsequent years generally rose, to as much as 13.5 per cent in 2005. Industrial producer price inflation also speeded up and has almost invariably been higher than consumer price inflation *(Figure 3)*. The 2005 slump in economic activity resulted in declining inflation, but the current pick-up in metal prices is translating into accelerating producer prices and will make disinflation of consumer prices more difficult.

Among the important factors behind the *demand-pull* inflation were:

* the persistent current account surpluses the country was running between 1999 and 2005, and resulting inflows of foreign exchange, and
* the fiscal stimulus that took effect on the eve of the 'Orange revolution' (largely via the doubling of pensions) and has been in place ever since.

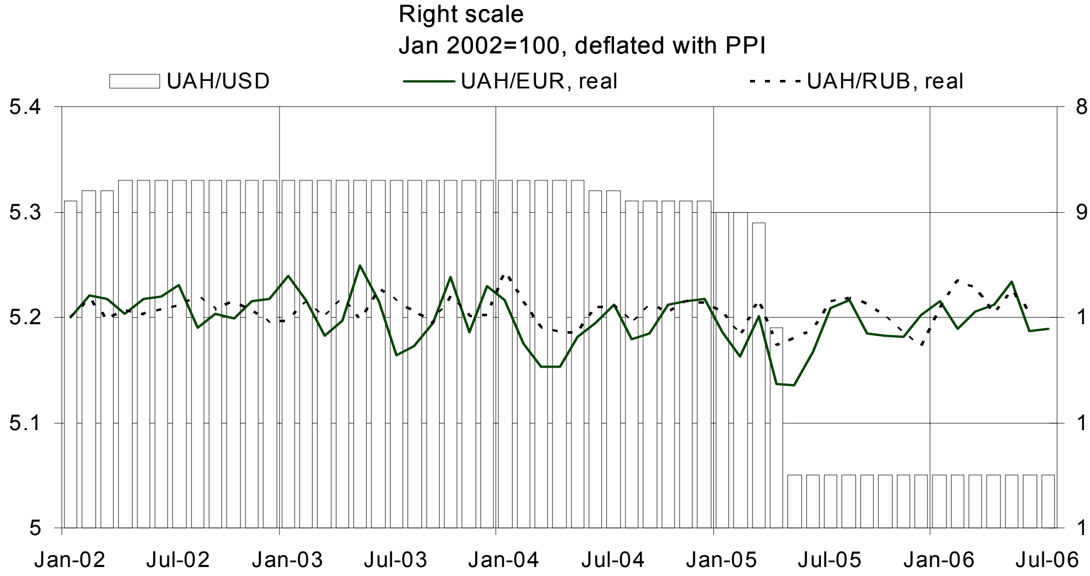
Most importantly, inflation in Ukraine was fuelled by relatively lax monetary policy. Given the country's economic openness and the virtual lack of domestic monetary instruments, the latter essentially boiled down to exchange-rate policy, in particular maintenance of a *de facto* exchange-rate peg to the US dollar at a level of UAH 5.33 since 2002. This policy implied a generally constant real-exchange rate for the hryvnia against the currencies of its main trading partners, Russia and the Euro Zone, due to higher inflation in the former and strengthening of the Euro against the US dollar in nominal terms in 2003–4 *(Figure 4)*. This helped to ensure the competitiveness of Ukrainian products in foreign and domestic markets and maintain a positive trade balance and ultimately sound economic growth, albeit accompanied by stubborn inflationary pressure.

Figure 3
Inflation, year-on change in %




During the boom of 2004, there was evidence that some industries were operating on the verge of capacity, so that the high aggregate demand increasingly translated into higher inflation rather than higher production volumes – a sign of "overheating". In addition, the impressive increase in the price of oil, particu-

Figure 4
Nominal and real exchange rates




larly from 2003, contributed to *cost-push* inflation as well, especially as Ukraine's economy is very highly energy intensive and energy-import dependent. (The price hike of imported natural gas at the beginning of 2006 has had a similar, albeit smaller effect than initially feared. The latter was not least due to the inability of some energy-intensive export branches facing international competition – such as chemicals – to shift the increased cost of inputs onto final consumers, and resulted in declining production volumes, at least initially.)

In an effort to combat inflation, the National Bank of Ukraine abandoned the previous peg in April 2005 and revalued the currency by 4.7 per cent to UAH 5.05/USD. This has been maintained since. The measure was intended to ease the inflationary pressure by depressing the cost of imports (especially energy), while reducing the current-account surplus and the resulting inflow of foreign exchange. In another move, the National Bank scrapped the 50 per cent surrender requirement for export earnings, which had been in place since the 1998 financial crisis. Although it can be argued that without the revaluation, the inflation in 2005 would have turned out even higher than it actually did, the measure hurt the real economy by reducing the competitiveness of domestic goods and boosting imports, particularly of consumer goods.

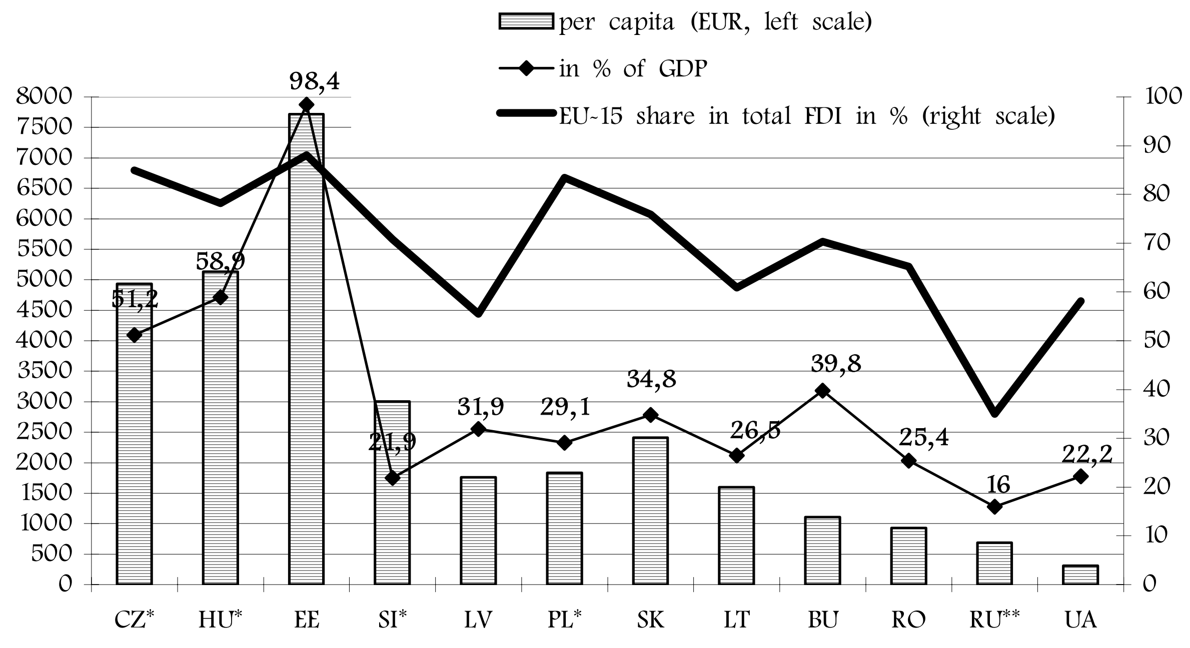
A breakdown of Ukraine's FDI stock by economic activity reveals that the sector attracting the most registered FDI is wholesale and retail, followed by metals, food processing, and the financial sector. Metals feature prominently mainly because of the Kryvorizhstal' deal mentioned earlier, while food processing and trade have been developing particularly fast in the past few years, taking advantage of an initial low level (trade) and opportunities for import-substitution, provided by the hryvnia devaluation in 1999 (food processing). Both branches have a relatively short pay-off period – a reflection of investors' concern over the country's longer-term prospects and the security of their property rights.

