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EU–UKRAINE RELATIONS IN THE CONTEXT OF A POSSIBLE FREE TRADE AGREEMENT

The article deals with the aspects of EU–Ukraine economic relations in the context of pending negotiations with regard to the creation of a free trade area. It outlines possible benefits and losses (risks) for the Ukrainian economy arising out of complete trade liberalisation, and seeks for instruments to make this process smooth and mutually beneficial.

The oncoming expiration of the initial stage of Ukraine's co-operation with the EU within the framework of Partnership and Co-operation Agreement between the European Communities and their Member States and Ukraine (PCA) poses an important question about the format of future relations between them. The formal beginning of negotiations about conclusion of an Enhanced Agreement has many potentially conflicting positions, both in theoretical and practical political aspects.

The aim of this article is to analyse the problem of setting up of a Free Trade Area (FTA) embracing the EU and Ukraine, with special emphasis on the necessary prerequisites for it, its possible characteristics and outcomes (both positive and negative), and viable instruments to optimise this process.

THE POLITICAL ORIGINS OF THE ISSUE

The free trade area perspective on EU–Ukraine economic relations was first mentioned as far as in June 1994 when the *PCA* was signed (entered into force in March 1998). In its Article 4, the Parties agreed that they would consult each other

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whether circumstances, and in particular Ukraine's advances in market oriented economic reforms and the economic conditions, “allow the beginning of negotiations on the establishment of a free trade area”. Nevertheless, at that time it was mere a sign of diplomacy in regard of Ukraine, the country which was then very far from completing a transition to a market economy and acquiring WTO membership, and when the EU was entirely absorbed in its enlargement process embracing the countries of Central and Eastern Europe.

The situation changed considerably by 2003–2004, when the EU adopted its new European Neighbourhood Policy (ENP), and Ukraine, in its turn, have advanced on its way to a market economy and WTO membership. The *Wider Europe – Neighbourhood Initiative* of the European Commission (2003) envisaged a development of objectives and benchmarks with this regard in relation to Western NIS countries. Moreover, it was an integral part of a broader concept of “four freedoms” – free movement of persons, goods, services and capital – a formula outlined as a longer-term prospect for European neighbours. This document was further developed by a more comprehensive strategy papers: European Commissions’ *ENP Strategy Paper* and *On Strengthening the ENP* (European Commission 2006), which served as a general foundation for bilateral relations with neighbour countries.

As BENITA FERRERO-WALDNER (2007), European Commissioner for External Relations and European Neighbourhood Policy, stressed, the newest vision of the EU *“is of an economically integrated area which spans the whole of the EU and its closest European and Mediterranean partners. An area where goods, services and capital flow freely...”*; it would mean *“the conclusion of deep and comprehensive free trade agreements. These should go beyond the level of tariffs and tackle "beyond the border" issues – as well as services and investment”*.

This new approach was embodied in the framework of bilateral Action Plans which the EU adopted with the relevant governments of its neighbour-states, including Ukraine (as of February 2005). It provided (p.1) for building “solid foundations for further economic integration, including through joint efforts towards an EU–Ukraine Free Trade Area following Ukraine’s accession to the WTO, on the basis of the adoption and implementation of economic and trade-related rules and regulations with the potential to enhance trade, investment and growth”. This objective was placed under No. 27 into the list of 71 measures included in the Action Plan. It sets (p. 10–11) the initial task: “in the light of advances in economic reform and implementation of PCA commitments, consider jointly the feasibility the establishment of a Free Trade Area following Ukraine’ s accession to the WTO”, which would incorporate the following two lines:

- Undertake review of the 1999 joint economic feasibility study on the establishment of a free trade agreement between the EU and Ukraine; and a review of progress on implementation of measures (July 2002).
- On completion of this review, hold consultations to agree next steps for both sides towards the above mentioned objective and to set out the priorities for the deepening of EU-Ukraine trade and economic relations.

