European Parliament

IN-DEPTH ANALYSIS

Ukraine's will to liberalise: Tested on many fronts

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ABSTRACT

Faced with a deteriorating economy, unstable internal security and the financial repercussions of military efforts in the east, Ukraine is striving to create a business-friendly climate. To this end, the country is preparing for the enforcement by 1 January 2016 of the Deep and Comprehensive Free Trade Area (DCFTA) created under the Association Agreement with the EU.

The war and a decline in industrial output have led Ukraine's foreign trade to contract. Imports have been hit by the country's shrinking GDP, and exports are also declining. In the case of exports to Russia, several embargos and the unpredictability of the Russian market have compounded the toll. On the other hand, exports to the EU have demonstrated a surprising resilience, thanks largely to the positive performance of agriculture. While the EU has granted the country autonomous trade measures, these may not be responsible for the recent strength of Ukraine's agricultural exports; instead, traders' new market orientation may be the cause.

Russia's opposition to the implementation of the DCFTA has been muted since trilateral trade negotiations with the EU and Ukraine were launched. A mutually acceptable solution may be found – or not – by the end of 2015.

Ultimately, any real improvement in Ukraine's economy will depend on the termination of military activities in the east, on not totally losing trade with traditional Eurasian partners, on the effective entry into force of the DCFTA, on debt restructuring and on a commitment to ambitious reforms. Ukraine's current trade barriers must be removed. For now, at least, Ukraine seems dedicated to doing just that.

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1 Internal political and military situation[1]

An agreement reached in Paris on 2 October 2015 between the leaders of Ukraine, Russia, France and Germany paves the way to a de-escalation of the conflict.

In September and October 2015, the ceasefire signed in Minsk in February has been respected for the first time since its entry into force. On 2 October 2015, important progress on the Minsk ceasefire accord was made in Paris. In a meeting of the 'Normandy Four', François Hollande, Angela Merkel, Vladimir Putin and Petro Poroshenko agreed on steps towards increased security for civilians and political transition in the war-torn parts of eastern Ukraine[2].

On 3 October, pro-Russian separatists in Luhansk and Ukrainian government forces announced that they had begun to withdraw tanks from the line of contacts, as well as light weapons from the buffer zone. The separatists in the Donetsk region started pulling out their weapons on 21 October.

This raises hopes for the stabilisation of an economy heavily impaired by the military operations in the east. However, the internal political situation may worsen if rumours concerning a government reshuffle, following the local elections of 25 October, are confirmed. The fight against corruption, the reform of the judiciary and the improvement of macro-economic conditions are the top priorities for the present government. Before the start of the 'Minsk 2' talks, President Poroshenko stressed that decentralisation would be one of the key reforms but this will have nothing to do with 'federalisation imposed by a neighbouring country'.

Rumours of a government reshuffle are hindering political stability.

One of the main aims of the reforms agreed in the Minsk Agreement is decentralisation. However, the separatists have not agreed to the government's proposal.

On 1 July 2015, the President proposed constitutional changes designed to give extensive new powers to the regions of Donetsk and Luhansk. The pro-Russian fighters in the separatist east were not satisfied by these measures and claimed that the Ukrainian government is in breach of the Minsk agreement, which reads as follows:

'Carrying out constitutional reform in Ukraine with a new constitution entering into force by the end of 2015 providing for decentralisation as a key element (including a reference to the specificities of certain areas in the Donetsk and Luhansk regions, agreed with the representatives of these areas), as well as adopting permanent legislation on the special status of certain areas of the Donetsk and Luhansk regions in line with measures as set out in the footnote until the end of 2015.[3]'

However, not only the separatists were dissatisfied: dissent and general discontent on the part of public opinion led to protests outside the Verkhovna Rada on 1 September. The protests quickly escalated into violence, as three police officers were killed and more than 140 people were injured. The violence appears to have been triggered in the first place by a

[1] Based on information available on IHS connect.
[2] See 'Ukraine and rebels to pull back heavy weapons in move that 'could signal end of war'', The Telegraph, 1 October 2015.
[3] See Package of Measures for the Implementation of the Minsk Agreements, done in Minsk, 12 February 2015 and approved by Resolution 2202 (2015) of the UN Security Council.

member of the extreme right-wing party Svoboda (10 members of which are currently under investigation) who was also a member of a volunteer battalion fighting in the east.

Final approval of the constitutional reform has been postponed to the end of the year and has been made conditional on the fulfilment of the clauses included in the Minsk agreement. The latter will be officially evaluated by the Organisation of Security and Cooperation in Europe Special Monitoring Mission to Ukraine (OSCE- SMM) at the end of 2015. Final approval by the Verkhovna Rada will require a qualified majority, i.e. 300 votes out of 450, a very difficult threshold to attain. This casts a dim shadow over the observation of the Minsk agreements.

2 Reform agendas

Ukraine's reforms are required by the Association Agreement (AA), which includes a Deep and Comprehensive Free Trade Area (DCFTA).

The Association Agenda with the EU defines the priorities.

There are several reforms in Ukraine's agenda, each with a different legal basis, aiming at modernising the country and improving its business climate:

- The **AA/DCFTA**, signed on 27 June 2014, is the general legal basis for all economic reforms. The latter have been duly defined with clear deadlines and flexibilities.
- The AA/DCFTA priorities are detailed and specified in the 'EU-Ukraine **Association Agenda** to prepare and facilitate the implementation of the Association Agreement', endorsed by the EU-Ukraine Association Council on 16 March 2015. Its short-term priorities are:
    - Constitutional reform
    - Electoral reform
    - Preventing and combating corruption
    - Judicial reform
    - Public administration reform
    - Deregulation
    - Public procurement reform
    - Taxation reform, including VAT refunds
    - External audit
    - Energy sector reform
- **Bilateral commitments with lenders:** IMF loans and EU macro financial assistance are based on a reform plan. The case of the latest 'Loan Facility from the European Union of up to 1.8 billion EUR',

Reforms are also included in the country's bilateral commitments with lenders...

...as well as in Ukrainian authorities' political commitments.

approved by the EP in March, is detailed in the annexed Memorandum of Understanding (of May 2015)[4];

- **Political commitments** of the Government and the Parliament: In particular, the agenda of the Verkhovna Rada, elected on 26 October 2014, is based on the coalition agreement signed on 21 November 2014 by five of the six parties, which passed the electoral threshold. The agreement is the most ambitious reform plan ever drafted in Ukraine. Key areas include foreign and domestic policy priorities: budget and tax codes; public service; police; the judiciary (judges and procedural codes); economic competition (demonopolisation of economy); and the market in land.
- The Package of Measures for the Implementation of the **Minsk Agreements** (Minsk II), signed by the leaders of Germany, France, Ukraine and the Russian Federation on 12 February 2015, includes trade-related commitments on:
  - Full restoration of socio-economic relations.
  - Restoration of the banking system in Donetsk and Luhansk, with Germany and France providing technical support.
  - Support for the continuation of tripartite negotiations between the EU, Ukraine and Russia on gas supplies. These negotiations will be encouraged in order to fulfil the 'winter gas package'.
  - Support for the tripartite negotiations between the EU, Ukraine and Russia in order to develop practical solutions to issues of concern to Russia in connection with the **implementation of the DCFTA** between Ukraine and the EU.
  - Setting up a common humanitarian and economic space stretching from the Atlantic to the Pacific, based on full respect for international law and OSCE principles.

Ongoing reforms follow contradictory patterns: some are marked by true ambitions and a genuine effort to modernisation (such as privatisation, fiscal reform), others by resistance from vested interests (local electoral law, media reform, lustration process, natural gas reform). A tentative state of play, as at the beginning of September 2015 is reported in Annex I.

3 The EU's financial assistance to Ukraine

On 5 March 2014, the European Commission agreed upon a package of support, identifying a number of concrete measures for providing economic and financial assistance to Ukraine.

[4] See Memorandum of Understanding between the European Union and Ukraine, done in Riga, 22 May 2015.

The Commission's support package is worth a total of more than EUR 14 billion.

Key elements of the package are[5]:

- **EUR 3 billion** from the EU budget in the coming years: EUR 1.6 billion in macrofinancial assistance loans (MFA) and an assistance package of grants totalling EUR 1.4 billion;
- Up to **EUR 8 billion** from the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD);
- A potential **EUR 3.5 billion** to be leveraged through the Neighbourhood Investment Facility, and a SME facility of EUR 200 million (for all three associated eastern partners).
- Setting up a donor coordination platform;
- Provisional application of the **Deep and Comprehensive Free Trade Area** measures, with autonomous concession of preferential access to the EU market from April 2014 up to 31 December 2015;
- Organisation of a **High Level Investment Forum / Task Force**;
- Modernisation of the Ukraine Gas Transit System and work on **reverse flows**, notably via Slovakia;
- Acceleration of the **Visa Liberalisation Action Plan** within the established framework; offer of a Mobility Partnership;
- Technical assistance on a number of areas, from constitutional to judicial reform and including preparation of elections.

The EU's latest macrofinancial assistance (MFA) package, adopted on 15 April 2015, allocates EUR 1.8 billion to Ukraine.

In late 2014, faced with a deep economic recession and a severe confidence crisis due to the protracted armed conflict in the eastern part of the country, Ukraine requested additional financial assistance from its multilateral and bilateral partners, including the EU. On 8 January 2015, the Commission issued a proposal for a **new macrofinancial assistance** (MFA) programme for Ukraine of up to **EUR 1.8 billion**, in order to alleviate the country's large external financing needs and to support the ambitious reform programme of the authorities. The European Parliament and the Council officially adopted the decision on the third MFA programme for Ukraine on 15 April 2015. On 22 May 2015, Ukraine and the EU jointly signed a **Memorandum of Understanding** outlining the policy programme attached to the MFA operation. This programme largely builds on the reform agenda pursued by the Ukrainian authorities and covers a broad range of areas, including public finance management, governance and transparency, the energy sector, social safety nets, the business environment and the financial sector. The first tranche (EUR 600 million) was disbursed in July; the second is due to follow in autumn 2015.