## FOREIGN DIRECT INVESTMENT

The current structure of Ukraine's exports may not provide much room for long-term growth. As exemplified by the recent U-shaped path of economic performance, this makes the country highly vulnerable to volatile world steel prices. The deficiencies of current economic structure are not least due to disappointing FDI inflows *(Figure 5)*. By the end of 2005, the cumulative inward stock of FDI per capita – arguably the most appropriate indicator of FDI penetration – amounted to only 310, which is far below the levels seen in the advanced new member-states of the EU (such as Estonia or Poland), and even in Bulgaria or Russia. Ukraine has also lacked behind in terms of FDI stock as a per centage of GDP – though the gap is not so striking as the country's GDP remains very low. Finally, the EU–15 share in FDI stock, an arguably appropriate indicator of FDI quality in terms of bringing in new technologies and managerial know-how, stands at 58 per cent, which is largely in line with most other East European countries, Russia being an important exception. However, the share increased dramatically in just one year (2005) through a single deal: the 4 billion resale of Kryvorizhstal' to the German subsidiary of Mittal Steel, which was statistically captured as German FDI into Ukraine.

Apart from the EU, another important investor in Ukraine is Russia, though officially it ranks only sixth, with a share of a mere 5 per cent. The official figure hardly reflects the true situation, as the bulk of Russian FDI in Ukraine flows via the offshore countries such as Cyprus, ranking second, and the Virgin Islands, ranking eighth. (in fact the FDI from such offshore countries also represents Ukrainian capital that had previously fled the country.) The high importance of Russian capital in Ukraine reflects not only the cultural and geographical proximity, but economic dependence. Much

Figure 5
Stocks of inward FDI in Ukraine and selected countries, December 2005




* EU–15 share as of 2004. ** EU–15 share estimate.

of the Russian investment has been driven by the latter's failure to honour in good time its energy-related debt to Russia (particularly for gas), resulting in a series of debt-for-equity swaps. Russian acquisitions in Ukraine gained momentum in February 1998 after the two countries signed a ten-year Agreement on Economic Cooperation, which enabled Russian companies to participate in Ukraine's privatization. Assets acquired by Russian investors include refineries, energy-distribution companies, underground storage tanks, port facilities, aluminium plants, dairies, banks, telecommunications and broadcast media.

However, the inflows of FDI into Ukraine in 2005 accelerated markedly – not only due to the Kryvorizhstal sale, but because of the  860 million acquisition of the country's second biggest bank, Aval, by Austria's Raiffeisenbank. This deal can be seen as part of a general trend of mounting interest in the banking sector from foreign investors – including those from Russia. Among other banks sold to foreigners in the course of 2006 were Ukrsibbank (to BNP Paribas of France), Mriya (to Vneshtorgbank of Russia) and Ukrsotsbank (to Banca Intesa of Italy). More generally, the country's prospects of attracting more FDI may improve after WTO accession – likely in 2007 – and subsequent formation of a free trade area with the EU.

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# UKRAINE AND THE WTO

*Volodymyr R. Sidenko*

Ukraine has almost reached the end of its marathon negotiations for accession to the World Trade Organization, which have taken more than 13 years.

On bilateral negotiations-related market-access issues, Ukraine has concluded bilateral protocols with 48 out of the 56 members of its Working Party. The bilateral protocol with Chinese Taipei has been initialled, but negotiations with the Kyrgyz Republic are not yet completed because of incremental demands on the Kyrgyz side.

Tariff reductions since 1996 have brought Ukraine close to the binding tariff system (*Table 7*), although progress has been inconsistent, with some with substantial reversals. However, for some tariffs (on meat, fish and foodstuffs), Ukraine is to gain *transition periods* up to 2010.

Furthermore, Ukraine is committed to joining 16 WTO sectoral plurilateral agreements and initiatives, on chemical harmonization (envisaged import tariffs of 5.5–6.5 per cent), textile and clothing (0–17.5 per cent), steel, toys, wood, non-ferrous metals, pharmaceuticals, paper, agriculture equipment, furniture, Information Technology Agreement, scientific instruments, construction equipment, medical equipment, civil aircraft, and distilled drinks (all with a zero tariff).

Ukrainian expert views differ on these initiatives. No damage is expected from free imports of scientific and medical instruments or IT products, as most of these high-technology items are not produced in Ukraine, or produced at an inadequate technological level. Free imports of them will stimulate technological advance. The textile initiative brings no radical new liberalization, as Ukraine is already working under an EU textile agreement based on these terms. With most other sectoral initiatives, the Ukrainian government asserts that they relate mainly to inputs and raw materi-

Table 7
Changes in Ukraine's import tariffs and expected tariffs after accession
(%)

| Import tariff rate | Actual tariff rate on | | Expected bound tariffs after WTO accession |
|---|---|---|---|
| | March 1, 2005 | Sept. 1, 2005 | |
| Simple average | | | |
| Total of commodity nomenclature | 10.47 | 6.51 | 6.28 |
| Industrial goods | 8.29 | 4.40 | 4.85 |
| Agricultural products | 19.71 | 13.84 | 11.16 |
| Weighted average | | | |
| Total of commodity nomenclature | 7.77 | 7.02 | 5.09 |
| Industrial goods | 6.70 | 6.11 | 4.77 |
| Agricultural products | 21.10 | 18.19 | 10.07 |

*Source:* Cabinet of Ministers of Ukraine (2006): Information and Analytical Papers on Ukraine's Accession to the WTO. Prepared for parliamentary hearings on "The Current State of Preparation for Ukraine's Accession to the WTO. Problems and Prospects". Kiev, November 1, 2006, p. 25.

als, and could stimulate Ukrainian production and involvement into international production-cooperation chains. One of the most disputed is the civil aviation agreement, where Ukraine has actually employed a zero tariff since 1994, but this is a questionable solution for the development prospects of Ukrainian aircraft facilities.

In the services sector, Ukraine is to adopt specific commitments in around 150 sectors (out of 155) – an extremely high proportion compared with most WTO members, most of which have no more than 100 sectors covered by WTO commitments.