In an Outline of the Policy Agenda of Ukraine contained in the document titled *“European Neighbourhood and Partnership Instrument. Ukraine. Country Strategy Paper 2007–2013”*, the EU authorities admitted (p. 5), in the realm of external policy for trade promotion, that the Ukrainian government envisages, once the WTO accession process is completed, *“an early start to negotiations on a Free Trade*

Area (FTA) as part of an Enhanced Agreement with the EU". This position finds (p. 28) full support in the EU. From the EU stand (p. 14), it would mean a set of assistance measures offered to support the process of market and regulatory reform, bearing in mind the challenges Ukraine will face with a view to the EU-Ukraine FTA. This would cover *"a broad range of areas including customs legislation and procedures, technical regulations, standards and conformity assessment, sanitary and phytosanitary issues (SPS), establishment and company law, financial services and markets, taxation, competition and consumer protection policy, development of the legislative and administrative framework for SMEs, intellectual and industrial property rights, public procurement and statistics"*.

Another ENPI document on *National Indicative Programme 2007-2010*, in its Priority Area 2: Support for Regulatory Reform and Administrative Capacity Building (p. 9), put emphasis on the process of gradual alignment of Ukraine with the EU's internal market rules, which would require *"major efforts on approximation of Ukrainian legislation, norms and standards with those of the EU, also bearing in mind the challenges Ukraine will face with a view to the EU–Ukraine Free-Trade Area envisaged once the WTO accession process has been completed"*. This support will be rendered basing on the compiled experience of accession of the new Member States, incorporating not only the measures of technical advice on approximation of legislation and alignment of procedures (technical regulations, conformity assessment procedures and standards) but also on administrative capacity building to ensure national ownership and effective enforcement of approximated rules and regulations. Community programmes, agencies and networks will be open to Ukraine, in order to contribute to this process.

Following the above mentioned guidelines, the European Commission and the Ukrainian government have already commenced the process of consultations regarding the issue of possible FTA. This preparatory stage, which is not yet a genuine negotiation process (the latter is viable only after Ukraine's accession to the WTO), also included preparation of a feasibility study on this issue.

ANALYTICAL BACKGROUND OF THE ISSUE

The initial comprehensive analysis of the problem of a FTA between the EU and Ukraine was performed as early as in 1999 by P. BRENTON and J. WHALLEY (1999). Building upon the methodology of numerical general equilibrium trade models, they made a conclusion that FTA might increase industrial imports from the EU to Ukraine by approximately 10 percent, and the relevant Ukrainian exports to the EU by 15 percent. The most evident would be the impact in the more protected areas, such as nonorganic and organic chemical goods and fertilizers, other chemical goods, plastics, clothes, and motorcars. But the most significant impact FTA could make in agricultural sector, because both in Ukraine and the EU the level of protection here reaches the highest peaks. Thus, agricultural imports of Ukraine might rise by 60 percent, while its exports by nearly 50 percent. The authors found that exclusion of agricultural sector from the FTA would significantly decrease its benefits. In general, the authors drew a conclusion that these trade reforms could have a major impact on the structure of Ukrainian trade but a limited effect on the country's welfare that might be risen, within a long-term period, by no more than 10 percent. And the effect on the EU's economy would be completely negligible because of serious deficiencies of the Ukrainian economy and its minor current economic potential.

BRENTON (1999), summarizing the research results, came to an inference that mere removing of customs tariffs would exert only an insignificant impact on Ukraine's economy, not to say about the influence on the EU's economy.

However, these initial estimates of a possible EU–Ukraine's FTA are no longer applicable because of substantial changes not only in the regulatory regime of Ukraine, according to its adjustment to the WTO rules and PCA commitments (including, *inter alia*, the conclusion in 2005 of an agreement on liberalization of trade in textiles), but also owing to the EU enlargement process which brought in new factors to be accounted for.

In response to the above mentioned clauses of the bilateral Action Plan regarding a FTA, a new general research of its prerequisites and possible outcomes was performed by the Centre for European Policy Studies, Brussels (M. EMERSON et al. 2006), which was acting in co-operation with the Institut für Weltwirtschaft (IFW), Kiel and the International Centre for Policy Studies (ICPS) in Kyiv. The report on this research published in April 2006 under the title "The Prospect of Deep Free Trade between the European Union and Ukraine" contained the following major findings related to different alternative options for FTA (EMERSON et al. (2006, p. 3–11, 125–130)):