This new macrofinancial assistance programme builds on top of the two previously existing MFA operations in Ukraine, under which a total of EUR 1.61 billion was disbursed in 2014 and early 2015. A first MFA package of EUR

[5] See 'European Commission agreed a package of support to Ukraine', EEAS, 5 March 2015.

610 million in loans, based on decisions from 2002 (EUR 110 million) and 2010 (EUR 500 million), was provided to Ukraine to support economic reforms in the country and to address persistent external financing difficulties. The first tranche of EUR 100 million was disbursed in May 2014, followed by a second disbursement of EUR 260 million in November 2014 and a final tranche of EUR 250 million in April 2015.

A total of EUR 2.2 billion has been disbursed so far.

So far, the EU has disbursed EUR 2.2 billion in macrofinancial assistance.

On 28 April 2015, the Ukrainian authorities in Kiev organised an **International Conference on Support for Ukraine.** This conference was the occasion for the government to present its reform plan to high-ranking representatives of the international community, including the UN, the OECD, EU institutions and Member States and G7 countries, as well as other international organisations.

Finally, on 13 June 2015, the European Commission granted EUR 150 million to Ukraine, Georgia and Moldova for the implementation of the DCFTA.

4 Economic outlook

4.1 Overall situation

Ukraine´s economy is in dire straits. The government’s reform efforts have so far failed to significantly improve the country’s business climate. Ukraine is ranked 83rd out of 189 countries in the latest World Bank's ‘Doing Business’ 2016 index. This score is the second worst in Europe. Ukraine is still considered the most corrupt country in Europe as well (rated at number 142 out of 175 by Transparency International in 2014). The persistent state of war has disrupted industrial production, which is mainly located in the eastern regions (-21 % in April 2015 compared to the previous year).

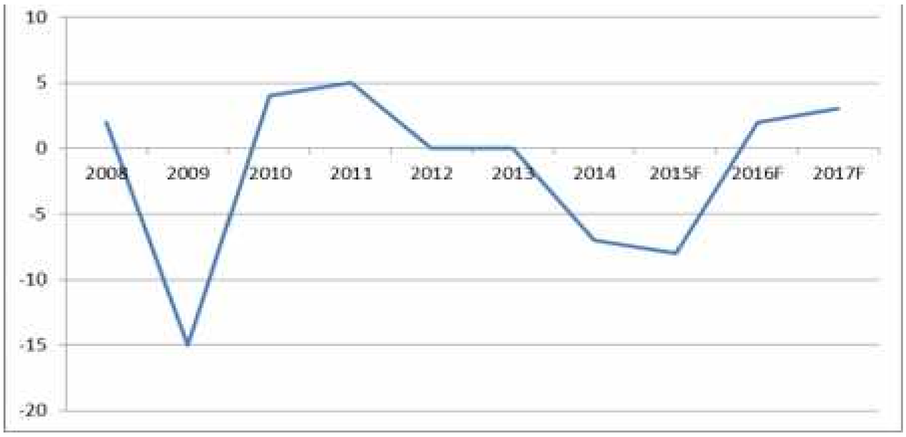
The economy is collapsing as a result of the war.

In the first quarter of 2014, Ukraine’s real GDP showed a year-on-year decline of 1.1 %. This decline accelerated to 4.7 % year on year in the second quarter, 5.3 % in the third quarter, and a staggering 15.2 % in the fourth. Forecasts for the first quarter of 2015 point to a 17.6 % fall in GDP.

The average fall in GDP over 2014 was 7 %, and it is expected to fall by a further 8-12 % in 2015 (see Figure 1). The IMF expects Ukraine to slightly recover in 2016, but its forecast, based on the assumption that the eastern front will calm down, remains to be verified.[6]

[6] See IHS Connect, Ukraine, country report.

Figure 1:
GDP growth in Ukraine

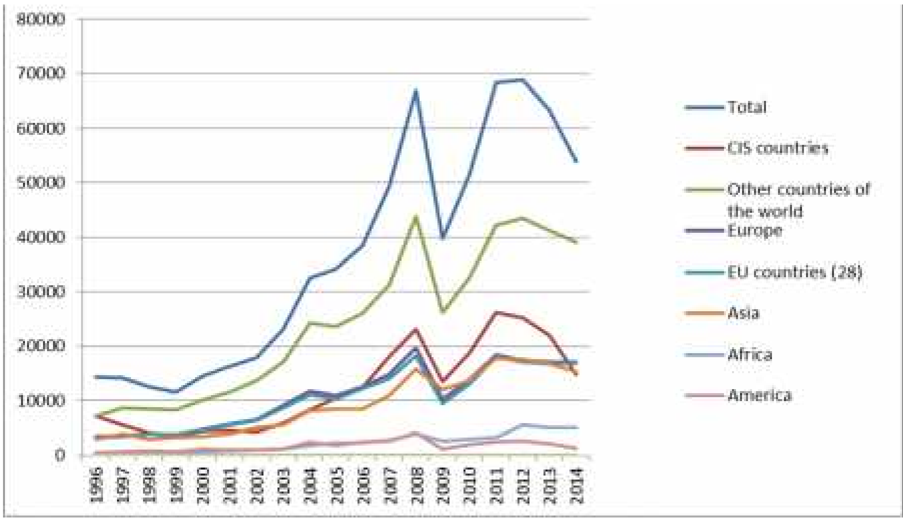


Source: World Bank

Exports are declining, GDP contracting and the currency depreciating.

Compared with a year-on-year decline of 13.6 % in total exports in January 2015, exports fell by 36.6 % in February 2015. Exports to Russia were the most affected, with a decline of almost two thirds. The sharpest decline in exports was recorded for mineral fuels (down by 83.0 % in the first two months of 2015). Exports of **coal** were down by 95.1 %, while exports of natural gas fell to zero, whereas in 2104 they accounted for 16.8 % of the total value of Ukrainian exports. Exports from the two rebel-held regions were the most severely affected, the fall in Donetsk being 67.1 % and that in Luhansk 97.3 %. In contrast, exports of **agricultural products** rose from just 5.6 % of total exports in January-February 2014 to 21.2 % in the same period a year later, mainly thanks to a bumper harvest in late 2014. Evolution of bilateral trade with the EU is discussed in chapter 5.

Figure 2:
Ukraine's exports,
in USD millions



Source: Ukrstat

The devaluation of the hryvnia since November 2013 (see Figure 3) and the central bank's inability to support the UAH 7.99 / USD 1.00 exchange rate level led to a 70 % drop in the hryvnia's value by late February 2015. Devaluation of the hryvnia, a 50 % increase in domestic gas prices and a 40 % rise in the cost of utilities drove up consumer prices and brought inflation to 45.8 % by March 2015 (see Figure 4).

Figure 3:
Exchange rate hryvnia/euro (source: IHS Connect)

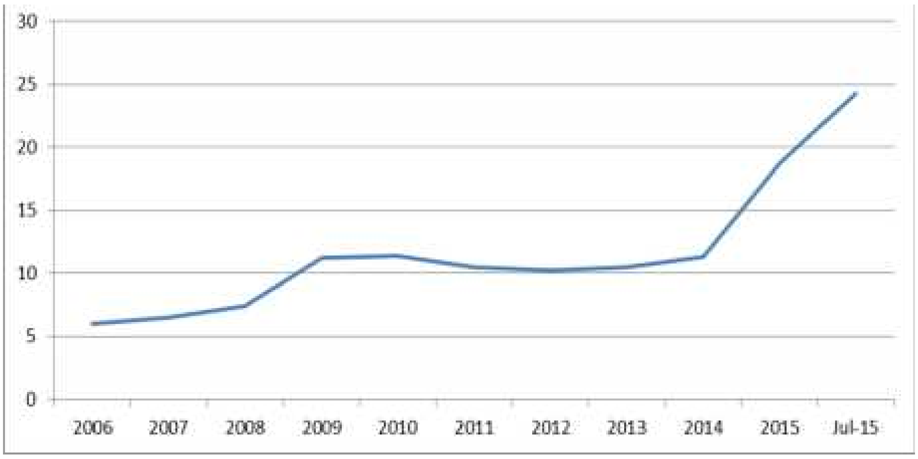
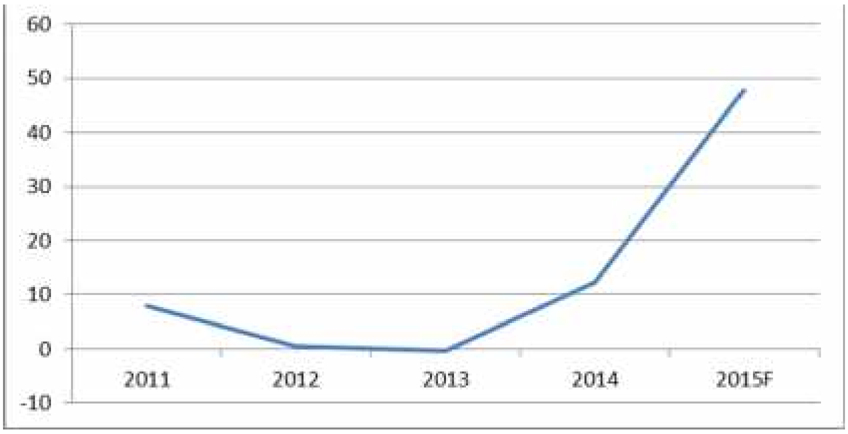


Figure 4:
Inflation (consumer price index, % change)