Ukraine passed 18 pieces of legislation between 2005 and October 2006 to further harmonization of its legal system with WTO norms. They include the following:

* Basic trade procedures harmonization: amendments to the Customs Code of Ukraine, and to national procedures related to anti-dumping and safeguard measures according to WTO agreements.
* Intellectual property protection in conformity with the TRIPS Agreement.
* Suspension of some distorting taxation schemes, *i.e.* with regard to the special VAT regime for agriculture.
* Harmonization of the technical regulation mechanism, *i.e.* bringing certain sanitary and phytosanitary measures into conformity with regulations under relevant WTO agreements; new norms relating to standards, technical regulations and conformity assessment procedures; standards relating to quality and security of foodstuffs and food raw materials; consumer protection issues.
* Liberalization of the goods market: reduction of import tariffs on agricultural products (Groups 1–24 of the trade nomenclature based on the HS); cuts in export duties on exported oilseeds (aimed at bringing them down from 16 to 10 per cent over a six-year period); liberalization of motor-car imports; withdrawal of local content requirements in motor-car production.
* Liberalization of the services market: activity of foreign insurance-company branches in Ukraine (allowed after a 5-year transition period from WTO accession); auditing activities; foreign investments in TV and broadcasting activities.

To finalize this harmonization process, the president and government of Ukraine submitted to Parliament a set of 21 priority bills to be passed within November 2006.[1] These included the following:

* On systemic and sectoral trade issues: preparation of a substantially amended version of the act on external economic activities; bringing licence payments for alcohol production and trade up to the real cost of licensing procedures for alcohol beverages and tobacco products; substitution of a current ban on exporting waste and scrap of non-ferrous metals and doped ferrous metals with export duties on them; gradual reduction of export duties on scrap of ferrous and non-ferrous metals and semi-manufactures of non-ferrous metals (from a current €30 per ton to €25 from the moment of accession and to €10 over a six-year transition period); gradual reduction of export duties on live animals and raw skins (from 50 and 30 per cent immediately after accession to 10 and 20 per cent, respectively after eight and ten-year transition periods respectively); repeal of the prohibition on importing old motor-cars (over eight years old).
* On the agriculture and food sector: abrogation of preferential VAT rates for home producers (9 per cent for agriculture and for forestry); bringing state support for agriculture into con-

[1] Twelve had been approved by Parliament by November 17, 2006, including all those covering intellectual property-protection issues and services.

formity with WTO norms; cancellation of export subsidies for milk and milk products production (though not actually used in Ukraine); bringing change in the quota system in production and marketing of sugar and revocation of the mandatory export of sugar made of imported raw material; introduction of a tariff quota for raw cane sugar imports equal to 260,000 t (with a 2 per cent import tariff within the quota and 50 per cent outside it); harmonizing veterinary medicine regulations with those set by the WTO.

* On intellectual property protection: amending legislation on production of pharmaceuticals and on pesticides and agrochemicals (with regard to restricted information protection); introduction of legislative norms on the national regime and most-favoured-nation treatment for geographical indications of products; amending the Customs Code to account fully for intellectual property protection in customs clearance procedures.
* Amending the law on the service sector: on insurance with the view to revoking certain restrictions on insurance activities by foreign companies (intermediation, re-insurance related to maritime carriage, commercial aviation, space launching, and freight); on banking and banking activities with regard to admitting foreign bank branches in Ukraine, generally on a national-treatment regime; on the legal profession (admitting foreign lawyers to Ukrainian legal proceedings); on publishing (repeal over a five-year transition period of restrictions on foreign capital participation in distribution services for printed materials).

WTO accession is expected to have multiple effects on the Ukrainian economy. In the macro economy, the government expects effects on the following main indicators:[2]

* Acceleration of GDP growth by 1.5–2.0 per centage points.
* A 150–200 per cent increase in FDI inflow within one or two years of accession.[3]
* An annual export increment of USD 1.43–1.57 billion,[4] for instance because of a consolidated stand on anti-dumping[5] and special investigations, and circumscribed trade restrictions and discrimination.
* Increased state budget revenues of about UAH 3–4 billion from suspension of tax and tariff preferences, increased production volumes, and intensified market turnover. So the suspension of most import tariff preferences is to offset the loss caused by tariff reductions.[6]

A study of the economic impacts of Ukraine's accession to the WTO was made by a research consortium from Ukraine's Institute for Economic Research and Policy Consulting, Copenhagen Economics, and the Osteuropa-Institut München, based on a dynamic general equilibrium model (GEM).[7] The principle ones appear in *Tables 8* and 9.

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[2] Secretariat of the President of Ukraine (2006). Information and Analytical Papers Regarding Ukraine's Accession to the WTO, Kiev, pp. 14–15.

[3] Some government forecasts suggest an annual FDI increment of USD 500 million.

[4] Optimistic estimates range from USD 1.5–2.0 to 4.0 billion, or 7–10 per cent.

[5] Ukraine currently faces 24 anti-dumping investigations in 11 countries in the metallurgical sector, and 8 in 4 countries in chemicals. The overall value of exports subject to trade restrictions is around USD 1 billion.

[6] So the total reduction in import tariff revenues for 2007 is forecast at a low 4.70–4.49 per cent of total revenue, or 1.48–1.36 per cent of GDP.

[7] For a summary of results see: Secretariat of the President of Ukraine (2006), pp. 22–30.

Table 8
Aggregate economic effects of Ukraine's accession to the WTO, cumulative changes, %

| Changes of indicators | Aggregate result of WTO accession | Changes due to reforms in trade barriers | Changes due to improved market access |
|---|---|---|---|
| Aggregate welfare, % | 10.2 | 3.8 | 6.4 |
| Real GDP, % | 4.8 | 2.0 | 2.7 |
| Consumer price index, % | –2.0 | –2.2 | 0.2 |
| Prices for production factors, % | | | |
| Qualified workers | 5.7 | 3.8 | 1.9 |
| Non-qualified workers | 5.7 | 3.5 | 2.1 |
| Capital | 1.1 | 1.2 | –0.1 |
| Costs of adjustment to new conditions, % | | | |
| Qualified workers | 1.8 | 1.2 | 1.2 |
| Non-qualified workers | 2.7 | 2.2 | 2.0 |
| Capital | 0.3 | 4.2 | 0.1 |
| Aggregate export, % | 9.2 | 6.4 | 2.6 |
| Aggregate import, % | 11.8 | 7.6 | 4.1 |
| Fixed capital accumulation, % | 3.7 | –0.2 | 3.8 |

*Source:* Burakovsky I., J. Jensen, V. Movchan, F. Pavel and L. Handrich. Macroeconomic effects of Ukraine's Accession to the WTO. In: Ukrainian Centre for International Integration. The Accession to the World Trade Organization: New Opportunities for Ukraine, Kiev, 2006, pp. 33–7 (in Ukrainian).

