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**BALANCING IMBALANCES:
UKRAINE'S GEO-ECONOMIC POSITIONING IN
THE EAST EUROPEAN GREAT GAME**

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The Hurford Fellowships, administered by the Carnegie Endowment for International Peace, support the Euro-Atlantic Security Initiative (EASI) Next Generation Network in identifying young academics conducting innovative research on international security in the Euro-Atlantic area.

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(I) INTRODUCTION

This research paper argues that Ukraine, to move out of its current crisis, above all must focus on maximizing its position as a geo-economic entity in Eastern Europe. It is based on the presumption that Ukraine's most existential concern is not to choose between east and west but to facilitate a conducive economic landscape at both the international and domestic levels. It is in the field of state reform and economics, not military balancing, in which Ukraine, with its international supporters, enjoys a relative advantage. The political circumstances call upon Ukraine to smooth its geo-economic transition, which otherwise fuels the growing division between Europe and Eurasia; and simultaneously to apply a national reform strategy that could fill the economic vacuum and remove it as a source of instability.

First, the research paper explores the feasibility for Ukraine, in implementing association with the EU as template for reform and development, to define a working relationship with the Russia-led Eurasian Union. 'Balancing imbalances' refers not only to Ukraine's geo-economic transition to the EU but also to the management of Ukraine's own regional imbalances. Second, the paper seeks to identify Ukraine's most urgent needs to secure an overall improvement of its business climate that would allow the country to start generating economic growth on its own. The paper traces economic opportunity or uncertainty as it frames the politics of the Ukraine crisis. Findings are based on existing research, analytical findings, and my personal interviews carried out with representatives of government, the business community, and think tanks in Kyiv.¹

(II) ORIGINS OF THE CRISIS

The Ukraine crisis originated in the country's inability to sustain itself, leaving it in an uncomfortable situation dependent on external support – with the tough decision dilemmas this posed for Kyiv's leadership when faced with having to choose either Europe or Russia. This calls for an understanding of the crisis as economic opportunity within a framework of geopolitical permissiveness.

Ukraine as an Underperforming State

¹ References to interviews are indicated throughout the paper under anonymity. I am grateful to these people for the time they have taken to answer my questions during my visit to Kyiv in October 2014. I am grateful as well to the World Economic Forum in Geneva for inputs and ideas during a visit in November 2014. I wish to thank the research community at the Harvard Kennedy School's Belfer Center for Science and International Affairs for great scholarly inspiration. I am grateful to the RAND Corporation, U.S. Department of State staff, and the Johns Hopkins University's School for Advanced International Studies for comments. A special thanks goes to the Carnegie staff and researchers.

Fragility and domestic mismanagement have continued to hamper Ukraine's economic development since independence. Despite possessing a skilled and educated workforce and important natural resources, the country has struggled to sustain economic growth. Corruption and institutional inefficiency remain major problems hampering the development of a responsive state, making it difficult or impossible for successive governments to implement reform. Ukraine's rulers have been a problem rather than a solution, using state structures to enrich themselves and their oligarchic allies.² Reforms have been subordinated to concerns of keeping or expanding incumbents' power base.

Ukraine in 1991 started from approximately the same level of development as Poland while possessing superior material resources; but today it is four times poorer. High commodity prices (steel, chemicals, and agricultural products) facilitated seven per cent growth rates during 2001-07 and led to huge inflows of foreign investments. However, favorable external demand did little to solve Ukraine's fundamental problems of domestic mismanagement and a poor investment climate. Ukraine's dependence on a few commodity-based exports caused its economy to crash when the global recession hit in 2009.³

Ukraine's failure to reform itself is a major source of its economic underperformance. In 2013, the Fund for Peace Research ranked Ukraine as 117th and listed the country in the 'warning' group on its Failed States Index.⁴ Of all indicators, Ukraine scores worst in corruption, according to Transparency International ranking the 114th of all countries in 2013.⁵ Political scientist Francis Fukuyama has categorized Ukraine not primarily as a failure of the political system to become or to remain democratic but as a failure to build institutions and to deliver the basic services that people demand from their government.⁶