- **Option 1** – *simple free trade, or minimalist FTA,* for example following the templates of an early agreement of the EEC with the European Free Trade Area (EFTA) or the Euro-Mediterranean agreements, could add to the general WTO conditions zero tariffs for trade in goods attained through a short-term or medium-term period, further liberalisation of services (perhaps with only limited liberalisation in some sectors), and ensure freedom for capital movement accompanied by some visa-facilitation measures by the EU to complement the visa-free regime already introduced by Ukraine; it is the simplest option for implementation, but its effect is assessed as not big, and the cost-benefit ratio is not sufficiently profitable: there could be even some negative outcomes, if liberalization is not accompanied by complementary measures to improve the business climate.
- **Option 2** – *customs union* (an example of which is the model of relations between the EU and Turkey) is to be rejected because of its serious disadvantages both in the aspects of implementation capacity and cost-benefit ratio.
- **Option 3** – *deep free trade* (in its extreme, for instance, after the model of the EU-Swiss relations) is treated as sophisticated and posing higher demands on implementation capacity, though providing prospects for substantial economic benefits of strategic value. This option would provide for a rather complex set of measures, already included in the EU-Ukraine's bilateral Action Plan.
- **Option 4** – *full integration into the European Market* (for instance, according to the model of the European Economic Area – EEA), looks not viable, at least in a middle-term perspective.

The above mentioned four options are complemented by a range of intermediate sub-options that include *deepened free trade in goods, deepened free trade in services, deepened investment in infrastructures, deepened reforms of corporate and public economic governance*.

The authors of the above mentioned study chose option 3, as the most advantageous one among the four, both by its contents and potential interest for Ukraine.

The proposed option of the *deep free trade package (FTA+)* could mean drawing on the following (EMERSON et al. 2006, p. 3–4):

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

According to the mentioned study by EMERSON et al (2006, p. 5–6), using an updated and extended version of a computable general equilibrium (CGE) model, the expected gains would be much larger in case of a deeper free trade (see *Table 1*).

THE FTA MAIN DILEMMA: ECONOMIC EFFECT MAXIMIZATION VS. FEASIBILITY

As we see, by its contents, this FTA+ option would incorporate multiple objectives which have already been fixed in the ENP bilateral Action Plan. So, in the view of the author of this article it is reasonable to consider that the effects of a proposed deep FTA would arise from integration of free trade mechanisms in a broader context of ENP co-operation, which would create a new Enhanced Agreement between the EU and Ukraine on a much broader agenda.

However, this formula leaves many questions unresolved. From a pure theoretical point of view, such an approach would mean a complete departure from the classic definition of the stages of economic integration, according to which the integration process is to pass distinctive upgrading paths from a FTA through a customs union and, further, common market to an economic and monetary union, culminating in political integration.

The FTA+ formula in the sense outlined before does not fit into this scheme, because it contains simultaneously the elements of the initial stage of integration with substantial elements of common market (free movement of capital) and even partly economic union (adoption of a significant part of the *acquis*). And this rises a difficult question: whether such an approach could be practically implemented?

It is true that the development of the EEC did not follow precisely the logic of the mentioned scheme of stages; i.e. it allowed parallel development of free trade, customs union, and some sectoral elements of common economic policy, especially CAP, coal and steel (European Coal and Steel Community), and atomic energy (Euratom). However, though these sectoral integration trends went at once rather deep, they rested on rather specific proximity of basic economic interests of the parties concerned and did not expand *instantly* on the economy as a whole (this happened only following the adoption of the Maastricht Treaty in the 1990s).

Table 1
Summary of economic effects of a deep FTA on the Ukrainian economy in a model by Emerson et al.

		Short-term		Long-term	
		"A"	"B"	"A"	"B"
Welfare gains according to comparative static simulations	Deeper free trade	6.50	9.86	4.50	6.67
	Simple free trade	1.91	0.00	2.99	-0.06

	Deeper free trade
Welfare gains taking into account dynamic effects	2–3 times as large
Welfare gains due to reductions in the cost of capital	Reduction by 16.7–17.1 percent resulting in extra 4.5–4.8 percent of welfare
Impact of improved institutional quality	GDP increase in the range of 20 to 30%
Full opening the financial and other key service sectors, such as telecommunications	Increase in the annual growth rate by 1.5%
Distribution of population income	More equal due to enhanced competition that will cut down monopoly profits (assumed at 35 per cent of GDP)

„A" = Compared with EU-15 base
„B" = Compared with accession of CEECs and SEECs+Turkey
Source: Author's summary of results published by Emerson et al. (pp. 5–6, 199–226).

Table 1 (continued)

Summary of economic effects of a deep FTA on the Ukrainian economy in a model by Emerson et al.