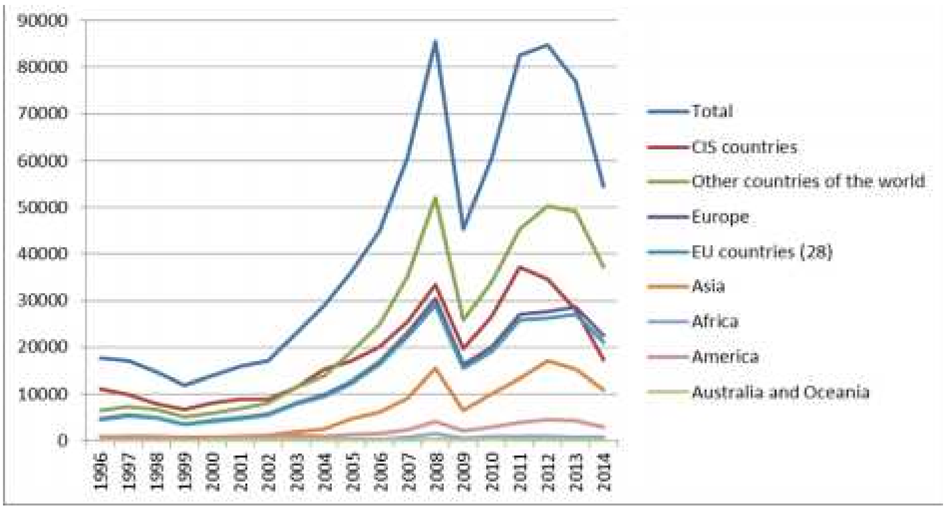


Source: HIS

In April 2015, Ukraine cut gas consumption by 21 % compared to 2014 levels, while gas imports decreased by 45 %. In addition, Ukraine imported four times more gas from the EU (1.2 bcm) than from Russia (300 mcm). On 7 May 2015, Gazprom started the process of suing Naftogaz at the Arbitration Institute of the Stockholm Chamber of Commerce. Gazprom estimates that Naftogaz owes the Russian company USD 23.8 billion worth of debt.

The combination of these factors triggered a sharp decrease of imports (see Figure 5), allowing Ukraine to almost resorb its trade deficit.

Figure 5:
Ukraine's imports from different sources, in USD millions



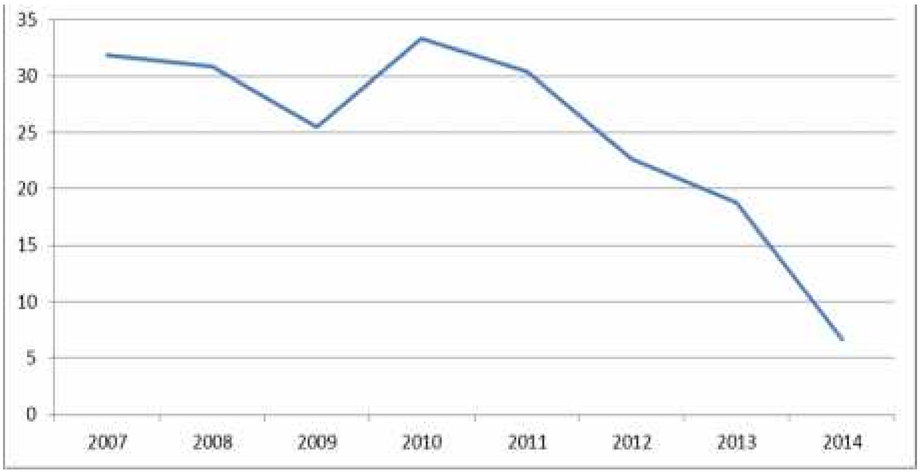
Source: Ukrstat

However, with foreign exchange reserves falling dramatically (see Figure 6), the Ukrainian government has announced that it would need an additional USD 15 billion in order to meet its foreign debt repayment and service obligations, finance its current account deficit, and pay for natural gas imports from Russia (including an outstanding bill for 2013 and 2014).

The IMF and the EU are providing emergency macro financial aid.

On 30 April 2014, the IMF agreed to a two-year Standby Arrangement that envisioned a total disbursement of USD 17 billion, with the Ukrainian authorities committing to a multi-year roadmap of austerity measures. The IMF released two tranches in 2014 (USD 3.19 billion on 30 April 2014 and USD 1.39 billion on 29 August 2014). On 11 March 2015, the Executive Board of the IMF approved a four-year extended arrangement under the Extended Fund Facility for Ukraine, after Ukraine had decided to cancel the Standby Arrangement. The new arrangement mobilises the same amount as the first agreement (USD 17.5 billion). The extended arrangement was followed by an immediate disbursement of USD 5 billion. On 31 July 2015, the first IMF review was completed, paving the way for a second disbursement of USD 1.7 billion. Currently, the IMF is discussing the results of the second review. A visit by IMF staff took place from 22 September to 2 October 2015. The Ukrainian government hopes that the IMF will disburse the third tranche in fall 2015.

Figure 6:
Foreign exchange reserves, excl. gold (USD billion)

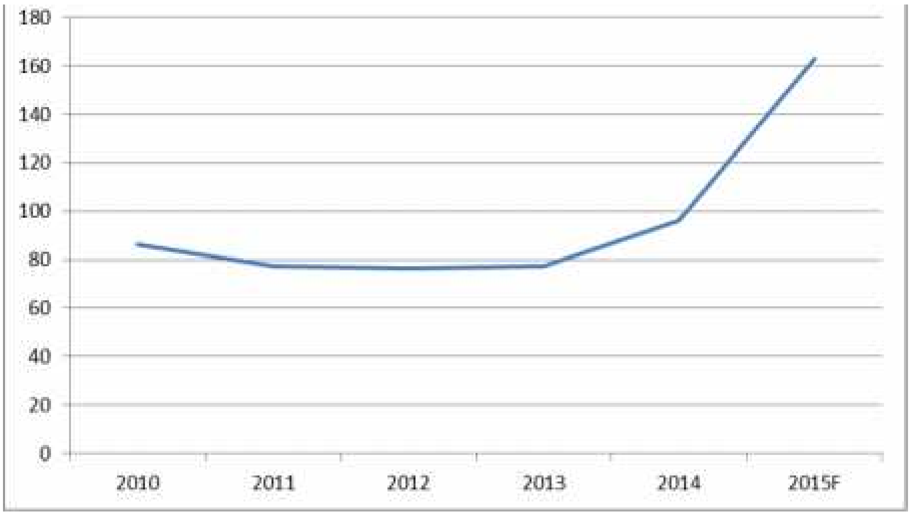


Source: HIS

The rapidly degrading economic situation and the costs of the conflict in the eastern regions increased the Ukrainian government's need for liquidity. The external debt of Ukraine rose dramatically to cover the costs of military operations, estimated to be between USD 5 and 10 million per day.

Following the increase in international borrowings, decrease of GDP and devaluation of the hryvnia, total external debt as a percentage of GDP doubled from 80 % in 2013 to 160 % in 2015 (see Figure 7).

Figure 7:
Ukraine's total external debt



Source: HIS

Ukraine needs to restructure its unsustainable foreign debt. The country secured the majority of bondholder votes required to restructure sovereign Eurobonds worth USD 14.4 billion on 14 October 2015. More than 75 % of debt holders agreed on the Ukrainian government's exchange terms. New bonds and GDP-linked securities will be issued in mid-November. In the meantime, Ukraine proceeds to restructure its quasi-sovereign debt, worth USD 1.8 billion. However, up to now Russia insists on the repayment of Ukrainian Eurobonds worth USD 3 billion by 20 December 2015, as it treats the bonds as official and not commercial debt[7]. Ukraine, however, treats the Eurobonds as commercial debt and has invited Russia to participate in the debt exchange, on which more than 75 % of sovereign bondholders have already been agreed upon. Russia had the possibility to vote on this issue at an adjourned meeting scheduled for 29 October 2015, but decided to not attend the meeting. Should no agreement be reached with Russia and should Ukraine be unable to repay its debts, the validity of the IMF loan worth USD 17.5 billion might be called into question, as legally the IMF may not lend money to a country if it is in arrears on an official loan. Nevertheless, Ukrainian Prime Minister Arseny Yatseniuk has announced that Ukraine will not pay off its debt to Russia, if Russia does not agree on restructuring the debt. Instead, Ukraine would impose a debt moratorium.

4.2 Economic forecast

The short-term outlook foresees an accelerated GDP decline in 2015, compared to 2014.

Ukraine is facing growing external debt service and repayment obligations. In spite of the boost from which its foreign exchange reserves are benefiting - made possible by access to multilateral financing - payments to Russia for

[7] The bond issued in December 2013 was part of a bigger package, on which Russia and Ukraine agreed on 18 December 2013 (overall USD 15 billion and lower gas prices). With this deal, Russia intended to support the decision of Viktor Yanukovych to reject the association agreement with the EU.

winter gas, as well as the need to support the hryvnia, have made the country ever more vulnerable to foreign exchange fluctuations. The downward pressure on the exchange rate and a one-off utility price increase resulted in accelerated inflation throughout 2014. The latter is predicted to climb to staggering heights in the near term.

Two possible scenarios are the following[8]:

Trade sanctions and protracted military activity suggest the economy may suffer further...

1 - **A negative scenario** is based on protracted conflict in eastern and south-eastern Ukraine and a diplomatic standoff with Russia involving punitive trade sanctions and cuts to gas supplies. This outcome would further aggravate Ukraine's economic situation; yet political congestion in carrying out the required reforms may derail the rescue plan endorsed by the International Monetary Fund (IMF). The country could be forced to default on its foreign obligations.

The new government is struggling to regain control of Ukrainian territory, losing much of the country's industrial heartland. The situation is aggravated by IMF austerity measures, leading to political unrest across the country. Ukraine faces a severe and prolonged crisis, in spite of the support received from its multilateral and bilateral lenders.