A majority of the Ukrainian people looks to European markets and political systems as a desirable way of life. At the same time, Ukraine has benefited from underpriced commodities from Russia. Kyiv has traditionally balanced between Russia and the EU in what has been labeled a 'multi-vector' foreign policy attempting to ensure its independence and maximize domestic wealth. In that sense, the essence of the policy remained unchanged. Succeeding Ukrainian governments faced no crucial incentive to reform. Decisions requiring the political courage to incur the costs of restructuring the nation's economy to underpin its sovereignty and independence from outside subsidy have failed or their implementations were perpetually postponed.⁷

However, the balancing exercise became increasingly difficult and unsustainable for Kyiv as its room for maneuver between the EU and Russia narrowed. The EU in 2009 launched the Eastern Partnership to strengthen the eastern dimension of the existing European

² Kapitonenko, M., 2014. 'Ukraine: The Political Crisis', http://www.gmfus.org/wp-content/blogs.dir/1/files/mf/1404920650Inayeh_UkraineCrisisRegionalOutlook_Jun14_web.pdf.

³ World Bank, 2010. 'Country Economic Memorandum: Strategic Choices to Accelerate and Sustain Growth in Ukraine,' <https://openknowledge.worldbank.org/handle/10986/2905>.

⁴ 'The Failed State Index 2013', <http://ffp.statesindex.org/rankings-2013-sortable>.

⁵ 'Transparency International Corruption Perception Index', <http://www.transparency.org/cpi2013/results>

⁶ Fukuyama, F., 2011. 'The Origins of Political Order', New York: Farrar, Straus, and Giroux, pp. 5, 11.

⁷ Collins, J.F., 2014. 'Ukraine Isn't a West vs. East Super Bowl', <http://carnegieendowment.org/2014/02/24/ukraine-isn-t-west-vs-east-super-bowl/h1nf>.

Neighborhood Policy with the so-called Association Agreement (AA) as an instrument to promote EU standards and norms. Russia advanced Eurasian integration as an alternative to the European choice in 2010 by launching the Eurasian Customs Union, which in January 2015 led to the establishment of a Eurasian Economic Union (EEU). Pursuing a multi-vector course became difficult for Ukraine under such circumstances and it was instead forced to make a clear either-or choice to compensate for its domestic fragility.

The 2014 crisis can be seen as the dénouement of Ukraine's economic and state failure and the related dilemma of having to choose closer ties either with the EU or with Russia as the interaction between the two came to resemble a Great Game for Eastern Europe. President Yanukovich oversaw an increasingly corrupt and mismanaged country and was in need of a financial buffer to cover a declining state budget in the run up to the presidential elections originally due in early 2015. Yanukovich, during the fateful Vilnius Eastern Partnership summit in November 2013, refused to sign the Association Agreement with the EU, including the substantial Deep and Comprehensive Free Trade Agreement (DCFTA). Russia's President Putin offered Yanukovich a much-needed financial package (\$15 billion, of which only three billions were disbursed) as a reward for not signing the AA/DCFTA.

The details and circumstances of Yanukovich's deal with Russia to date remain unclear. However, from the time the Eurasian project was launched Russia had never left any doubt that it would like to see Ukraine join as a full member, and it was clear that Ukraine would be a critical demographic and economic addition to this project. Yanukovich's decision to officially suspend signing AA with the EU after many years of preparations ultimately proved fateful: he was ousted by the Euromaidan movement, which demanded domestic reform following a European template and a fundamental break with Ukraine's post-Soviet dysfunction. Ukraine's dependence on external subsidy has deepened under the post-Euromaidan government, however, given the country's deteriorating financial situation.

Any effort to contain the conflict in Ukraine must focus on economic solidity or volatility as a factor that plays into international stability or change. A self-sustaining Ukraine is less likely to emerge as a source of contention between Russia and the EU, just as a permissive or at least stable geo-economic environment is positively linked to domestic performance. Against the conflict's strong political economy backdrop, it is necessary to explore the application of instruments with the potential to unlock Ukraine's vicious circle of state failure and geo-economic exposure. This calls for the integration of two bodies of scholarship, 'geopolitics' and 'economic foresight', with their different visions of the origins of and the solution to the Ukraine crisis.