		Deeper free trade				Simple free trade			
		Short-term		Long-term		Short-term		Long-term	
		“A”	“B”	“A”	“B”	“A”	“B”	“A”	“B”
Rise of output in	Food processing	22.18	8.06	55.23	15.81	13.07	11.90	34.03	30.47
	Textiles	20.28	9.42	34.24	9.68	9.92		22.39	
	Metals	3.92		93.13	25.31	6.38	11.34	54.12	87.45
	Light manufacturing	12.52	5.92	38.29	20.64	6.23	11.65	14.63	29.01
	Heavy manufacturing	10.27	7.50	28.95	13.18	2.58	3.96	13.93	10.02
	Minerals						1.29		1.37
	Services	7.51	0.65	17.07	6.12	6.81	1.23	10.33	1.79
Fall of out-put in	Agriculture	-5.91	-3.66	-22.58	-15.29	-2.34	-1.58	-8.61	-4.38
	Minerals	-29.90	-28.35	-47.55	-43.11	-2.17		-7.31	
	Metals		-2.31						
Ukrainian exports to the EU		38.63	15.76	158.58	57.99	19.75	63.67	19.78	85.39
Ukrainian imports from the EU		19.27	18.26	50.97	53.57	0.86	-1.69	5.91	11.35

„A” = Compared with EU-15 base

„B” = Compared with accession of CEECs and SEECs+Turkey

Source: Author’s summary of results published by Emerson et al. (pp. 5–6, 199–226).

It is clear that Ukraine, objectively, currently shares no such a common ground with the EU. It has plenty of differences with the latter not only in terms of the level of economic development and maturity of market institutions, but also in cultural foundation, political tradition, and geopolitical stand.

The capacity of the country for further rapid pro-European institutional changes looks questionable: many economic and political institutional solutions "imported" from Europe within the process of approximation of legislation have only a *quasi-European shell* which is filled with *non-European contents*. The signs of this we see in Ukraine everywhere – in business, political activities, government regulation, and judicial practices.

We are also to take into account the fact that the ENP's guiding formula "sharing all but institutions" (which was once offered by ROMANO PRODI, the former President of the European Commission) conflicts with the basic Europe-building principle through which the EEC and later the EU actually developed: creating common institutions as a locomotive of integration. With this regard it is hard, for instance, to disagree with K. WOLCZUK (2004, p. 20) in her statement that *"it is unlikely that the pursuit of the free trade area in the short term, and inclusion in the EU's single market in the long-term, could sway the Ukrainian elite and society and thereby overcome domestic obstacles to reforms..."*, and that the balance of costs and benefits for Ukraine here would be not too attractive, not only because of *"entrenched business interest and the lack of legislative and administrative capacity to enact the acquis"*, but also *"because of the sheer costs involved"*.

It is extremely important to emphasize that it has been a *common*, fault of all studies based on CGE models, not only in the above cited case, that they treat trade liberalization effects too simplistically, seriously underestimating, if not ignoring, huge *implementation costs* arising from trade and associated reforms: the fault that was profoundly criticized by J. STIGLITS and E. CHARLTON (2005). There are no reasons why this criticism could not be applied in case of Ukraine's trade liberalisation.

The concept of deep FTA, like the ENP paradigm in general, requires from Ukraine enormous restructuring, with tremendous public and private spending for this purpose. But what for? Simply to comply with European regulations, which are not in all cases suitable for, essentially, a developing country, without any chance to influence the process of the European law-making? It looks questionable, from the country's strategic point of view.

In fact, Ukraine's current positioning on the world competitiveness map poses some doubts in respect of desirability for the country of a rapid opening of the markets of goods and services. That is why many Ukrainian economic experts have certain reservations as to the effective readiness of Ukraine to enter a FTA with the EU in the near future, especially if such regime would imply free capital movement. The latter, as is well known, is a usual requirement for economically advanced countries, which are OECD members, and has no direct relevance to a free *trade* regime. Ukraine is certain to face some difficult problems in the context of its full adaptation to the WTO norms, after it has acceded the organization. It is highly questionable, whether adding a new burden (associated with a FTA) to these problems would really benefit the country.