As a result of an unstable and unsettling financial situation and position in the banking world, the government has been accumulating payment arrears and issuing local currency as treasury bonds - which end up in the central bank's vault. Capital flight is accelerating and resulting in an acute balance of payments crisis; the hryvnia's value keeps dropping as inflation rises, aggravating Ukraine's fragile economic situation ever more acutely.

...while the prospect of an end to hostilities, greater internal security and an ambitious commitment to reforms could promise a more optimistic outcome.

2 - **An optimistic scenario**: A revival in Ukraine's exports, together with IMF assistance as well as a substantial debt haircut, and a diplomatic solution avoiding a standoff with Russia, would ease liquidity concerns, fostering the possibility of a strong economic recovery. This would require accrued internal stability and a more ambitious effort in the reform process. In the medium term, an improved business climate can contribute to attract FDI, should a significant product demand be matched in the internal and foreign markets.

5 Evolution of Ukraine´s bilateral trade with the EU

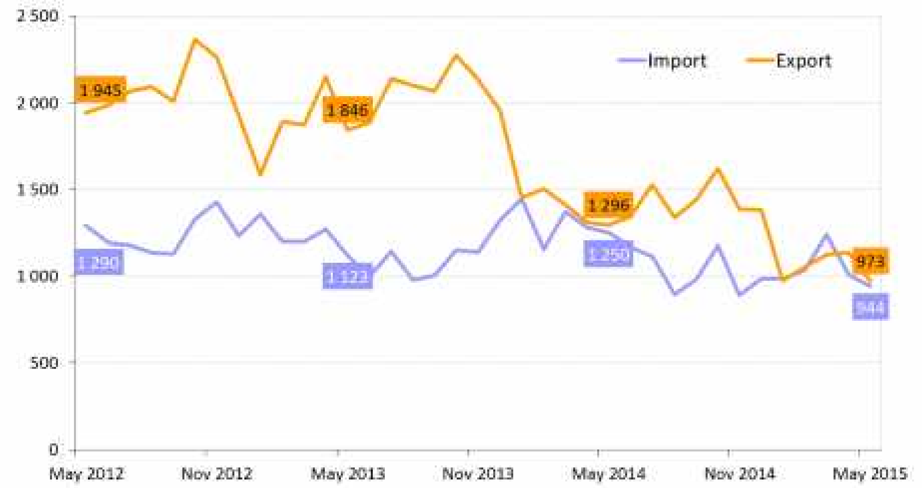
Ukraine's exports to the EU have not suffered the same fate as its imports.

Ukraine's international trade picture (see Figures 2 and 5) is still unsatisfactory. **Imports** from the EU have been affected essentially by the deterioration of the economic situation in the country. The fall in GDP has depressed internal demand and affected Ukraine's imports. The trend is expected to remain negative, despite upcoming liberalisation reforms, unless internal demand rebounds. This has had the unintended effect of almost zeroing the deficit with the EU, but has also demonstrated that economic recovery is not within reach. Overall **export** performance has also been

[8] See IHS Connect.

depressed: only exports to the EU have not been affected by this downward trend (see Figure 2).

Figure 8:
EU-28 exports to and imports from Ukraine (goods), in EUR million



Source: EPRS on Eurostat data

The peculiar trend of Ukraine's exports to the EU calls for an in-depth descriptive analysis.

Russia is Ukraine's second partner, but bilateral trade is significantly declining.

Ukraine´s main trade partners are the EU and Russia and the country's trade policy strategy has traditionally been oriented to developing and maintaining trade with both partners simultaneously. On 19 October 2011, the day following the signing of the Free Trade Agreement with the Commonwealth of Independent States (CISFTA), Ukraine began negotiating a free trade agreement with the EU. As has recently been affirmed by the Ukrainian government, Ukraine has resolved to continue its commitment to the CISFTA, regardless of its tensions with Russia.

Nonetheless, trade with Russia is in progressive decline (see Figure 2). The European Commission´s trade data (see Figure 9) offer an overview of Ukraine's exchanges with its main trading partners in 2013, when the Russian Federation accounted for a 30 % share (which fell to 19 % in 2014).

Figure 9:
Top merchandise trading partners, 2013

Imports				Exports				Total trade			
	Partner	Value (Mio €)	Share in World (%)		Partner	Value (Mio €)	Share in World (%)		Partner	Value (Mio €)	Share in World (%)
	World	59,017	100.0		World	48,516	100.0		World	107,562	100.0
1	EU 28	20,734	35.1	1	EU 28	12,855	26.5	1	EU 28	33,589	31.2
2	Russia	17,816	30.2	2	Russia	11,552	23.8	2	Russia	29,368	27.3
3	China	6,058	10.3	3	Turkey	2,918	6.0	3	China	8,149	7.6
4	Belarus	2,765	4.7	4	China	2,091	4.3	4	Turkey	4,339	4.0
5	USA	2,125	3.6	5	Egypt	2,086	4.3	5	Belarus	4,286	4.0
6	Turkey	1,421	2.4	6	Kazakhstan	1,626	3.3	6	USA	2,807	2.6
7	Japan	755	1.3	7	Belarus	1,521	3.1	7	Egypt	2,191	2.0
8	Switzerland	695	1.2	8	India	1,514	3.1	8	India	2,157	2.0
9	India	643	1.1	9	Moldova	697	1.4	9	Kazakhstan	2,149	2.0
10	South Korea	637	1.1	10	USA	682	1.4	10	Japan	1,107	1.0
1	EU 28	20,734	35.1	1	EU 28	12,855	26.5	1	EU 28	33,589	31.2

World trade: excluding intra region trade
Top partners: excluding region member states
Growth: relative variation between current and previous period

Source: European Commission

More recent statistics show that Ukrainian export to the Eurasian Union was USD 12.489.5 million in 2014, i.e. 23.6 % of total export[9].

This deterioration is due to political factors (Russian bans on Ukrainian exports, threats of suspension of trade preferences under the CISFTA, cancellation of contracts and military developments.

The war in Donbass has directly affected the mining and mechanical sectors, which are mainly located in the eastern regions, thus impacting on the macroeconomic situation.

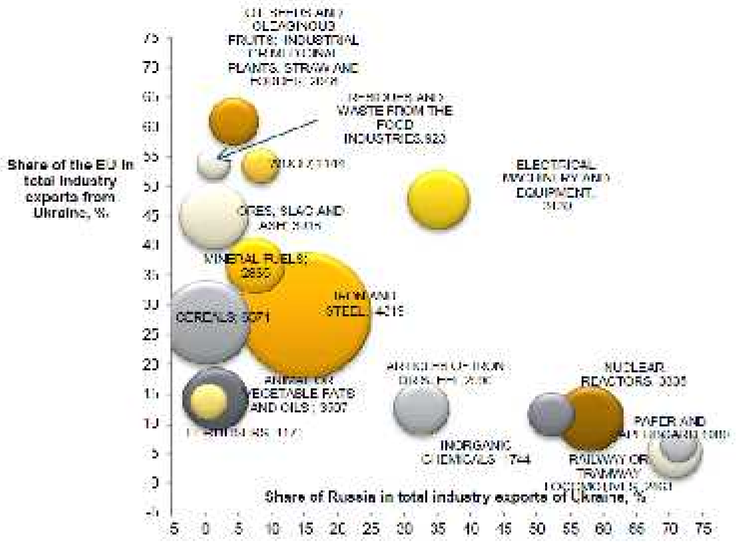
Ukraine's trade with the EU and Russia respectively are concentrated in different sectors.

Bilateral trade with Russia fell by 58 % in the first half of 2015 (by 80 % for agricultural products), in contrast with a mere 35 % fall in trade with the EU. Taken on a yearly basis, bilateral trade with the EU in May 2015 had declined by 'only' 17 % since the approval of EU´s autonomous preferences.

As argued in a previous study by the Policy Department[10], Ukrainian exports to the EU and the Russian Federation are qualitatively different. A further study has visualised this qualitative divide in the following graphic:

[9] See Ukraine: external trade, Europa World Plus, October 2015.
[10] See 'When choosing means losing The Eastern partners, the EU and the Eurasian Economic Union`. European Parliament, DG External Policies, Policy department, March 2015.

Figure 10:
Destinations of Ukraine's top 15 export industries, 2013[11]



Note: Horizontal axis: share of Russia in total industry exports from Ukraine; vertical axis: share of the EU in total industry exports from Ukraine. Bubble size corresponds to the value of the industry exports in USD million.
Source: Authors' calculations based on UN Comtrade data.

Some **industrial exports** are mainly directed towards Russia, within a post-Soviet system of vertical specialisation, which makes certain products unlikely to be exported to the EU (e.g. cargo planes, nuclear reactors or railway equipment). Other goods, however, compete with EU domestic products in their home market, among them fertilisers and steel products. In order to address unfair practices, the EU has imposed five anti-dumping measures, which are currently in force relating to two steel products (seamless pipes and tubes; steel ropes), two chemical products (biodiesel and bioethanol) and a mechanical product (ring binders).