Between Economic Foresight and Geopolitics

From one perspective, development scholars and analysts have focused on Europeanization as a template to move Ukraine's economy beyond its post-Soviet dysfunction. Ukraine's commitment to adopt the existing and future EU *acquis* in key sectors allows it an unprecedented level of integration. Ukrainian firms are granted access to the EU internal market and investors will enjoy the same regulatory environment in Ukraine as in the EU. DCFTA is more than a classical free trade agreement in that it not only removes import tariffs but also involves regulatory reform and opening up service sectors. Provided that Ukraine

meets certain conditions, Ukrainian exporters will no longer have to pass tests with EU agencies and bodies but with the domestic authorities. European and global markets will perceive the accreditation of EU quality standards to Ukrainian goods as a sign of trust, conducive to both to exports and the inflow of foreign direct investment.

Development scholars agree that Ukraine's adoption of DCFTA with the EU is good news insofar as its implementation, provided genuine political will and support among stakeholders nourishes expectations towards sustained domestic reform. This pertains to the quality of Ukraine's economic governance (business, investment climate) and the gradual building of responsive state institutions (accountability, efficiency). Ukraine's alignment with European standards covering investment protection, public procurement, and competition policy will contribute to tackling the country's widespread corruption problems and improve the country's dire business conditions.⁸ It has even been argued that Ukraine will be on a path to Europeanization modeled on the development that Central Europe underwent in the 1990s, albeit without, as yet, an explicit membership prospect.⁹

From another perspective, it is impossible to ignore the geopolitical contest that is playing out centered on Ukraine. For realist theorists of international politics, Ukraine is a confirmation of the rule that a declining power, when vital interests are at stake, will take destiny in its own hands to preserve the status quo or go on the counteroffensive. Russia reacted militarily to an erosion of its regional influence. Because of Ukraine's geographic proximity, size, and historical importance, Russia has pursued a strategy intended, at a minimum, to keep Ukraine in geostrategic limbo as a neutral buffer state between east and west or, ideally, link the country to its sphere of Eurasian integration.¹⁰

By the same (realist) logic, the EU and the United States actively encouraged Ukraine's westward slide through political and financial support because of a perceived interest in pro-European reform in the country. As the interest of most western states in Ukraine and the preservation of its sovereignty, even as a matter of principle for European security, has been rather peripheral, however, they have shown unwilling to risk a military confrontation with

⁸ Dreyer, I., 2012. 'Trade Policy in the EU's Neighbourhood. Ways Forward for the Deep and Comprehensive Free Trade Agreements', http://www.note-europe.eu/media/i.dreyer_tradepolicyineighbourhood_ne_may2012.pdf?pdf=ok; Inayeh, I., Schwarzer, D., and Forbrig, J. (eds.), 2014. 'Regional Repercussions of the Ukraine Crisis. Challenges for the Six Eastern Partnership Countries' http://www.gmfus.org/wp-content/blogs.dir/1/files/mf/1404920650Inayeh_UkraineCrisisRegionalOutlook_Jun14_web.pdf; Manoli, P., 2013. 'Political Economy aspects of Deep and Comprehensive Free Trade Agreements', *Eastern Journal of European Studies*, vol. 4 (2), pp. 51-73; Shumylo-Tapiola, O., 2012. 'Ukraine at the Crossroads: Between the EU DCFTA and Customs Union', http://carnegieendowment.org/files/Ukraine_at_the_Crossroads-Between_the_EU_DCFTA_Customs_Union.pdf.

⁹ Åslund, A., 2014. 'What will happen to Russian-Ukrainian trade after the war in Donbass', *KyivPost*, October 3, <http://www.kyivpost.com/opinion/op-ed/anders-aslund-what-will-happen-to-russian-ukrainian-trade-after-the-war-in-donbass-366864.html>; Åslund, A., 2013, 'Ukraine's Choice: European Association Agreement or Eurasian Union?', <http://www.iie.com/publications/pb/pb13-22.pdf>.

¹⁰ Allison, G. and Simes, D.K., 2015. 'Russia and America: Stumbling to War', <http://nationalinterest.org/feature/russia-america-stumbling-war-12662>; Kissinger, H., 2014. 'How the Ukraine Crisis Ends', *Washington Post*, March 5; Mearsheimer, J.J., 2014. 'Why the Ukraine Crisis Is the West's Fault', *Foreign Affairs*, vol. 93 (5), pp. 1-12; Walt, S., 2014. 'Would You Die for That Country?', *Foreign Policy*, March 24, <http://foreignpolicy.com/2014/03/24/would-you-die-for-that-country/>.