In any case, the guiding logic of the study by M. EMERSON et al. (2006) directed at finding a compromise between implementation capacity and cost-benefit ratio appears to be misleading. In fact, there is a high risk that *better cost-benefit ratio* *simply could not be reached because of excessive agenda of institutional changes*. The existence of such a risk is clearly proved by the problematic implementation by Ukraine of the ambitious (though less ambitious than the above outlined FTA+ formula) bilateral Action Plan under ENP (see European Commission 2006a). Moreover, these risks are evident from the analysis of the study performed by EMERSON et al. (2006, p. 6–7, 13, 18–20, 127).

Not unimportant also is a possible politico-economic opposition to a FTA on the part of certain sectoral lobbies, both in Ukraine and the EU, which might lose from it. Thus, according to LEFEBVRE (2006, p.18), some major concerns of France relate to Ukrainian agricultural and metallurgic exports, and when it came to define a *"deep and comprehensive free trade area" with this country, France "expressed real concerns and obtained some pledges from the European Commission that the Community's trade interests would be duly defended"*. O. SHUMYLO (2006, p.18–22) specifies this problem in a broader context: she registers opposition to Ukraine-EU's FTA on the part of large producers of agricultural goods from France, Spain and Italy and the European producers of ferrous metals and chemicals (Germany and France). In Ukraine, resistance may come out of the most powerful lobbying groups: ferrous metallurgy, iron and steel (the problem of export duty on Ukrainian scrap metal), agriculture (producers of sunflower seeds in favour of export duty), car manufacturing (protection policy and state support schemes).

POSSIBLE FTA IMPACTS FOR UKRAINE: WHAT IS BENEFICIAL AND WHAT IS RISKY?

Another difficult question: how would free trade influence the *structure of Ukraine's competitive advantage*? To answer this question, we are, first of all, to cast a glance at the existing overall tariff profiles of both Ukraine and the EU (*Table 2* and *Figure 1*).

Table 2

A comparison of the 2006 tariff profiles of Ukraine and the European Communities: an overall assessment for most favoured nation (MFN) applied tariff rates

	European Union	Ukraine
Simple average	5.4	6.8
Duty free (%)	29.0	31.7
Non-ad valorem duties (%)	4.6	3.9
Duties > 15 % (%)	4.5	6.4
Duties >3·AVG* (%)	4.1	3.2
Maximum duty	229	581
Coefficient of variation**	179	267

* *Share of ad valorem duties or their equivalents greater than three times the national average.*

** *Standard deviation of tariff line duty rates divided by the simple tariff line level average of all duty rates. Includes only ad valorem duties or their equivalents.*

Source: Author's compilation based on WTO and ITC UNCTAD/WTO (2007, p. 2–7).

Table 2 indicates that current levels of MFN simple average tariffs, shares of duty free lines, and percentages of non-*ad valorem* duties are rather close in both cases. But the coefficient of variation is significantly higher for Ukraine, as well as the rates of maximum duties and the share of the so called *tariff peaks* (that is duties above 15 per cent).

The frequency distribution of import duties (*Figure 1*) shows that in Ukraine and the EC it differs to some extent: for agricultural products, the EC has significantly higher shares of tariffs in duty free and, to a lesser extent, in 10<=15 intervals (which is not too high for agricultural products); and Ukraine is much ahead in 0<=5 and 15<=25 bands (the latter represents a vivid example of selective protection). For non-agricultural products, Ukraine has relatively more positions within duty free and 10<=15 intervals (selective protection not only in the second instance, but in the first as well, because it refers primarily to production inputs, thus raising the rate of *effective* protection). And the EC is well ahead only in the rather moderate 5<=10 interval.