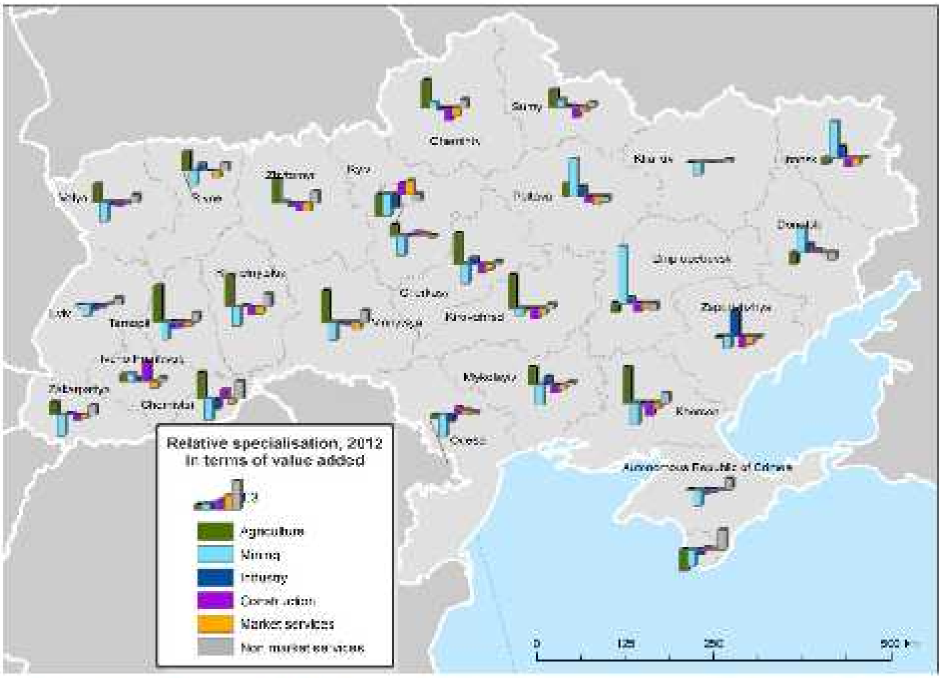
The decline of mining and industrial exports (mainly of coal and mineral fuels) is traceable in the drop in industrial production (annual industry growth fell by 14.2 % in 2014, compared to - 3.8 % of 2015[12]). Other industrial products, such as medicines, have the potential to find a market in the EU provided that the standards compatibility issue is addressed.

While some industries are likely to export to the EU over the medium term, Ukraine's exports are dominated by agricultural products.

However, as Figure 10 shows, the specialisation of Ukraine's western regions favours **food exports** to the EU. The unilateral liberalisation granted in 2014 (with Regulation 374/2014 introducing autonomous measures with regard to Ukrainian exports) did not cover all agricultural products, while granting immediate preferences to 82.2 % of Ukraine's agricultural exports. For other products (cereals, pork, beef, poultry and a handful of additional products), a partial liberalisation was achieved by granting duty-free tariff rate quotas (TRQs), which limit the amounts of certain goods eligible for the trade preference.

[11] See 'How to Stabilise the Economy of Ukraine', Amat Adarov, Vasily Astrov, Peter Havlik, Gábor Hunya, Michael Landesmann and Leon Podkaminer, April 2015.
[12] World Bank data.

Figure 11:
Relative sectorial specialisation of Ukraine's regions[13]



Note: The bars refer to the share of a particular economic activity in region's value added minus the share of that economic activity in the whole economy of Ukraine minus one.
Source: State Statistics Service of Ukraine.

According to the figures, Ukrainian food exports to Russia in the first half of 2015 stood at 2 %, compared to 8 % in the previous year.

Figure 12:
EU trade flows with Ukraine, by SITC section, 2014

		Imports				Exports			
		Value (Mio €)	Share in Total (%)	Share in Extra-EU (%)	Growth* (%)	Value (Mio €)	Share in Total (%)	Share in Extra-EU (%)	Growth* (%)
	Total	13,761	100.0	0.8	0.9	17,143	100.0	1.0	28.3
0	Food and live animals	2,488	18.1	2.7	13.8	1,310	7.6	1.7	-19.5
1	Beverages and tobacco	18	0.1	0.2	-10.8	187	1.1	0.7	-20.4
2	Crude materials, inedible, except fuels	2,602	18.9	4.0	-15.9	418	2.4	1.1	-24.0
3	Mineral fuels, lubricants and related materials	1,040	7.6	0.2	-7.0	2,008	11.7	1.6	-19.3
4	Animal and vegetable oils, fats and waxes	615	4.5	7.3	32.8	54	0.3	1.3	-8.1
5	Chemicals and related prod. n.e.s.	554	4.0	0.3	-0.2	3,683	21.5	1.3	-19.8
6	Manufactured goods classified chiefly by material	3,044	27.9	2.2	-1.0	2,601	15.2	1.3	-24.0
7	Machinery and transport equipment	1,419	10.3	0.3	3.0	4,931	28.8	0.7	39.4
8	Miscellaneous manufactured articles	631	4.6	0.3	8.8	1,681	9.8	0.9	27.9
9	Commodities and transactions n.c.e.	33	0.2	0.1	2.6	83	0.5	0.1	47.3
	Other	516	3.8	n.a.	n.a.	191	1.1	n.a.	n.a.

Source: Eurostat

In 2014, with Regulation 374/2014, the **EU adopted autonomous measures eliminating duties on industrial and agricultural products** and introducing tariff quotas for certain sensitive agricultural products (ATM). It is interesting to investigate a possible correlation between exports to the EU and these measures.

[13] See 'How to stabilise the Economy of Ukraine', Amat Adarov, Vasily Astrov, Peter Havlik, Gábor Hunya, Michael Landesmann and Leon Podkaminer, April 2015.

The impact of EU autonomous trade measures is not clear, since Ukraine's agricultural exports have generally largely exceeded the duty-free quotas.

Ukrainian exports to the EU have proved to be resistant to the general economic crisis, and the main component is represented by agriculture. However, recent trade patterns demonstrate that duty-free TRQ 2014-2012 were largely surpassed for certain products, including honey (with more than 20 000 tonnes versus a duty free TRQ of 5 000 tonnes), maize (8 million tonnes versus a TRQ of 400 000), grape and apple juice (80 000 tonnes versus a TRQ of 10 000 tonnes), barley products (groats, meal, flakes - 12 000 tonnes versus a TRQ of 6 300). It implies that Ukrainian exporters have preferred the EU market, even with high duties, to traditional markets.

Only exports of tomato paste and poultry meat can be linked with TRQ, since exports exceeding the duty-free TRQ 2012-2014 are very limited. Wheat exports have, moreover, recently surpassed the TRQ; nevertheless, they already represented 1.6 million in 2012 (the TRQ is 0.95 million). The EU, on the other hand, is exporting 20 million tonnes to Ukraine.

The reason for these increased agricultural exports probably stems from market operators' efforts to seek out alternative and more predictable markets, rather than from trade policy measures.

The autonomous measures granted in 2014 may have eased exports of some products. Many agricultural products are exported nonetheless, **as exporters chose to exceed the duty-free TRQ** rather than change export markets.

This aspect is probably due to the trade restrictions imposed by the Russian Federation and to expectations of new, even stricter ones once the DCFTA enters into force. While Russia is performing an impressive effort of import substitution, Ukrainian exporters are anticipating new trade obstacles and are trying to establish stable trade channels with more predictable markets.

The Agricultural Policy and Food Ministry of Ukraine has stated that the strategic importance of the Russian market for Ukraine is a Soviet throwback. Due to the non-predictability of the Russian market, its artificial restrictions, meat and dairy disputes and the blocking of confectionery products, **Ukrainian producers started aiming towards the European, Asian, African and American markets** a long time ago. Their successful diversification made it possible to counterbalance for profits from exports to Russia. China receives the largest share of Ukrainian agricultural exports (USD 783.3 million), followed by Egypt (USD 567.8 million), India (USD 563.3 million), Iran (USD 350.2 million), Spain (USD 340.65 million) and Turkey (USD 339.3 million).

6 The implementation of the DCFTA and talks with the Russian Federation

After a one-year postponement, implementation of the AA/DCFTA is expected to begin on 1 January 2016. Russia appears - for the moment - not to be opposed.

In the context of the deteriorating economic situation, the European Union declared at the Riga summit on the Eastern Partnership held in May 2015 that it would implement the free trade pact with Ukraine from 1 January 2016.

In fact, the **AA/DCFTA** with Ukraine has a **controversial story of postponements**. Initialled on 19 July 2012, it was signed only on 27 June 2014, following the Maidan revolution. However, the provisional application of the DCFTA was postponed until 31 December 2015, while the political part of the Association Agreement entered into force on 1 November 2014. A meeting bringing together then EU Trade Commissioner Karel De Gucht, Ukrainian Minister of Foreign Affairs Pavlo Klimkin, and Russian Minister of Economic Development Alexei Ulyukayev took place on 12 September 2014 – before the European Parliament´s ratification of the agreement – and resulted in the postponement of the entry into force to 1 January 2016. During this period of suspension, the EU is continuing to grant Ukraine unilateral autonomous trade preferences. A Dutch referendum on the Association Agreement might impair its ratification process. Following the collection of more than 300 000 signatures in the Netherlands specifically on the matter, a referendum will be held on 6 April 2016. Although the result will not be binding on the government, it will have to be taken into account if the turnout is above 30 % and a majority vote against the agreement.

A Dutch referendum on the ratification of the agreement may hamper its definitive entry into force.

The rationale for the postponement was the need to cope with 'concerns raised by Russia' and to provide Ukraine with more time to prepare for the provisional application.

Trade concerns of the Russian Federation have been mentioned in the Minsk agreement (see chapter 2) and at the Riga summit[14]. Both have reinvigorated the trilateral negotiations on the implementation of the DCFTA, and for the time being, Russia has not openly opposed the entry into force of the trade part of the agreement. The current EU Trade Commissioner, Cecilia Malmström, Pavlo Klimkin and Alexei Ulyukayev have met so far on 11 July and 12 September 2014 and on 18 May and 7 September 2015.

Trilateral trade talks – as mandated by the Minsk agreement and the Riga summit – are ongoing.

The final declaration of the meeting of 7 September 2015 expresses **cautious optimism**, stating the following:

'Taking note of the current unsatisfactory developments of the trade flows, the participants have reaffirmed their commitment towards achieving practical arrangements that would contribute to maintaining open economic relations with a view to enabling economic growth'[15].