Table 9
Main long-term sectoral economic effects of Ukraine's accession to the WTO

| Sector (industry) | Output growth, % | Export growth, % | Employment change, % |
|---|---|---|---|
| Metallurgy and metal working | 22.0 | 25.6 | +19.2 |
| Chemical industry | 20.8 | 26.6 | +17.6 |
| Agriculture | 1.5 | 43.5 | –2.4 |
| Financial intermediation | 3.9 | 6.3 | |
| Telecommunications | 7.8 | | +4.2 |

*Source:* The Cabinet of Ministers of Ukraine (2006). *Op. cit.*, pp. 44–52.

The sectors due to gain most are metallurgy and chemicals, through export-led growth. The most problematic is agriculture, where the rate of tariff liberalization is highest, and accompanied by a substantial cut in restricted agricultural subsidies classified under the WTO amber-box support measures. Thus the current AMS level in Ukraine is estimated at 12–13 per cent of total agricultural production (as opposed to 5–10 per cent permitted within the WTO).[8] The final level for Ukraine is not yet agreed because of a dispute over the reference period: the Ukrainian position is to use 1994–6, while the other side demands 2000–2002 or later.[9] And within five years of accession, the agreed AMS level will be cut by 20 per cent. In spite of the intensified competitive pressure and decreased state support, the aggregate output is forecast by the

[8] *Ibid.*, p. 7.

[9] This would push down the AMS value for Ukraine from the requested USD 1.14 billion to slightly over USD 60 million.

source mentioned to grow moderately, due to a presumed huge increase in agricultural exports. However, these expectations may well be thwarted unless current high subsidization of agriculture[10] is eased.

However, the results of the GEM modelling mentioned in estimating the outcomes of Ukraine's accession to the WTO have to be treated with caution. There are economic and econometric methodological restrictions inherent in the models that reduce their reliability, especially in countries with poor institutional quality and weak capacity to utilize the preferences of the world trading system. [11] So we are not to expect the positive effects to be immediate or effortless on the part of the government or the private sector. But the negative effects need no action to pave their way. Much will depend on ability to restructure the economy and make it more competitive internationally in the sectors dominant in the contemporary global economic system.

To sum up, the aggregate outcome of Ukraine's pending accession to the WTO will depend largely on its competitive strategy and capacity-building policy.

* * * * *

[10] In 2004, the EU spent on such subsidies USD 150.6 billion (1.25 per cent of GDP, of which only 2 per cent consists of agricultural output), the United States USD 108.7 billion (0.93 per cent, 1 per cent), and Japan USD 60.9 billion (1.30 per cent, 1 per cent). See Millennium Development Goals Indicators Database. http://unstats.un.org/unsd/mdg/Data.aspx; World Bank Development Indicators 2006, Table 4.2.

[11] For WTO activities, the restrictions have been thoroughly analysed in Stiglitz, J. E., and A. Charlton (2005). Fair Trade for All: How Trade Can Promote Development. Oxford: Oxford University Press.

# II. Prospects for EU–Ukrainian Relations

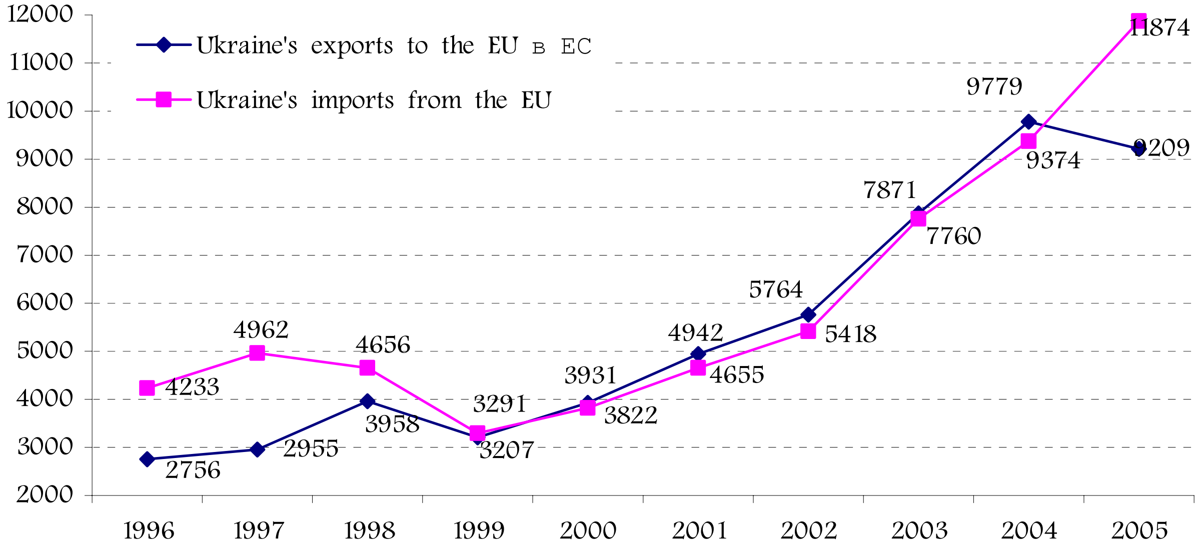
## EU–Ukrainian Relations within European Neighbourhood Policy (ENP)

*Dr. Volodymyr R. Sidenko*

Trade relations between Ukraine and the EU have grown fast *(Figure 6)*. Exports to the EU rose over 3.3-fold in the ten years after 1996 and imports by a factor of 2.8.

There are two troughs in the ascending curve, one back in 1998–9, when hryvnia devaluation produced a fall in imports from the EU, and the other in 2005, when hryvnia appreciation coupled with the energy price rise, rising domestic inflation, and shrinking world demand for metals caused a marked fall in Ukrainian exports to the EU and a surge of EU imports. The result was a

Figure 6
Ukraine's EU goods exports and imports, 1996–2005
(USD billion)



record trade deficit of USD 2665 million. Aggregate trade in goods and services amounted to USD 24.1 billion in 2005 – 11.8 per cent up on 2004. Exports of goods and services were worth USD 10.9 billion (down 3.2 per cent) and imports USD 13.2 billion (up 28.4 per cent), giving a trade deficit of USD 2.2 billion instead of a surplus of USD 1.1 billion in 2004.

A positive feature is that the EU, since enlargement, has become Ukraine's largest export market, accounting for 33.6 per cent of its total trade in goods and services. But the development in mutual trade has taken place on an old structural basis more characteristic of trade between developed and developing countries *(Table 10)*.

Ukraine specializes in exporting mineral products (above all energy sources), non-precious metals and products thereof (mainly ferrous metals recently, though aluminium and copper also featured prominently earlier). Imports are dominated by various machinery and equipment. There is a tendency towards intra-trade in the textile and clothing and the chemicals and associated industries.

