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Now So Near, and Yet Still So Far: Economic Relations between Ukraine and the European Union

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- Kiev is not so far away from Brussels as one might expect. Ukraine already performs quite well when compared to the other countries in the queue for entry into the EU. Especially the fiscal and external debt figures are better than in other countries. On the negative side, there is a considerable backlog with respect to the development of administrative and judicial institutional capacities, and a potential for macroeconomic instability due to monetary expansion, rising inflation rates, and real exchange rate instability.
- From a macro perspective, the most pressing issue is to end inflationary pressures resulting from targeting the exchange rate to a weakening dollar. Among the alternative frameworks available to Ukraine, the current exchange rate anchor can be made more flexible by targeting a basket made of the US dollar and the euro. Such an exchange rate anchor framework provides a clear indication to the public about monetary policy, disciplines fiscal policy, and is relatively easy to manage. Additionally, a clearer link to the euro may be useful for a greater integration into the EU.
- From a micro perspective, the most pressing issues which can be targeted in the short run are taxation and competition policy. The tax system is unstable, complex, and inconsistent. A reduction of tax exemptions could broaden the tax base and allow for lower nominal tax rates. Privatization has been rather limited in the non-traded goods sectors. Additionally, the completion of privatization needs to be coupled with a more robust and consistent regulatory framework in order to attract more FDI, as was the case in the new member states of the EU.
- Sandwiched between the EU and Russia, Ukraine is likely to derive substantial gains from EU integration. Excluding the energy sector reveals that Ukrainian trade with the EU already outperforms its trade with Russia. In addition, EU integration is likely to attract more inflows of foreign capital if the new government is able to provide a more attractive macroeconomic and institutional environment.
- Ukraine should press for fast reforms and use the "honeymoon" period of the new government to open negotiations for EU membership by submitting a formal application. This will, among other things, help to prevent vested interest groups from blocking the reform process. A pragmatic approach for an integration strategy would include four elements: identifying reform priorities; harmonizing Ukraine's legislation with EU law; undertaking steps to get a market economy status from the EU; and, finally, signing a free trade agreement with the EU.
- The EU, on its side, should actively support the continuation of the reform process in the country, especially with respect to institution building. Finally, one must stress that the EU itself will gain from this enlargement, as it has gained from all the previous ones. In our view both sides are now facing a historic opportunity that should not be missed, neither by Kiev nor by Brussels.

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