However, at the same time the conclusions reveal that a certain disagreement persists:

'Taking note of the different views, the participants agreed to mandate the experts to continue the work at the technical level with a view to developing a blueprint by October 2015 with practical solutions to concerns raised by Russia with regard to the implementation of the DCFTA'.

The outstanding issues are expected to be addressed by November 2015.

A stocktaking meeting is foreseen for the end of 2015 to allow a mutually satisfactory solution to be applied by the end of the year.

[14] See Joint Declaration of the Eastern Partnership Summit (Riga, 21-22 May 2015), point 9: 'Summit participants look forward to the provisional application of the Deep and Comprehensive Free Trade Area (DCFTA) with Ukraine starting on 1 January 2016 and the positive impact its implementation will bring about. Constructive efforts in the trilateral consultations on EU-Ukraine DCFTA implementation, using the existing flexibilities available to the contracting parties within the DCFTA, are important.'

[15] See Outcome of the Trilateral Talks on the Implementation of the EU-Ukraine Association Agreement/Deep and Comprehensive Free Trade Area, 7 September 2015.

Russia's concerns relate to possible circumventions of customs duties...

The outstanding issues stressed by the Russian side are the following:

Customs cooperation

– Maintenance and further improvement of customs data exchange and electronic verification of origins by means of strengthened customs cooperation and dialogue towards the convergence of customs information systems;

– Commitment to tackle additional issues (e.g. the fight against fraud);

– Commitment by Ukraine and Russia to consider initiation of a revision of the rules of origin of the CISFTA;

...harmonisation of standards...

– Readiness on the part of the EU to strengthen the informal dialogue on customs cooperation with Russia and, where requested, provide EU expert advice and technical support to the Parties;

Technical barriers to trade (TBT)

– Creation of a dedicated working group to further develop the harmonisation process with a view to minimising the impact of the regulatory changes, recognising the importance of convergence of technical regulations and standards as a tool to facilitate trade flows;

...and sanitary and phytosanitary rules.

– Consideration of extension of the transition periods for the regulatory alignment when and if appropriate for specific sectors or products, by taking advantage of the flexibilities built into the DCFTA;

Sanitary and phytosanitary issues (SPS)

Establishing the compatibility of the DCFTA and the Commonwealth of Independent States Free Trade Area (CISFTA) may be a positive outcome of negotiations.

– Consider the preparation of an updated arrangement between Ukraine and Russia on bilateral acceptance of veterinary certificates.

These concerns underline the Russian worries regarding a possible circumvention of the Eurasian Economic Union external tariffs via the two free trade agreements, in which Ukraine will simultaneously participate: the EU-DCFTA and the CISFTA. The two agreements are in principle compatible, as extensively analysed in a previous study by this Policy Department[16]. Other studies, including a recent Russian one, confirm this orientation[17]. One of the policy options suggested by the Policy Department study was 'enhancing the compatibility of the DCFTA and the CISFTA free trade areas', a result, which only direct and solution-oriented negotiations can achieve. Both partners seem at present committed to this goal, while the European Commission has made its mandate clear: it does intend to renegotiate and not postpone the DCFTA, and it has no intention of creating overwhelming additional burdens for EU customs authorities. However, all available flexibilities of the AA can be used to ease Russia's trade concerns. Taking this into account, Russian

[16] See 'When choosing means losing The Eastern partners, the EU and the Eurasian Economic Union`. European Parliament, DG External Policies, Policy department, March 2015.
[17] See 'Economic Consequences of the Ukraine Conflict', Peter Havlik, November 2014; 'Assotsiatsiya Ukrainy s Yevropeyskim Soyuzom: Posletstviya dlya Rossii' (Association of Ukraine and the European Union: Implications for Russia), Imemo Ran, 2014.

concerns have a concrete chance of being addressed before the end of the year.

If the concerns of the Russian Federation are not addressed, the CIS preferences that Ukraine enjoys may be suspended.

Should a solution not be found, Russia has threatened to suspend the CISFTA preferences, using the safeguard clause (Annex 6 CISFTA)[18], which requires, if preferences are to be suspended, that one of the parties to the agreement should have provoked an increase in imports in other parties in quantities that harm or threaten to cause injury to an industry of the CISFTA members. Once an increase in imports is confirmed, Russia should only have the right to impose duties on specific Ukrainian goods: a general suspension of preferences does not seem in line with the wording of the treaty. Suspension could, rather, be based on the Vienna Convention of 1969, Article 60 (Termination or suspension of the operation of a treaty as a consequence of its breach), but only if the Russian Federation was able to demonstrate that Ukraine, when enforcing the AA with the EU, is in breach of the CISFTA treaty. It is hard to provide such a demonstration since the CISFTA parties are not prevented from concluding trade agreements with other states or custom unions (see Article 18 CISFTA).

7 Trade concerns and policy options

It is hoped that the DCFTA will enter into force in January 2016. Ukraine is progressing on its path to reforms (see Annex I), and the ceasefire proved workable for the first time in September and October. Russian dissent seems at present channelled into trade negotiations, even if a solution for Russia's concerns has not yet been found. Should a solution not be found before the end of the year, the Russian Federation is likely to choose to suspend the CISFTA trade preferences for Ukraine.

Political relations between Russia and Ukraine are deteriorating. This is reflected in several **economic irritants**. Apart from the mentioned suspension of trade preferences, potentially affecting Ukrainian exports to Russia, Belarus and Kazakhstan (23 % of Ukrainian exports in 2014[19]), the main disputes concern the following issues:

Harmful economic disputes between Moscow and Kyiv are likely to affect Ukraine's external debt …

- Russia insists on the **repayment of** USD 3 **billion external debt** by 20 December 2015. In case no solution on debt restructuring is found, Ukraine may not receive further tranches of the IMF loan and risks a debt default.

...Ukrainian exports to Russia...

- Russia´s **punitive trade policy measures** towards Ukraine have not yet resulted in a general suspension of existing trade preferences (granted by the CISFTA), but they have led to a number of ad hoc trade bans, based on the allegation of non-compliance with SPS and

[18] See text of Annex 6 (safeguard clause) of the CIS Free Trade Zone Agreement (CISFTA), signed on 18 October 2011 by Russia, Ukraine, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Armenia and Tajikistan.
[19] See Ukraine: external trade, Europa World Plus, October 2015.

industrial standards: a ban on imports of Ukrainian confectionery products (July 2013); enhanced border controls for imports from Ukraine (August 2013); a ban on imports of Ukrainian railcars (September-October 2013); a ban on imports from a large Ukrainian poultry producer (February 2014); a ban on imports of selected cheeses (April 2014); a ban on imports of potatoes from Ukraine (June 2014); and a ban on imports of raw milk and dairy products from Ukraine (July 2014).

...flights between the two countries...

- On 25 October 2015, **direct flights between Russia and Ukraine were suspended** indefinitely. Talks between Russian and Ukrainian negotiators ended without any result on Friday, 23 October 2015. From Sunday, 25 October, travellers were forced to take more expensive, indirect flights over Moldova, Belarus or the Baltic states or to use a slow overnight train. This will affect up to 70 000 passengers per month who regularly use the flight connection to do business or visit their families. Moreover, the airlines, which conducted the flights, have to expect serious financial losses. According to the Russian transport minister, losses in ticket sales are estimated at USD 110 million per year for both countries.

...personal remittances from Russia...

The flight ban is affecting Ukrainian workers in Russia (2.9 million in 2012), who are a precious source of income. In 2013, they sent home personal remittances totalling USD 3 billion (according to the World Bank) or 4 billion (according to the Central Bank of Russia). When expressed as a GDP ratio, this represents between 2.3 and 3.1 % of GDP. If the self-damaging Ukrainian measure of flight suspension is followed by Russian measures thwarting work permits for Ukrainian citizens, this could further jeopardise remittances from Russia.

...gas transit fees...

- **Gas transit fees** paid by Gazprom total around USD 3 billion per year[20]. The ongoing projects to bypass Ukraine with North Stream 2 and Turkish Stream may offset this valuable source of income as well. Quite ironically, the doubling of North Stream will help to supply Ukraine's needs in 'reverse flow' from the EU[21].

...and energy security.

- Ukrainian consumption of Russian gas benefited from the t**rilateral agreement** of 30 October 2014 (the so-called '**winter package** 2014'), backed by the Barroso Commission. A new agreement for winter 2015 was concluded on 25 September 2015 by EU commissioner Maroš Šefčovič, energy ministers Vladimir Demchyshyn (Ukraine) and Alexander Novak (Russia)[22]. A price discount on gas imports has been granted to Ukraine, but lack of trust requires advance payments of gas supply. A legal battle over

[20] See 'The Russian-Ukrainian gas deal: Taking the bite out of winter?', European Parliament DG External Policies, Policy Department, November 2014.
[21] See 'German-Russian Deal on Nord Stream Two Alters European Energy Balance', The Jamestown Foundation, 10 September, 2015.
[22] See 'Russia, Ukraine, and EU agree winter gas deal', EU Observer, 26 September 2015.

the existing unpaid debt is ongoing in the Stockholm Court of Arbitration, with Gazprom claiming an existing debt of more than USD 29 billion[23].

The implementation of the DCFTA will not be complete unless Ukraine lifts the special trade measures related to its balance of payments.

Better strategic relations with the EU have not prevented the existence of a number of trade disagreements, which need to be addressed in view of the upcoming entry into force of the DCFTA.

A precondition for truly liberalising trade with the EU is the lifting of the special *erga omnes* **duty surcharge** (5 % on imports of industrial goods and 10 % on imports of agricultural goods), imposed on 25 February 2015 on the grounds of 'exceptional conditions' affecting the balance of payments. Ukraine declared to the WTO that these measures would be lifted by the end of 2015. In June 2015, all WTO members *except one* considered this measure as being in line with WTO rules (Article XII of the GATT 1994 and the Understanding on Balance-of-Payments Provisions), provided it is lifted by the end of the year[24]. The **EU has attached the greatest importance to these measures being lifted**, since the issue may affect the disbursement of the third tranche of the MFA loan approved in 2015.