Russia. Certain commentators argue that the EU has made itself a de facto guarantor of Ukraine's political success against Russia's declared intentions – but that this is unlikely to last due to the asymmetry in the willingness to commit power resources.¹¹

Ukraine has testified how resources of a magnitude that was hardly imaginable before the crisis can suddenly be mobilized in support of a re-awakening of geopolitical interest. Russia annexed Crimea and transformed the Donbas region into a new (frozen) conflict similar to Transnistria and Abkhazia/South Ossetia. It has resorted to trade sanctions (no official embargoes and quotas but tighter customs procedures and sanitary requirements) intended to dissuade Ukraine from its European choice. Brussels pledged loans and grants to Ukraine that it was unwilling to commit just some months earlier because it quickly found itself in the position of being a party to a conflict in whose positive outcome it had already invested a significant amount of money and prestige.

Either scholarship separately fail to adequately comprehend the dynamics of the Ukraine crisis. Ukraine must be seen as more than a mere pawn in a great power game whose outcome is determined by either side's willingness to commit resources to the success or failure of the Ukrainian state-building project. Ukraine has independent room for maneuver as a country, and its ability or inability to achieve economic robustness must be counted into the equation. Conversely, over-confidence in the implementation of European standards and norms to overcome its post-Soviet dysfunction fails to apprehend the degree to which Ukraine's reform capacity is dependent on its ability to perform geo-economic balancing. The 2014-15 events have certainly underlined Ukraine's vulnerability to Russia and its Eurasianist ambitions.

Both scholars and policymakers need to address the mercantilist character of the crisis, i.e. the link between the national interest and opportunities, challenges, or uncertainty to economic growth that stem from the conclusion of international trade agreements. Emerging scholarship acknowledges that the conflict is rooted in geo-economic rather than ideological or strict balance-of-power principles.¹² The EU with the extension of AA/DCFTA and a possible change in mindset in Russia to the EU has become a highly politicized actor in East European politics, perhaps comparable to the controversy surrounding NATO and the Membership Action Plan in 2008. The politicization of economic affiliations cannot be ignored as a factor in the promotion of international stability.

¹¹ Techau, J., 2014. 'Why the EU Will Fail as Ukraine's Guarantor', <http://carnegieeurope.eu/strategieurope/?fa=56631>; Charap, S. and Mylovanov, T., 2015. 'For Ukraine, Weakness Could Be Its Greatest Strength', <http://nationalinterest.org/feature/ukraine-weakness-could-be-its-greatest-strength-12073>.

¹² Larsen, H.B.L., 2014. 'Great Power Politics and the Ukrainian Crisis: NATO, EU and Russia after 2014', http://www.diiis.dk/files/media/publications/import/rp182014_lindboe_nato_forweb.pdf; Lehne, S., 2014. 'Time to Reset the European Neighborhood Policy', http://carnegieendowment.org/files/time_reset_enp.pdf; Nitoiu, C., 2014. 'EU–Russia relations: Between conflict and cooperation', *International Politics*, vol. 51, pp. 234–253; Trenin, D., 2014. 'The Ukrainian Crisis and the Resumption of Great-Power Rivalry', http://carnegieendowment.org/files/ukraine_great_power_rivalry2014.pdf.

Convergence with the *acquis* means a shift away from ties Ukraine has with Moscow,¹³ adding to Russia's steady decline as a trade partner since the 1990s.¹⁴ DCFTA, due to its 'deep' and 'comprehensive' nature further isolates Russia from a region in which it has significant capital interests and exports. In terms of investment, which shapes future economic structure, both Russia and Ukraine are oriented towards the EU rather than towards one another between them.¹⁵ The EU's own trade interest in Ukraine (and the Eastern neighborhood at large) remains very low at current levels – at 1.1 per cent of the EU's overall trade with the external world.¹⁶ Some (especially eastern) EU member states have been explicit about the positive geopolitical impact of increased economic interaction with Ukraine.¹⁷

In sum, policy going forward must reconcile the economic development expectation facilitated by the implementation of DCFTA with the need for geo-economic permissiveness or stability. This calls for the exploration of two corresponding principles. First, it is necessary to understand the basis for Ukraine's harmonization with both economic integration schemes, DCFTA and EEU, given its almost equal, though asymmetric, dependence on both markets distributed variably across its regions.¹⁸ Second, it is necessary to uncover a set of clear priorities to improve the business/investment environment that would help building domestic solidity and attenuate the effect of Ukraine's position as a periphery state.