EU direct investment in Ukraine's economy increased by a factor of 53 between 1995 and 2006 (*Figure 7*). After the enlargement and start of the ENP, the European Union strengthened its role as leading investor, so that it now accounts for 71.7 per cent of the FDI total. This is a remarkable increase since 2004, when the proportion for the EU 15 was 35.3 per cent and for the EU 25 56 per cent. However, the upsurge was largely caused by two major investments: acquisition of 93.02 per cent of the shares of Kryvorizhstal (UAH 24.2 billion or USD 4.8 billion) by Mittal Steel Germany GmbH, and of a 93.5 per cent tranche (USD 1028 billion) of Aval Bank shares by the Austrian Raiffeisen International Bank-Holding AG.

At the same time, EU countries such as Greece and Ireland decreased their FDI to Ukraine, while there was a slow investment increase from Italy, Spain, Slovenia, Finland and the Czech Republic.

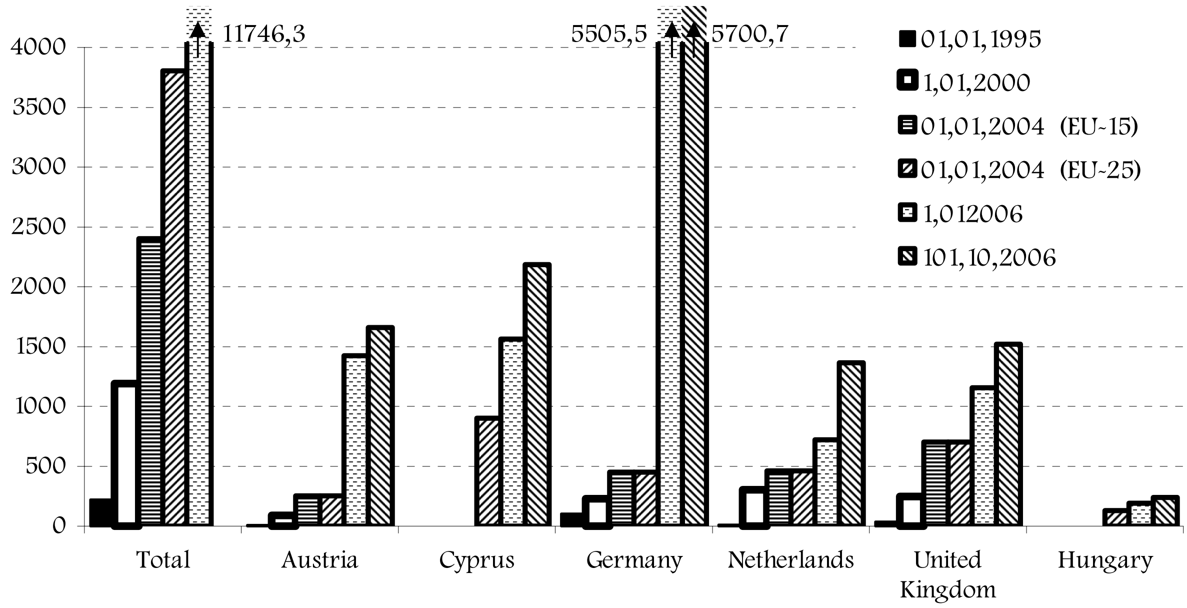
The development of EU–Ukrainian economic relations after adoption of the ENP is partly explained by further trade liberalization. It mostly relates to trade in steel products under an agreement signed on July 27, 2005 for the period of 2005–6, raising Ukraine's quota from 730,000 to 980,000 t in 2005 and to 1,004,500 t in 2006. After accession to the WTO, steel exports to the EU will be fully liberalized.

Table 10
Main features of the goods-trade structure between Ukraine and the EU, 1996, 2000 and 2005, %

| | Exports to EU | | | Imports from EU | | |
|---|---|---|---|---|---|---|
| V. Mineral products | 29.5 | 20.1 | 27.8 | 6.6 | 9.3 | 2.0 |
| VI. Products of chemical and associated industries | 14.5 | 10.7 | 7.0 | 13.3 | 13.3 | 15.1 |
| XI. Textile and textile products | 8.2 | 10.1 | 7.9 | 5.7 | 9.0 | 5.9 |
| XV. Non-precious metals and products thereof | 15.8 | 28.9 | 28.8 | 6.9 | 7.6 | 6.2 |
| incl. ferrous metals and products thereof | 8.8 | 17.6 | 25.1 | 2.9 | 4.5 | 3.5 |
| XVI. Mechanical equipment; machinery and equipment, electrical equipment and parts thereof; devices for sound and video recording and reproduction, *etc.* | 3.9 | 9.6 | 6.0 | 24.0 | 25.2 | 29.9 |
| XVII. Means of transport; transport equipment, units and accessories | 2.9 | 1.5 | 2.1 | 4.8 | 4.9 | 11.0 |

*Source:* Ministry of Economy of Ukraine.

Figure 7
Growth of FDI from the EU and some EU member-states to Ukraine, 1995–2006
(USD million)




*Source:* State Statistics Committee of Ukraine.

Since January 1, 2005, the requirements for export and import licensing for all textile and clothing supplies, including the double checking system, have been repealed, even though Ukraine had not acquired WTO membership by that date. In June 2005 Ukraine introduced changes in its customs tariff schedule to levels agreed in the agreement on textile products with the European Communities.

Exclusion of Ukraine from the list of transition economies, which took place in December 2005, was an extremely important event for development of mutual economic relations, enabling Ukrainian exporters to acquire more favourable treatment within EU anti-dumping procedures.

Further liberalization steps may be associated with adoption of an extended Partnership and Cooperation Agreement between the EU and Ukraine, to take over from the current Cooperation and Partnership Agreement in 2008. A major element could be transition to a free trade area, with talks starting after Ukraine's WTO accession.

The most important line of development of the EU–Ukrainian economic relations at present is implementation of the ENP Action Plan. For instance, a number of agreements have been signed since 2005:

* on cooperation between Ukraine and the European Investment Bank,
* on cooperation over the Global Navigation Satellite System (GNSS),
* on Ukraine's participation in the European Galileo Programme for satellite radio navigation, which is a first step to full extension to Ukraine of the European Geostationary Navigation Overlay Service,
* on civil aviation, providing free access of European air carriers to the Ukrainian air transport market and leading to joining the EU common aviation area,
* a memorandum on mutual understanding of cooperation in the energy sector, focusing on four key sectors: nuclear safety, integration of the electricity and gas markets, security of energy supplies and transit of carbohydrates, and structural reform, higher standards, safety, and environment protection in coal mining,

* on cooperation with the European Atomic Energy Community (EURATOM) on peaceful use of nuclear energy; this incorporates financial participation in the construction of a new shield at Chernobyl, and modernization of nuclear reactors at Khmelnitsky and Rivne.