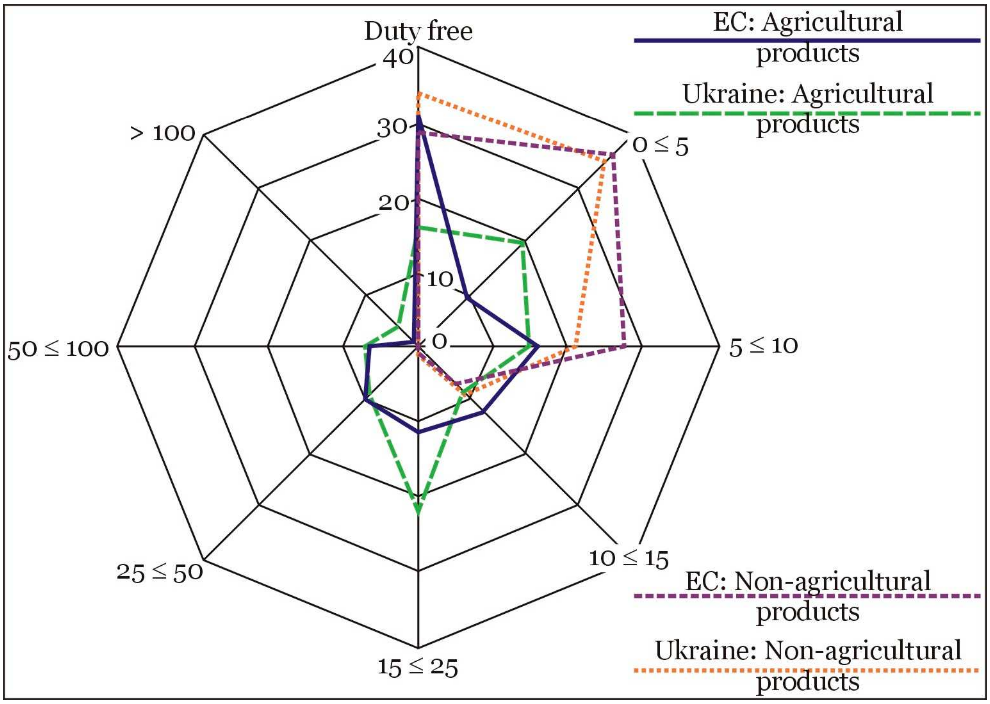

Figure 1
Frequency distribution of the 2006 import duties in Ukraine and the European Communities (MFN applied tariff rates)[1]

[1] Source: Author's compilation based on WTO and ITC UNCTAD/WTO (2007, pp. 78, 168).

Thus, summing up the above mentioned data, we can conclude that they testify to a *more pronounced presence in Ukraine of selective protection* of certain products and production branches.

Ukraine is certain to cover a longer and more difficult path to a free trade area. Though trade liberalisation, according to standard trade theory predictions, is to deliver certain welfare gains to the country and increase its trade turnover, there remains a problematic issue of how dismantling of selective protection would impact the sectors currently using it. It is clear that without restructuring of the state aid to priority sectors in favour of alternative modes (not connected with specific sector subsidies) these sectors will face in the home market more stringent competitive environment and suffer certain losses, including the loss of perspective for high-tech development in selected areas[1].

To get a more detailed picture of the problem, we are to look at the sectoral tariff profiles (*Table 3*). At that, it must be kept in mind that the EU's and Ukraine's export structures are entirely different: according to the Ministry of Economy of Ukraine (2007), in Ukrainian export to the EU the bulk consists of ferrous metals and products thereof (28.3 per cent), energy materials, oil and products of oil refining (13.4), ores (5.4), textile clothes (4.8), electrical machinery and equipment (4.4), fats and oils (4.3), making in total over 60 per cent. And in agriculture, the dominating items are oilseeds and grain (in favourable market years). For the majority of these products, the EC average import duties are currently low (not exceeding 5.9 per cent) or very low (1.9–2.7 per cent). And for Ukrainian grain import duties are set, according to the EU's database on customs tariffs (TARIC), at a zero level, though tariff quotas are to be observed. So the only current tariff problem now are import duties for textile clothes, where conventional import duties are set for Ukraine at 12.0 per cent, and for items within tariff preferences at 9.6 per cent (TARIC data).

At the same time, certain lines of perspective interest to Ukrainian producers (marked in the *Table 3* with italic) encounter no significant tariff barriers. Thus, for machinery and other manufactures they do not exceed 4.1 per cent, and for chemicals 4.6 per cent, that is the figures which cannot substantially impact market competitiveness, unless non-price factors affect market position. The only substantial tariff problem is again registered in the EU's agricultural sector.

As far as the EU's export is concerned, we see that a large portion of it (over 40 per cent) refers to various machinery and equipment, followed by chemicals, including polymer materials, plastics and pharmaceuticals, with paper and related products also representing a conspicuous export line. But in all these cases, perhaps excluding transport equipment (7.9 per cent), the average tariff rates are already rather moderate. Nevertheless, the above mentioned selected protection policy reveals itself in the existence of high maximum rates (25 per cent) in the sectors of entire machinery and other manufactures, and for chemicals they are reaching the boundary level of a tariff peak (15 per cent).

[1] Here, the author relies not on the neoclassical orthodoxy which, within certain limits, admits the so-called infant industry protection argument, but departs from the provisions of the so called new trade theory developed by P. Krugman (1986) with regard to strategic trade policy.