A recent Ukrainian ban on wood exports is harmful for the EU processing industry.

On 21 October 2015 the Ukrainian cabinet approved a draft law for the abolition of extra import duty from 1 January 2016. This draft law now waits the rapid approval of the Verkhovna Rada, but this is not to be taken for granted.

To promote the Ukrainian processing industry, the Verkhovna Rada narrowly approved, on 9 April 2015, a series of **export restrictions on wood** which appears **harmful to the EU industry**. The law was promulgated by President Poroshenko on 10 July 2015. It provides for:

- a moratorium (ban) on exports of raw round wood (excluding pine wood) for 10 years as of 1 November 2015;
- a moratorium on exports of raw round pine wood for 10 years, to be applied from 1 January 2017;
- the obligation for Ukrainian exporters (other than for those covered by the above moratorium) to obtain certificates of origin for round wood and sawn timber, to be issued by the relevant forest districts, in order to be able to export outside Ukraine (applied from 10 October 2015).

This ban appears to violate the EU ATM (trade preferences) regulation and the DCFTA.

Among the major importers of Ukrainian softwood in the EU are Romania, Slovakia, Poland and Austria. According to Eurostat, these four countries imported last year nearly 1.4 million cubic metres of round wood from Ukraine.

This measure seems to be in breach of both the standstill obligation included

[23] See UPDATE 2-Russia's Gazprom says Ukraine's total gas debt is $29.5 bln, Reuters 28 May 2015.
[24] See Members adopt report on Ukraine's import surcharge imposed for balance-of-payments reasons, WTO website, June 2015.

in Regulation 374/2014, granting unilateral trade preferences for Ukraine (ATM) and the Association Agreement (Article 35), which states:

'No Party shall adopt or maintain any prohibition or restriction or any measure having an equivalent effect on the import of any good of the other Party or on the export or sale for export of any good destined for the territory of the other Party, except as otherwise provided in this Agreement or in accordance with Article XI of GATT 1994 and its interpretative notes.'

At the same time, this provision seems not to be in line with WTO rules, since it discriminates against domestic and foreign industry and does not seem to comply with the exception provided by GATT Article XI[25], which allows export restrictions only for temporary periods (a ten-year period does not appear to be in line with the 'temporary' provision referred to in that article).

A possible ban on metal scraps risks undermining the country's efforts to liberalise and may damage the EU steel industry.

Similar considerations may be expressed regarding the potential introduction of a ban on **export of metal scraps**, a vital raw material for the EU metal and steel industry. Ukraine cancelled this ban in 2006, under its WTO commitments, and substituted it with a system of export licences. Talks on its reintroduction are ongoing, on the request of the Ukrainian metal industry. In July 2015, the industry lodged a formal request with the Ministry of Economic Development, claiming that an acceptable volume of exports, which would not harm domestic consumers this year would be 500 000-600 000 tonnes, in contrast to the current ceiling of 1.25 million tonnes[26]. This request, reiterated at the end of October, is based on shortage considerations, in theory admitted by the WTO, and it is possible that the Ukrainian government will ask EU advice to help it shape a WTO-compatible measure. Such a measure risks affecting the EU metal and steel industry and causing heavier damage than the wood measure.

A safeguard applied by Ukraine to passenger cars was judged to be inconsistent with the WTO safeguard agreement in July 2015.

Another **trade irritant** worth mentioning is the **safeguard on passenger cars** applied by Ukraine in 2013. This measure was challenged in the WTO by Japan (the EU and the Russian Federation joined the consultations), and led to a panel decision, adopted on 20 July 2015. The panel report declared the measure unsubstantiated (sudden, sharp and significant increase of imports was not demonstrated, nor were serious injury and causal link), and recommended Ukraine to remove it[27]. The leading role played by Japan avoided the need for the European Commission to take a stronger stance against Ukraine in a dilemma opposing political solidarity and the economic interests of the EU car industry. Following pressure from the European Commission and a **visit by the European Parliament's Committee on International Trade**, the Interagency Commission on International Trade decided to lift the special measures regarding car imports to Ukraine, irrespective the country of origin and export, on 12 September 2015, following the WTO panel decision. The abolition of

Efforts of reform endangered by vested interests.

[25] For the exceptions, see art. XI GATT 1947, (which does not include developing a processing industry).
[26] See Ukraine considers ferrous scrap export restrictions, Recycling Today, 17 July 2015.
[27] See Ukraine — Definitive Safeguard Measures on Certain Passenger Cars, WTO, DS 468.

import duties on passenger cars took effect in October.

It is to be hoped that the above-mentioned measures relating to balance of payment stabilisation and export restrictions on wood will be removed and that export taxes will not be introduced on scrap metal. The removal of trade obstacles remains an important prerequisite for a genuine and ambitious liberalisation, as required by the Association Agreement.

In any case, **trade irritants are not hindering the ongoing efforts on economic reform** (see Annex I). While it is not easy to arrive at an unequivocal evaluation of the results, and vested interests have weakened many reforms, the effort to modernise the country is now undeniable.

Deeper concerns arise from the persistent confrontational climate between Russia and Ukraine. The conflict in Donbass seems close to termination, and the Minsk accords seem to have been respected in the last two months, especially following the agreement reached on 2 October2015 in Paris between France, Germany, Russia and Ukraine. Yet, the potential collapse of the trilateral negotiations on the implementation of the DCFTA, possibly to be followed by the suspension of CISFTA preferences, risks undermining 19 % of Ukrainian exports. Should this suspension be extended to the whole Eurasian Union, exports to Belarus and Kazakhstan risk being impaired as well, with a total loss of around 23 % of trade. A less confrontational attitude would be economically welcome, as it would also be for energy, working emigrants and the financial interests of Ukraine.

Annex I: Monitoring of Ukrainian reforms (October 2015)[28]

Sector	State of play	Comment
Politics and the judiciary		
Political sector	In February 2014 the Yanukovych-era system was replaced with a mixed parliamentary/presidential system that limits the powers of the presidency.	
	Presidential (May 2014) and parliamentary elections (October 2014) restored the legitimacy of the political order. A pro-reform coalition was formed in the Verkhovna Rada.	The coalition and alliance between President Poroshenko and PM Yatsenyuk are currently under strain; many observers believe it may not last, and early elections are likely.
Constitutional decentralisation reform	On 1 September the first votes on the amendments were passed. Following the revolts, the Parliament's final approval will be given at the end of the year, along with the evaluation of the respect of the truce, this time by a qualified majority (300 votes out of 450), which will be very difficult to attain.	Lack of mutual trust risks endangering the process. The constitutional amendments were not negotiated with the separatist government, as required by the Minsk agreement.
Local elections	On 14 July the Ukrainian authorities passed a law after many disagreements. On 2 October an agreement reached in Normandy provided for elections in the separatist-controlled area once OSCE standards are met.	The law is likely to favour big parties and could prevent candidates from smaller parties from being elected. Local elections were held on 25 October 2015 in Ukraine (with the exception of certain areas). OSCE-ODIHR will publish a report on the election observation mission in November. In a press statement, the OSCE-ODIHR indicated that violations have been observed, but these were not systematic.
Anti-corruption laws	Judicial processes have been improved to introduce greater transparency and opportunities for public oversight of corruption cases.	
New law on the prosecutor's office	Approved in autumn 2014, amended in July 2015 to enable prosecutors to be more active in anti-corruption activities. Local prosecutors' offices are being reformed; all local-level prosecutors and deputies are being dismissed. Kyiv's general prosecutor's	

[28] Based on Carnegie Endowment for International Peace and open sources.

	office is in charge of replacing them.	
The National Anti-Corruption Bureau and the National Agency for Prevention of Corruption	The two organs have been established; the Bureau will fight corruption among high-ranking officials and will be in place by September 2015.	However, concerns are raised about efforts to manipulate the choice of the Bureau members. The Agency, a central government executive authority with a special status, started operations in April 2015.
Spoil system (civil service and judiciary)	The adopted legislation on lustration aims to exclude all civil servants linked with the previous government from public office. The lustration process was launched in the civil service and in the judiciary in 2014.	This law excludes all civil servants from public office regardless of whether they were involved in acts of corruption. For this reason it has been criticised by the Council of Europe’s Venice Commission. The law is under review in the Constitutional Court of Ukraine.
Judicial reform	A set of draft laws is yet to be approved by parliament. The reform was approved by the Council of Judges of Ukraine on 11 December 2014. These draft laws introduce changes regarding the selection, promotion, and prerogatives of judges, strengthening the independence of the judiciary, and providing citizens with faster and fairer access to the justice system.	
	Economics and energy	
Fiscal devolution	A reform package was introduced in December 2014. The reform removed several budgetary bottlenecks which had obstructed effective local delivery of services and economic development. It introduced two additional types of local taxes (a destination-based local excise and a property tax), creating revenue sources for local self-government.	The fiscal decentralisation reform introduced financial transfers for all decentralised functions except health, secondary education, and vocational education. The new system aims to partly equalise per capita revenue rather than expenditure needs.
Fiscal policy	In 2014, notable changes to the Tax and Budget Codes were made, which reduced the number of taxes and allowed for additional revenues for local budgets as part of the decentralisation process.	
Banking and the financial sector	The central bank aims to clean up the banking system: over 50 banks have been declared insolvent since the end of 2013, and transparency of the ownership structure is now prioritised. The World Bank allocated USD 500 million in September 2015 for restructuring the banking sector.	