There has been some progress in cooperation in science and technology, based on an agreement of July 4, 2002, focusing on issues of environment, climate, and surface; biomedical and health care research; agriculture, forestry and fishing; industrial and production technologies, materials science and metrology; non-nuclear power engineering; transport; information society technologies; social science; science and technology policy; education and exchange of research personnel. Ukraine is participating in 43 research projects under the EU's Sixth Framework Programme.[12]

With the view to facilitating the entry of Ukrainian industrial products onto the EU market, the two sides agreed in December 2005 to measures aimed at Ukraine's accession the Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA) by 2011. An action plan was adopted and the EU expressed readiness to extend technical assistance under the Tacis and the TAIEX programmes.

In trans-border cooperation, the core developments are associated with four functioning Euro-regions that include EU members or acceding countries: "The Buh" (Ukraine–Poland–Belarus), "The Carpathian" (Ukraine–Hungary–Poland–Romania–Slovak Republic), and "The Lower Danube" and "The Upper Prut" (both Ukraine–Moldova–Romania). The new approach in this field is associated with the introduction of neighbourhood programmes: "Poland–Belarus–Ukraine", "Romania–Ukraine", and "Hungary–Slovak Republic–Ukraine". Here concepts for common development of frontier territories of Ukraine, Hungary, and Romania (INTERREGIO), and between Ukraine and Hungary have been adopted.

According to the ENP Action Plan, Ukraine will develop annual implementation plans that specify terms, responsible agencies, and sources of technical assistance (if referred to certain positions of a plan). The principle directions of these implementation measures embrace:

* Liberalization measures for trade, especially in line with WTO accession procedures.
* Harmonizing the tax system with EU principles, including suspension of several tax preferences that distort competition, *i.e.* aspects of VAT[13] and excise duties,[14] and administration of taxes and customs duties; a government concept for financial control and audit; adoption by Parliament of a law on securities and stock exchange.
* Finalizing the process of joining the main international agreements for intellectual property protection, though enforcement remains below required standards.
* Modernizing the technical-regulation system and consumer protection to conform with WTO requirements and relevant European regulations, while simplifying certification procedures relating to compatibility assessment with regard to national standards.[15]

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[12] The National Information Centre for Ukraine–EU S&T Cooperation. Statistical Data on Participation of Ukrainian scientists in the EU's Sixth Framework Programme, Bulletin No. 32–3, April–May 2006.

[13] *E.g.* with tolling schemes, temporary imports, operative leasing, *etc.*

[14] Primarily on alcohol.

[15] In May 2006, Ukraine introduced 3147 national standards harmonized with international and European standards, of total of 16,765 standards valid in March 2006 (State Committee on Technical Regulation and Consumer Policy (2006). Green Book on the Policy of Adaptation of National Legislation in the Sphere of Technical Regulation and Consumer Policy to European Requirements, Kiev, p. 31). However, over 60 commodity items posing no significant risk to consumers were excluded from the list for compulsory certification.

* Strengthening competition policy and streamlining regulatory mechanisms through enhanced protection of competition; laws on quality and safety of food products; bringing state support for automobile production into conformity with WTO norms; government procurement, *etc.*

But there are negative as well as positive sides to ENP implementation: failure to adopt some legislation, *e.g.* a new version of the company act, to ensure civilized relations among Ukrainian joint-stock companies,[16] or an act on general responsibility for product safety; there have been frequent postponements in the implementation process, over adoption of new acts and amendment of current legislation, for instance, over measures to promote the adoption of ISO 9000 or ISO 14000 standards, or Hazard Analysis and Critical Control Point (HACCP).

From 2007, the EU will alter its external support instruments to bring cooperation onto a new level. This includes new instruments such as the European Neighbourhood and Partnership Instrument, technical assistance instruments AENEAS and TAIEX, and new project implementation mechanisms (Twinning).

Ukraine will concentrate its efforts on adopting key elements of the *acquis* in the sectors of environment, competition and energy, including renewable energy sources, with a view to joining the Energy Community Treaty. Progress will mean forming open electricity and gas markets in Ukraine, with growing integration with relevant EU markets. Ukraine is seeking to assert itself as a key East–West transporting agent for oil, especially through the Euro-Asian Oil Transport Corridor, of which the Odessa–Brody pipeline is an integral part. However, these plans require adequate financing, for which a form of international consortium is seen as a suitable solution. Ukraine is also engaged on the INOGATE programme to reform Ukraine's gas transportation system.

The prospects of cooperation will largely depend on the specific content of the new Partnership and Cooperation Agreement, to be negotiated from 2007.

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[16] One major reason for poor portfolio investment in Ukraine has been disputes over violation of the rights of shareholders, especially minority shareholders.

# Alternatives to Full EU Membership

*Sándor Meisel*

Not for the first time in its history, the European Union has to face pressure from some countries for accession. The EU has also had to handle several times before the problem of reorganizing relations with neighbouring countries, to fit the relationship better to the EU processes of deepening and widening.

Based on the events of the past, it can be concluded that the EU Union usually makes alternative proposals for full-fledged membership or proposals for bringing such countries into a close-to-membership position. Some of these institutional constructions have been workable, such as the European Economic Area. Another example of an alternative to membership might be the first-generation association agreements reached with four Mediterranean European countries in the 1960s and 1970s.

## The theoretical framework

The legal and institutional frames for an alternative to membership exclude the two extreme cases of fully fledged membership and of nothing being offered.

Every enlargement in the history of the European Communities and European Union has meant full membership for the acceding countries. That does not mean each new member-state could participate fully in all common policies and community mechanisms from its date of entry, for all accessions prescribed some temporary arrangements. But those arrangements never curbed the new member-state's involvement in the common institutions or in decision-making.

Starting mainly in the early 1990s, there could be seen a process of segmentation in the Community. Certain countries would not participate in certain fields of integration, not on a temporary basis, but without any final date for the opting out being set. Segmentation takes place in the intergovernmental pillars of the Union (*e.g.* the second pillar) and in the community pillar, at least some elements of it (*e.g.* the EMU, or some of the Schengen). It is important to state that opting out has been reserved exclusively for original member-states, not acceding countries, where such arrangements are disallowed by the accession criteria, and all elements of the *acquis* have to be accepted.

It is not clear whether this will remain so in the future. Theoretically it is not possible to preclude the possibility of a type of membership that does not guarantee full participation in all fields of integration, excluding new members from certain elements and mechanisms of integration indefinitely, as a sort of limited or second-class membership. There are some views on what areas such limitations on new members might apply, such as policies involving financial redistributions, *e.g.* structural funds, agricultural subsidies and budgetary issues. This might also relate to certain elements of the four freedoms. The extent of limitation of membership would be the result of a workable compromise between the original members and the new member. It would be a very delicate question to find the point where limited membership remained attractive and acceptable for the acceding country, and where the balance of limited rights and advantages of being a member could be established, if such point exists at all.

Institutionalizing limited membership of the EU has serious risks to do with further segmentation of integration, which might lead beyond second-class membership to third or fourth-class membership, *etc.* That would devalue membership itself, even for some existing member-states.

Another theoretically possible alternative to membership would keep a country within the framework of EU external relations, probably as an associated partner, but with substantially enriched content of association.