Table 3
A comparison of the 2006 tariff profiles of Ukraine and the European Communities: a sectoral assessment for MFN applied tariff rates[1]

Product Groups	Average		Duty free (%)		Maximum	
	EC	Ukraine	EC	Ukraine	EC	Ukraine
Animal products	25.4	36.7	23.2	6.3	219	277
Diary products	53.8	36.0	0	0	229	85
Fruit, vegetable, plants	11.8	21.4	21.4	12.9	195	162
Coffee, tea	6.5	7.3	27.1	31.9	43	20
Cereals & preparations	25.6	16.8	5.8	4.1	139	55
Oilseeds, fats & oils	5.9	13.8	46.8	16.6	87	142
Sugars and confectionery	32.9	58.7	0	0.6	134	142
Beverages & tobacco	20.2	72.4	19.8	0	192	581
Cotton	0.0	2.4	100.0	20.0	0	5
Other agricultural products	5.3	6.8	64.8	36.6	125	114
Fish & fish products	10.3	3.3	15.9	58.7	26	10
Minerals & metals	1.9	3.6	50.7	42.7	12	20
Petroleum	2.7	0.6	31.1	78.3	5	6
Chemicals	4.6	3.3	20.2	34.1	17	15
Wood, paper, etc.	1.1	2.9	80.3	52.2	10	20
Textiles	6.6	3.7	3.1	36.8	12	15
Clothing	11.5	11.4	0	1.0	12	12
Leather, footwear. etc.	4.2	6.9	25.7	23.8	17	103
Non-electrical machinery	1.7	3.1	28.1	32.8	10	25
Electrical machinery	2.5	4.9	31.2	26.2	14	25
Transport equipment	4.1	7.9	17.0	33.2	22	25
Manufactures, n. e. s.	2.4	6.3	26.9	23.4	14	25

This picture gives us an idea what could happen in case of a FTA: it would not significantly improve overall market competitiveness of EU producers in the Ukrainian market; this would happen selectively in those areas which the Ukrainian government would prefer to develop domestically. Is this the right way to raise their competitiveness? If it were a gradual process of trade liberalization, the answer might be almost definitely yes. But one could hardly imagine what would happen to those producers who currently enjoy a 25 per cent protection and lose it almost instantly with a rapid introduction of a FTA.

[1] Source: Author's compilation based on WTO and ITC UNCTAD/WTO (2007, pp. 78, 168).

Thus, the problem of cost-benefit ratio looks more intricate than under a simplified neoclassical orthodox approach. Essentially, it calls us to review a possibility of a *differentiated approach to a free trade regime formation*.

WHAT COULD MAKE A VIABLE AGENDA FOR A FTA?

It is clear that in order to be viable, the policy of setting up of a free trade area is to be governed by a set of principles that are not confined solely to imaginable welfare effects or trade surpluses. Within this context, prime importance, in the author's view, is to be given to the following.

First. However useful the CGE predictions on a EU-Ukraine's FTA might seem, we are not to overestimate their accuracy and forecasting capacity. That is why we are not to let themselves be trapped in a labyrinth of mathematical formalization, which, as it often happens, rests on oversimplified initial premises, ignores complex and often uncertain interaction between economic and non-economic factors, and underestimates institutional backgrounds for desired policy options.

For any FTA-forming strategy to be successful, it is highly important that this institutional capacity factor be made focal. With this in mind, one could imagine that in the formula "FTA+" this *plus is more important than FTA itself*. That is why any deep FTA must result from success in general ENP implementation, not solely from WTO accession, as has been asserted.

For example, we are to understand that no FTA would make easier access to the Single Market for Ukrainian goods and services in high technology or in food sectors, unless Ukrainian standards and technical requirements, as well as conformity assessment procedures, comply with the relevant European ones.

Second. Because of the highly variable structure of import tariff systems of both the EU and Ukraine, and their somewhat diverging views on what should be Ukraine's priorities and technological mode of development[1], any "*lump*" (or "all at once") approach to FTA formation does not appear feasible. The idea needs a profound sectoral analysis, with an elaboration of a *differentiated approach* depending on peculiar balance of interests in each case. This would imply that while some sectors could follow a deep FTA model decisively, others might choose a more moderate option; while in some sectors the necessary steps could be taken within a medium (five-year) term, others might require a more prolonged period.