Exchange rate	The Central Bank introduced a floating rate regime and liberalised the foreign exchange market.	This resulted in a 50 % devaluation of the hryvnia in early 2015. To prevent capital flight and further currency devaluation, the government was forced to introduce capital controls in late February.
Inflation targeting	In December 2014, the Monetary Policy Committee was created within the National Bank of Ukraine to formulate monetary policy.	
Independence of the central bank	In June 2015, two laws promoting independence of the central bank were approved by the parliament.	
Law on the natural gas market	In April 2015, a law on the natural gas market was adopted, aiming to harmonise Ukraine's legislation with the third EU energy package and ensuring non-discriminatory access for independent gas suppliers to the gas transportation system. Part of this law entered into force on 1 October 2015.	
Deregulation and improvement of the business climate	In April 2015, parliament adopted a law on investor protection and repealed a number of regulations.	
Public governance	A requirement to provide open data on the budget was introduced in April 2015.	
Privatisations	The Ministry of Economic Development and Trade is ready to launch an extensive privatisation plan.	Unless carefully shaped, this may lead to increased 'oligarchisation' of the economy, a very worrying aspect of the current policies.
Economic blockade	A draft law has been introduced in the parliament calling for an economic blockade of parts of Luhansk and Donetsk not controlled by the Ukrainian government.	This law is at odds with the Minsk II Agreement (Article 8), which requires the resumption of socio-economic ties, including pensions, health services and salary payments.
Media reform	In May 2014, a law on public broadcasting was adopted by parliament, aiming to transform the state broadcasting service into an independent public service.	Implementation of this law has been significantly delayed; various interest groups attempted to derail the process. Broadcasting remains largely controlled by the Ministry of Information Policy, which uses broadcasts for propaganda purposes.
	Security and defence	
National security and defence	A national security strategy was approved in May 2015, prioritising territorial integrity and a defence upgrade in response to key security	

	threats.	
NATO and Ukraine	At the September 2014 summit held in Wales, NATO and Ukraine signed a memorandum of agreement that will facilitate the implementation of a NATO-Ukraine Trust Fund established to help Ukraine reform its armed forces.	In the 2015 budget, military spending was increased to 2 percent of GDP, the standard NATO target. The US government has provided USD 75 million in non-lethal military assistance out of the USD 200 million allocations announced earlier in 2015.
National police	A new law on the national police has been adopted in April 2015, together with a package of laws improving the collection of traffic fines and reorganising traffic police registration centres (laws promulgated on 4 August 2015).	
Traffic police	A new traffic police service was launched in Kyiv in July 2015, to be followed by similar measures in Lviv, Kharkiv, Odessa, Dnipropetrovsk and Mykolaiv in the next four months. The project has been funded by the US (USD 15 million) and Canada (USD 5 million). Japan intends to participate.	The aim of reforming the traffic police is to curb corruption and traffic bribery.
Security service	The security service remains highly corrupt, as shown by the dismissal of the chief of the Security Service of Ukraine and his deputies in mid-June 2015 following allegations of corruption and contraband smuggling.	
National Guard	With a 2015 increase in funding, the Ukrainian National Guard has been building up its capabilities; increasing the number of units, modernising weaponry, and upgrading training programmes in line with US training standards and with assistance from US trainers.	
Volunteer battalions	The volunteer battalions are sparking great controversy; in June 2015 the Tornado battalion was disbanded amid allegations of involvement in smuggling and violent crime. The Aidar battalion was accused of committing abuses and violations of human rights.	

Annex II: Status of the ratification of the Association Agreement with Ukraine[29]

Main dates

Country	Negotiations (from/to)	Initialling	Signature	Provisional application	Ratification[2]	EP consent[3]
Ukraine	18 Feb 2008 – 19 Oct 2011	19 July 2012	27 June 2014	31 Dec 2015	16 Sep 2014[2]	16 Sep 2014

Ratification by EU Member States

Signatory	Date	Institution	Deposited
Austria	8 July 2015	National Council	6 August 2015
	24 July 2015	Federal Council	
	31 July 2015	Presidential assent	
Belgium	17 June-1 July 2015	Regional Chamber of Representatives	
		Royal assent	
Bulgaria	24 July 2014	National Assembly	9 September 2014
	28 July 2014	Presidential assent	
Croatia	12 December 2014	Parliament	24 March 2015
	18 December 2014	Presidential assent	
Cyprus	29 October 2015	House of Representatives	
		Presidential assent	
Czech Republic	10 December 2014	Senate	
	17 September 2015	Chamber of Deputies	
		Presidential assent	
Denmark	18 December 2014	Parliament	18 February 2015
Estonia	4 November 2014	Assembly	12 January 2015
	13 November 2014	Presidential assent	
EU	16 September 2014	European Parliament	
		Council of the EU	
Finland	10 March 2015	Parliament	6 May 2015
	24 April 2015	Presidential assent	
France	7 May 2015	Senate	10 August 2015
	25 June 2015	National Assembly	
	8 July 2015	Presidential assent	
Germany	8 May 2015	Bundesrat	22 July 2015
	26 March 2015	Bundestag	
	27 May 2015	Presidential assent	

[29] As of 4 November 2015.

Greece		Parliament	
		Presidential promulgation	
Hungary	25 November 2014	National Assembly	7 April 2015
	5 December 2014	Presidential assent	
Ireland	27 January 2015	House of Representatives	17 April 2015
Italy	10 September 2015	Senate	
	11 June 2015	Chamber of Deputies	
	29 September 2015	Presidential assent	
Latvia	14 July 2014	Parliament	31 July 2014
	18 July 2014	Presidential assent	
Lithuania	8 July 2014	Parliament	29 July 2014
	11 July 2014	Presidential assent	
Luxembourg	18 March 2015	Chamber of Deputies	12 May 2015
	12 April 2015	Grand Ducal promulgation	
Malta	21 August 2014	House of Representatives	29 August 2014
Netherlands	7 July 2015	Senate	Deposit suspended until referendum is voted
	7 April 2015	House of Representatives	
	8 July 2015	Royal promulgation	
	Next 6 April 2016	Expected referendum on the ratification	
Poland	4 December 2014	Senate	24 March 2015
	28 November 2014	Sejm	
	2 March 2015	Presidential assent	
Portugal	20 March 2015	National Assembly	13 May 2015
	23 April 2015	Presidential assent	
Romania	2 July 2014	Chamber of Deputies	14 July 2014
	3 July 2014	Senate	
	9 July 2014	Presidential assent	
Slovakia	24 September 2014	National Council	21 October 2014
	16 October 2014	Presidential assent	
Slovenia	13 May 2015	National Assembly	27 July 2015
	21 May 2015	Presidential assent	
Spain	15 April 2015	Senate	19 May 2015
	19 February 2015	Congress of Deputies	

		Royal assent	
Sweden	26 November 2014	Parliament	9 January 2015
Ukraine	16 September 2014	Verkhovna Rada	26 September 2014
	16 September 2014	Presidential assent	
UK	23 February 2015	House of Commons	8 April 2015
	9 March 2015	House of Lords	
	19 March 2015	Royal assent	

Annex III: Table on main data

People and geography			
Population	44.3 million	2014 estimate	
Capital city	Kyiv		
Other major cities	Kharkiv, Dnipropetrovsk, Odessa, Donetsk, Zaporizhia, Lviv, Kryvyi Rih, Mykolaiv		
Total land area	603 628 km^2		
Religions	Eastern Orthodoxy, Ukrainian Greek Catholic, Roman Catholic, Protestant, Islam, Jewish		
Ethnicity	Ukrainians Russians Belarusians Moldovans Crimean Tatars Bulgarians Hungarians Romanians Poles Jews Armenians Greeks Tatars	77.8 % 17.3 % 0.6 % 0.5 % 0.5 % 0.4 % 0.3 % 0.3 % 0.3 % 0.2 % 0.2 % 0.2 % 0.2 %	2001 census
Official language	Ukrainian		
Life expectancy at birth	76.2 (women) 66.3 (men)	2013	World Bank
Literacy rate	99.7 %	2012	World Bank

Rankings		
Name of index:	**Ranking:**	**Explanation and source:**
Human development index	'High' 83/ 187	United Nations Development Programme, Human Development Index (HDI) 2014.
Press freedom	129/ 180	Reporters Without Borders, Worldwide Press Freedom Index, 2015
Freedom in the World	'Partly free': political score: 3/7 civil score: 3/7	Freedom House, Freedom in the World, 2015. (1 represents the most free and 7 the least.)

Internal political

situation	
State structure	Republic
Head of State	President Petro POROSHENKO (since 7 June 2014)
Head of Government	Prime Minister Arseniy YATSENYUK (since 27 February 2014)
Majority parties	Popular Front, Bloc of Petro Poroshenko, Samopomich, Radical Party, Batkivshchyna
Main opposition parties	Opposition Bloc
Elections	Next parliamentary elections 2019, next presidential elections 2019; next local elections 2015 (autumn)
EU Delegation	Head of Delegation: Jan Tombinski

Annex IV: Main economic indicators

Currency	Hryvnia (€1 = 25.193 UAH)	4th May 2015				
GDP per capita	EUR 2 275*f*	2014				
Unemployment rate	9.2 %*f*	2014				
EU institutions' disbursement of ODA in 2013	around $370m					
EU Rank	1st	volume of aid in the country, 2013):				
World Bank 'doing business' ranking:	83					
Number of donors:	10-12 major donors, including IFIs and countries with significant bilateral development programmes					
Real GDP annual growth: %	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
	-15.1	4.1	5.4	0.2	0	-7.1*f*
Government debt : % of GDP	**2009**	**2010**	**2011**	**2012**	**2013**	
	NA	39.9	36.3	36.5	40.2	
Government deficit: % of GDP	**2009**	**2010**	**2011**	**2012**	**2013**	
	NA	-6.9	NA	NA	NA	