(III) WALKING THE GEO-ECONOMIC FINE LINE

The analysis starts with the geo-economic costs and benefits that Kyiv faces in navigating between European integration and Russian constraints – both as an 'objective' measure and as perceived by government officials, business representatives, and think tank researchers. This provides a basis for exploring viable options for maximizing practical cooperation with EEU, given the strong political sensitivity connected to this issue, and assessing the sustainability of diversion of trade away from Russia, given Ukraine's regional imbalances.

Navigating Europe and Russia

Ukraine sees the expected benefits of a transformation of its economy as by far outweighing the costs. Its integration into European value chains drives its production and export growth and, moreover, is expected to create new and deepen existing market ties. The many sectoral chapters of AA, including DCFTA, imply a drastic shift towards the EU's *acquis*.¹⁹ Ukraine's

¹³ Delcour, L. and Kostanyan, H., 2014. 'Towards a Fragmented Neighbourhood: Policies of the EU and Russia and their consequences for the area that lies in between', p. 3, <http://www.ceps.eu/book/towards-fragmented-neighborhood-policies-eu-and-russia-and-their-consequences-area-lies-between>.

¹⁴ Manoli, *op.cit.*, p. 59.

¹⁵ Razumkov Center, 2012. 'EU-Ukraine-Russia relations: problems and prospects', pp. 22-26, http://razumkov.org.ua/eng/files/category_journal/NSD_133-134_eng.pdf,

¹⁶ European Commission, 'European Union, Trade in goods with Ukraine', p. 2, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113459.pdf.

¹⁷ *Associated Press*, 2011. 'Poland sees EU path for democratic states in East', <https://trove.com/me/content/fd1PA>; *EUobserver*, 2014. 'Centre-right leaders give Ukraine hope of EU membership', <http://euobserver.com/foreign/123396>. Manoli, *op.cit.*, p. 70.

¹⁸ Dragneva, R. and Wolczuk, K., 2012. 'Russia, the Eurasian customs union and the EU: Cooperation, stagnation or rivalry?', p. 14, <http://www.chathamhouse.org/publications/papers/view/185165>.

¹⁹ Delcour and Kostanyan, *op.cit.*

integration into the EU's internal market requires regulatory convergence, which comes at costs to be borne by state authorities as well as businesses.²⁰ Cost and benefits are spread out over the years but with cost concentrated in the short run and expected benefits concentrated in the long run (increased trade, investment, and competitiveness).²¹ The business community says, on the other hand, that legal adoption of DCFTA at present represents little more than mere positive signaling for investors because of the country's volatile situation.²²

The political salience of Ukraine's European choice is highlighted by the fact that there exists no reliable estimate of the overall or sectoral costs connected to legal and regulatory convergence with DCFTA. The experiences of the former candidate countries in Central and Eastern Europe only serve as partial examples.²³ President Poroshenko's 'Ukraine 2020 Strategy' from an early stage stated EU membership as an end goal (though the means remain vague/unrealistic). The Coalition Agreement in late November 2014 listed economic reforms restricting the regulatory function of the state and introducing solutions from DCFTA in various sectors of the economy.²⁴ The Government Action Program of December 2014 uses the AA/DCFTA as guidance for reform.²⁵

The unequivocal message from Kyiv, conversely, is that it does not seek membership in the EEU because it is a customs union in which it would lose the sovereign competency to conclude free trade agreements with third countries.²⁶ A customs union is described as a marriage (with only one partner), because its protectionist character forces Ukraine to raise tariffs in many fields, while free trade agreements are like friendships (where many are possible).²⁷ According to business community and think tank representatives, moreover, Russia does not represent a positive model for economic development.²⁸ Most foreign institutions, with the notable exception of the Eurasian Development Bank²⁹, estimate that Ukraine will benefit economically from DCFTA more than from EEU, in part because the EU market is approximately ten times bigger, in part due to the expected inflow of foreign direct investment and economic modernization.³⁰

²⁰ Wolczuk, K., 2014. 'Ukraine and the EU: turning the Association Agreement into a success story', p. http://www.epc.eu/documents/uploads/pub_4360_ukraine_and_the_eu.pdf.