## Possible elements

Where the EU elaborated an enriched relationship without formal membership, as a substitute for the latter, there would need to be substantial advantages for such countries, to offset against their adjustment costs. This might make it "more expensive" for the EU than existing association agreements, but undoubtedly less problematic than limited membership.

The EU has a longstanding experience with association agreements with countries seeking closer relations. The main elements have been *trade concessions* coupled with financial assistance, but these would be insufficient for an enriched relationship that was to form an alternative to formal membership. In Hungary's experience, the concessions in the Europe Agreement were insufficient in some cases, as they did not cover the desired trade structure or the benefits of liberalization remained hypothetical. The EU needs to be less rigid in according trade concessions and to tailor them to the needs of individual countries concerned. The Union was always very cautious about concessions on access to agricultural markets, as the provisions of the various association agreements show. The trade provisions of an enriched and upgraded association would involve much *greater liberalization, especially in agriculture*, which is of crucial interest to the countries in question.

One element usually regarded as among the most attractive aspects of membership is participation in the *Single European Market*. This needs to be considered when devising an alternative to formal membership. Such complete market integration has proved to be a success in the European Economic Area. But it does not mean that automatic, rigid extension of single-market rules to neighbouring countries would be efficient and meaningful without the prospect of eventual accession. The provisions are a logical part of the EU offer, but need to be formulated less rigidly and differentiated according to the capacities of the countries concerned. Furthermore, situations of environmental, social and other dumping must be scrupulously avoided.

One oft-cited shortcoming of non-membership is lack of *free movement of persons and labour*. All neighbouring countries seek the ways to improve this problem, which has to be addressed somehow in enriched association, sensitive though the issue is and unrealistic though it would be to attempt a full resolution of it. But upgraded association might realistically include small, cautious improvement with precise timetables and assistance and closer cooperation accorded to border control authorities in the countries in question.

The other very sensitive question is *financing and financial assistance*. Participation in the common mechanisms is a natural and understandable privilege of a member-state. The Community financial system can be extended to non-members only with substantial limitations. Here the EU needs to clarify its priorities. It should pay attention to the administrative capacities of the beneficiary countries, and if possible simplify the transfer mechanisms. But this should not damage the EU system or efforts to combat illegal use of money and corruption.

Turning to *institutional relations* between the EU and countries with enriched association, the traditional schemes of existing bilateral association agreements again seem insufficient. Although involvement and full participation in common institutions and decision are a member-state privilege, closer institutional cooperation still needs to be elaborated, covering regular exchange of information, efficient dialogue, and consultations.

Further crucial elements of an enriched relationship would be control of the functioning of *democratic institutions, respect for human rights and the rights of minorities, and the rule of law*. This contributes to creating an area of stability in the EU neighbourhood, which is of vital interest to all the parties to the association. The EU should formulate general terms and be precise and more concrete in its expectations. Progress made by countries concerned might be rewarded by extending economic concessions and improving certain conditions of enriched association.

Enriched and upgraded cooperation with countries included in this type of non-member association should reflect the clear and *unambiguous position* of the EU and its member-states. As the experience of neighbourhood policy shows, individual actions by certain member-states, based on partial interest, would be counterproductive. Speaking with one voice and eschewing double standards are necessary elements in cooperation offered as an alternative to membership.

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# INTEGRATION PROSPECTS FOR UKRAINE: SES AND/OR „DEEP FREE TRADE" WITH THE EU?

*Zsuzsa Ludvig*

Ukraine has faced an "orientation dilemma" in recent years. What foreign and foreign-economic policy should be followed by a country located between an enlarged European Union and Russia, with close economic and political links with both? The issue will remain of key importance. According to widespread views in official circles in the EU and in Russia, Ukraine has to choose between the two partners – there is strategic incompatibility between the two directions of orientation. Yet this either/or approach cannot be accepted or followed by Ukraine, with its tight though very different ties towards both partners.

In a narrow, rather economic aspect, either/or means choosing between integration goals with the EU and participation in the Russian-initiated Single Economic Space (SES). The problem is that Ukraine has already made commitments in both directions. Negotiations on "deep free trade" between Ukraine and the EU have begun under the European Neighbourhood Policy (ENP), while Ukraine signed the agreement on creating an SES with Russia, Belarus and Kazakhstan in 2003, aimed at establishing a real integration zone within the CIS, starting from free trade and ending with economic union. However, since economic relations in both directions are highly important, it would be optimal for Ukraine to develop both integration processes in parallel, in ways that are not contradictory with each other.

## THE EITHER/OR APPROACH AND POLITICAL MOTIVATIONS

What answers do affected partners give on political level to the basic issue of integration in two directions? There have been significant changes in the official answers over the past few years, although the underlying content has not changed much, except in Russia's case.

On the EU side, a commission on "Communication on Relations with Russia" in February 2004 was sceptical about the concept of the SES, bearing in mind EU ideas on a common economic space with Russia and planned free trade with both Ukraine and Russia after their WTO accessions. However, the report failed to give specific reasons for this scepticism. One reason may have been the EU intention to develop deeper ties with Ukraine, which according to EU logic conflicts with a Ukrainian integration process with Russia. A second argument could be the way the SES concept involves CIS countries to which Brussels has yet to offer a free-trade option (Belarus and Kazakhstan). Later, EU scepticism was strengthened by worsening bilateral relations with an increasingly ambitious and forthright Russia, leading to conflicts in their shared vicinity, including Ukraine itself. Present EU positions on parallel integration remain unclear and detailed analysis of specific questions is still lacking.

The biggest change has been in the official Russian approach. In 2003, complementarity between Russian and EU plans seemed acceptable: Moscow and Brussels had agreed on the idea of a legally harmonized "common economic space" between them. The idea of SES already existed at the time: the Russians were thinking of a pan-European common economic space to include several CIS countries. Later, the process of legal harmonization with the EU came to be questioned in Moscow. Signs of an either/or approach have become increasingly apparent recently as EU-Russian relations worsen and indefinite Ukrainian-Russian links appear in the background. Russia is not officially against Ukrainian aims of European integration, including establishment of a deep free-trade zone, but in practice it tries to pressurize Ukraine by every means, including playing the "energy card". Russian behaviour can be explained by economic fears that Ukrainian reluctance over the SES initiative (due to EU scepticism and to internal political disputes) may obstruct deeper integration stages within the SES that constitute the essence of the initiative. There are also general fears in Russia that Ukraine's example may have fragmenting impacts on the CIS.

The Ukrainian approach is least definite of all, due to the divisions in the political elite and society. Official views expressed by Ukrainian leaders on the intention and depth of Ukrainian SES participation differ and fluctuate over time. On the one hand, the European choice for Ukraine remains a priority, at least in official rhetoric. On the other, a minimum of SES concept-free trade without restrictions is acceptable to most major political forces. The problem is that "free trade only" suits the interests of Ukraine, but remains unpalatable to Moscow.