It must be reminded that both globally (within the GATT and later the WTO) and regionally (the EU and a variety of regional trade blocs) the process of trade liberalisation has usually shown an uneven sectoral character, with some sectors going far ahead (like in the case of the so called sectoral initiatives within the WTO), and

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[1] Not only the European Union's authorities but many leading scholars in the EU tend to view strategically the Ukrainian economy as a supplement to the more advanced European core, with its comparative advantage located primarily in relatively cheap natural and human resources, with accompanying lack of capital and modern technologies. Such an attitude is implicitly present in the cited Emerson et al. (2006, p. 6) who propose "Ukraine's inclusion in the European supply chain" in order to "offer some EU industries, ranging from high-tech electronics to low-tech textiles, an opportunity to improve their competitiveness vis-à-vis the fast-growing Asian competitors by outsourcing labour- or resource-intensive parts of their production process". However, such a prospect is not completely favoured by those in Ukraine who see their country as following an endogenous model of technological development.

others being temporarily excluded from full-scale liberalisation (with agriculture being the most vivid example of it, both in the WTO and in the EU).

Third. Taking into account that the economies of the EU and Ukraine are currently very different in terms of their international competitiveness, certain sort of *asymmetry* in FTA formation is also required; that is the *EU might take the lead in liberalization*. Such approach might create in Ukraine the necessary impression that the country is taken seriously by their EU partners, contrary to the way it is happening currently under the ENP where an asymmetry in commitments exists in favour of the EU.

The above mentioned asymmetry in trade liberalisation existed earlier in the European Agreements concluded with then EU candidate countries, it is now existing in the form of the General System of Preferences (GSP) of the EU towards developing countries, and, principally, there is no reason why this approach could not be reproduced in case of a FTA with Ukraine.

Of course, any approach to a FTA based on these principles might well turn to be somewhat cumbersome, compared to a “lump” approach. But practical decisions reached on the former platform would inevitably be more enduring, with a positive spillover effect in the future.

The main problem is implied not in how to construct a scholastic scheme for a free trade arrangement but in how to make this scheme *owned* by major societal groups, make it fully operational. And this is possible not on the way of continuous market pressure solely but through creating better *opportunities* to progress in the right direction.

CONCLUSIONS

The issue of setting up a free trade area between the EU and Ukraine is an integral part of the European concept of “four freedoms” (free movement of persons, goods, services and capital) pursued by the EU as a long-term approach to its neighbouring countries. Nevertheless, it is currently more politically motivated than an economically substantiated matter.

The analytical studies of this issue performed so far do not provide compelling evidence of a significant positive impact of this arrangement on Ukraine’s economy, while its effects for the EU appear to be minor. Among different options for setting up a free trade area, the EU’s party evidently prefers, in terms of welfare gains and cost-benefit ratio, a deep free trade (or FTA+) option that would incorporate in a FTA a set of already existing (and maybe expanded) commitments under the ENP Action Plans. However, this formula leaves many questions relating to its feasibility unresolved.

The FTA+ formula does not fit into the widely acknowledged theoretical scheme of the stages of integration, because it merges the elements of the initial stage of integration (FTA) with its more advanced stages (common market and, partly, economic union, with regard of an adoption of a significant part of the *acquis*). It ignores the objectively existing substantial differences of the Parties in terms of the level of economic development, the maturity of market institutions, cultural foundation, political tradition, and geopolitical stand, as well as the capacity of Ukraine to perform rapid pro-European institutional changes because of the huge implementation costs arising out of internal restructuring. And the idea of augmenting the difficulties of adaptation to WTO norms by adjustment problems in the context of a FTA with a much more competitive partner bears an excessive risk.

Under the given circumstances and with a view to currently existing Ukrainian model of selective protection, a rapid setting up of a free trade area would place Ukrainian producers in a much more stringent competitive environment fraught with losses of capital and prospects for high-tech development in selected areas.

A viable agenda for a FTA might comprise the following principles: the primacy of the institutional capacity factor; the refusal from a "*lump*" ("all at once") approach to FTA formation in favour of a differentiated (in terms of rapid vs. gradual or deep vs. shallow FTA) approach depending on peculiar balance of interests in each sector of Ukraine's economy; asymmetrical approach to a FTA formation in favour of Ukraine, with the EU taking the lead in liberalization.

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