²¹ Interview with think tank researcher: for instance, trade barriers to trade (TBT) are easier and quicker to remove than sanitary and phyto-sanitary (SPS) measures, which require the establishment of laboratories – in DCFTA, SPS is the only chapter without a fixed timeline for that same reason.

²² Interview with think tank researcher and business representative.

²³ Wolczuk, *op.cit.*; interview with think tank researcher: it is close to impossible to make such estimations due to unforeseen circumstances.

²⁴ Olszanki, T., 2014. 'The Ukrainian coalition agreement', <http://www.osw.waw.pl/en/publikacje/analyses/2014-11-26/ukrainian-coalition-agreement>.

²⁵ Government Portal, 2014. 'Action Program of the Cabinet of Ministers of Ukraine', http://www.kmu.gov.ua/control/publish/article?art_id=247816166.

²⁶ Interview with official.

²⁷ Interview with think tank researcher.

²⁸ Interview with business official and think tank researcher.

²⁹ Ivanter, V. et al., 2012. 'The Economic Effects of the Creation of the Single Economic Space and Potential Accession of Ukraine', in *Eurasian Integration Yearbook 2012*. Almaty, Kazakhstan: Eurasian Development Bank.

³⁰ Åslund, *op.cit.*

Kyiv faces a Russian government that has used trade sanctions or threatened to do so if DCFTA is implemented. Moscow mounted a series of punitive trade measures against selected Ukrainian products in the run-up to the Vilnius Summit in November 2013 (calling AA a ‘suicidal step’) and it intensified these measures after Poroshenko signed AA in June 2014.³¹ Russia threatens to suspend the existing CIS Free Trade Agreement (CISFTA) with Ukraine and impose non-tariff barriers if DCFTA enters into force without ‘properly’ addressing Russian concerns.

According to leaked information, Russia has called for guarantees of the openness of the Ukrainian market, the removal of more than 2,000 positions of tariff-free EU exports to the Ukrainian market, and the simultaneous application of both CISFTA and DCFTA regulations.³² Estimates say that a complete Russian suspension of CISFTA and a return to the ‘most favored nation’ regime along WTO lines would result in an immediate \$3 billion reduction in exports, corresponding to 17 percent of Ukraine’s total exports to Russia and 1.7 percent of its GDP.³³ This study was done at a time when Ukrainian exports to Russia were at 24 per cent (slightly below the number going to the EU, at 25 per cent), whereas this number now conflicted has decreased to ten per cent. On the other hand, the traditional geographic dichotomy of exports between the EU and the EEU will represent the major challenge for the post-conflict trade reorientation.³⁴

Ukraine’s economic vulnerability is highlighted by the fact that exports are highly dependent on Russian markets, especially value-added goods and services that tend to provide not only more jobs but also higher-paying ones. Exports to Russia include machinery, transport equipment (locomotives), helicopter engines – in contrast to exports to Europe, which consist mostly of cereals and steel and iron.³⁵ Moreover, key agricultural, especially dairy, products are caught between two trade regimes because producers have to meet the tough EU requirements in food safety and for many years to come will rely on access to the Russian/Eurasian market. Certain agricultural exports are duty free but only up to certain quotas.³⁶ A reorientation of these linkages, many of which are in uncompetitive sectors remaining from the Soviet period, to other markets is both difficult and costly.³⁷

The Russia factor is a significant additional cost to Europeanization. However, Ukrainian officials and business representatives warn against fearing Russia’s trade sanctions because the

³¹ Cenusa, D. et al., 2014. ‘Russia’s Punitive Trade Policy Measures towards Ukraine, Moldova and Georgia’, p. 3, <http://www.ceps.eu/book/russia%E2%80%99s-punitive-trade-policy-measures-towards-ukraine-moldova-and-georgia>; Manoli, *op.cit.*, p. 67.