## THE ECONOMIC IRRATIONALITY OF THE EITHER/OR APPROACH

There is a duality in Ukrainian foreign economic relations. The EU and CIS spaces are both crucially important, but for different reasons. Ukrainian export volumes to the other three SES partners (Russia, Belarus and Kazakhstan) represent almost as big a market as the EU 25 *(Table 11)*. Much the same applies to Ukrainian imports, though fuel imports from Russia and other CIS countries make the post-Soviet share slightly higher.

Table 11
Ukraine's major trade partners in 2005
(%)

| Exports | | Imports | |
|---|---|---|---|
| Russia | 21.9 | Russia | 35.5 |
| SES | 26.4 | SES | 40.0 |
| CIS | 31.3 | CIS | 47.1 |
| EU 25 | 26.9 | EU 25 | 32.8 |
| Turkey | 5.9 | China | 5.0 |
| USA | 2.8 | USA | 2.0 |
| China | 2.1 | China | 1.7 |

*Source:* www.ukrstat.gov.ua.

But deeper analysis of structural features indicates important differences between the market significance of the CIS and the EU spaces. Iron, steel and chemical products are almost equally important in both, owing to the special significance of these industries to the Ukrainian economy. But while total Ukrainian exports to the EU, including other important product groups, represent very low added value, the structure of Ukrainian supplies to the Russian market is more favourable, with a 30 per cent share of machinery or a 16 per cent share of agricultural and food products *(Table 12)*.

Table 12
The structure of Ukrainian exports to the EU 25 and to Russia
(%)

| Product group | To EU 25, 2005 | To Russia, 2004 |
|---|---|---|
| Live animals | 0.2 | 8.0 |
| Food products | 1.5 | 8.3 |
| Mineral products | 24.5 | 3.1 |
| Chemical products | 7.1 | 7.8 |
| Textile products | 6.1 | 0.9 |
| Iron and steel | 32.7 | 27.1 |
| Machines | 5.2 | 18.0 |
| Vehicles | 2.3 | 12.4 |
| Above mentioned together | 79.3 | 85.6 |

*Sources:* Eurostat, Gostamkom.

Furthermore, both Russia and the EU are important sources of FDI for Ukraine. Although official Ukrainian statistics show strong asymmetry towards the EU, the presence of Russian capital in the Ukrainian economy is also vitally important if all the special, hidden flows of Russian capital are considered, such as arrival through tax havens or under Ukrainian cover *(Table 13)*.

Table 13
Shares of Ukraine's major investor countries in FDI stock, July 1, 2006
(%)

| | |
|---|---|
| EU 25 | 67.2 |
| Russia | 4.9 |
| (Cyprus) | 11.1 |
| (Virgin Islands) | 4.2 |
| United States | 7.2 |
| Above mentioned together | 94.6 |

*Source:* www.ukrstat.gov.ua.

The significance of Russian capital is also underlined by structural features. For example, the Russian shares in telecommunications, non-ferrous metallurgy and oil refining exceed 50 per cent, by Russian calculations. Russian firms control four out of the six big Ukrainian oil refineries. More importantly for the future is the strong intention on the part of Russian business and political circles to expand further in the Ukrainian economy.

## THE SUPERFLUITY OF THE EITHER/OR APPROACH

Expert opinion on all three sides emphasizes the dual character of the Ukrainian economy, which makes a choice between the two main partners impossible.[17] (Naturally, opposite opinions can also be found, especially within the EU.) These professional arguments against either/or perceptions understand the key importance of the issue and see it from a practical, economic point of view, while seeking a solution acceptable to all three sides. Could the solution be a pan-European area?

In principle, the EU offers a possible compromise, since it has built up parallel dialogues with Ukraine and with Russia, with very similar content, but different institutional forms: an ENP with Ukraine, and four common spaces with Russia. The formula of "deep free trade" or "free trade plus" emerged in the spring of 2006 in the ENP/Ukraine approach. The formula for "free trade plus" with

[17] See, for example, works from Ukraine by Valery Heyets and Volodymyr Sidenko of the Institute for Economy and Forecasting of the National Academy of Sciences of Ukraine, and by Natalia Kukharskaya of Odessa, from Russia from the Centre for Integration Problems of the Institute of Economics of the Russian Academy of Sciences, and from the Vienna Institute for International Economic Studies, as well as the important study "The Prospects of Deep Free Trade between the European Union and Ukraine," coordinated by the Centre for European Policy Studies, Brussels.

Russia also appeared during preparation for a new "strategic agreement" between Russia and the EU, to be concluded for the period after expiry of the recent Partnership and Cooperation Agreement.

The concepts of ENP-Ukraine and the common spaces between the EU and Russia have several features in common:

* Free trade ("free trade plus"), following WTO membership with a legal harmonization process.
* The idea of "four freedoms".
* Specific economic sides to energy dialogue (including ideas of linking power systems and perhaps gas and oil markets, joining the EU Galileo system, *etc.*)
* Intensive political dialogue (with cooperation on justice and home affairs, and in foreign policy issues).

Since the birth of the basic idea in a CEPS study entitled "The Prospects of Deep Free Trade between the European Union and Ukraine" in the spring of 2006, the features of "free trade plus" have been elaborated further by studying sectoral impacts. For Russia, the concept still needs developing and applying.

## Potential clashes between EU ideas and the Russian (SES) concept

In principle, the Russian initiative for a deep integration form within the CIS space, with Russia, Belarus, Kazakhstan and Ukraine taking part, does not necessarily clash with the idea of free trade between Ukraine (and Russia) and the EU, as its aims are very similar: the "four freedoms", including free trade, accompanied by a harmonization process. However, major questions emerge. How will the harmonization in the SES take place – in a way complementary to EU ideas or in a competitive way? Will the two processes match or clash? Will the SES be another paper institution in the CIS space, or a living one based on strict common rules? Though Russian intentions incline towards the latter, existing experiments on CIS frameworks suggest the opposite.

There are also important consequences for the SES in the specific conditions of the future WTO accessions of Ukraine and Russia. Common positions agreed by Russia and Ukraine might pave the way for the SES, but in practice, positions that were negotiated separately have narrowed the scope for deeper integration within the SES or call for its postponement. (For example, the creation of a customs union between the two countries is hampered by different customs tariffs with third countries negotiated during the WTO accession processes.)

## Conclusions

Theoretically, the EU ideas for creating "free trade plus" with Russia and with Ukraine could be applied alongside the SES concept, but there are several risks in the implementation on all sides, mainly of political character. There are serious uncertainties in Ukraine's political direction, due to constant struggles between rival political forces. The Russian approach to the EU also raises serious questions. The content of the negotiations on the new strategic agreement with the EU is still unclear. Will Russia be ready to compromise or present a very self-respecting face? What kind of Russia will there be after Putin? Finally, the EU side is not unified either. In fact, it is very divided, with no "one voice" on the Russian or Ukrainian issue, least of all on the EU–Russia–Ukraine triangle.

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