³² Zn.ua – see http://zn.ua/static/file/russian_proposal.pdf.

³³ Annual losses for Ukraine are estimated at \$33 billion and the cumulated overall losses at \$100 billion – see Adarov, A. et al., 2015. ‘How to Stabilise the Economy of Ukraine’, p. 44, <http://wiiw.ac.at/files/news/how-to-stabilise-the-economy-of-ukraine-n-83.pdf>; Ryzenkov et al., 2013. ‘Impact assessment of a possible change in Russia’s trade regime vis-à-vis Ukraine’, http://www.ier.com.ua/files/publications/Policy_Briefing_Series/2013/PB_04_2013_en.pdf.

³⁴ Adarov, *op.cit.*, pp. 32-36.

³⁵ Kapitonenko, M., 2014. ‘Will Elections Make Ukraine Stronger?’, <http://www.gmfus.org/archives/will-elections-make-ukraine-stronger>; Charap, 2015, *op.cit.*

³⁶ Guitton, J., 2015. ‘What Can Ukraine Expect from the Forthcoming Trade Agreement with the EU’, <http://voxukraine.org/2015/07/01/what-can-ukraine-expect-from-the-forthcoming-trade-agreement-with-the-eu/>.

³⁷ Adarov, A. et al., *op.cit.*, pp. 37-39.

temptation to accommodate Russian demands would prove fatal in the long run. The above-mentioned numbers deserve comparison with the destruction of industry in or de facto loss of great parts of the Donbas region, which before the conflict accounted for 16 per cent of Ukraine's GDP, 25 per cent of its industrial output, and 27 per cent of its exports. Crimea accounted for three per cent of its GDP before Russia annexed it.³⁸ The effect of Russia's punitive actions, economic sanctions and the deteriorated image caused by its military interference, combined with the EU's unilateral opening of its markets to Ukrainian goods instead pushes exports towards the EU. Trade with the EU rose by 14.9 per cent in the first half of 2014 compared to a year earlier, while trade with Russia declined by 23 per cent.³⁹

On the other hand, it should be clear that Ukraine would not be able to compensate for all of its vulnerabilities to Russia in terms of loss of trade ties by relying on the EU or other markets. Import of natural gas from Russia represents a separate category of Ukrainian dependence both as a critical input to Ukraine's economic output and as a matter of fiscal stability related to transit revenues and price levels.⁴⁰ This remains the case despite the significant reduction of the Russian share of gas imports in the winter of 2015 compared to the winter of 2014. Russia, surprisingly, has not (yet) used the energy weapons in any really painful way as part of its current confrontation against Ukraine.⁴¹

Regarding exports to Russia and Eurasia, estimates indicate that only 15 percent of Ukraine's major exports could be relocated.⁴² There is a sound economic rationale for mitigating an abrupt and clear-cut choice between Russia and the EU, as Ukraine's relatively technology-intensive production linked to Eurasia is exposed to significant risk in the case of one-sided EU integration. The paradoxical reality is that Ukraine's achievement of resilience relies on continued economic interaction with the very country it wants to build resilience against. At the same time, Ukraine needs ties to the EU and the West for real economic modernization.⁴³ While Ukraine cannot counterbalance all of its vulnerabilities to Russia by relying on the EU, its own financial and economic imbalances are so numerous that it cannot manage the challenge alone either.⁴⁴

The decision (on September 12, 2014) to postpone the entry into force of DCFTA until 2016 instead of as originally scheduled in November 2014 is a case in point testifying to Kyiv's dilemma about an either/or choice between east and west. The Ukrainian government initially

³⁸ Interview with business representatives and official.

³⁹ Cenuša, *op.cit.*, p. 3. Moreover, the share of export to the EU rose to 33.1 per cent of total exports from 27.3 per cent the year before, while the share of exports to Russia dropped to 19.9 from 24.7 per cent in 2013.

⁴⁰ Roughly fifty per cent of Ukraine's economic output is based on major gas-consuming industries (metallurgy, chemicals, and power generation). Gas is also a matter of fiscal stability, not only due to the price level that can be agreed with Russia but also due to the transit fees that Ukraine receives from Gazprom (approximately \$3.1 billion in 2013). Russia's plan to build a 'Turkish Stream' bypassing Ukraine alternative to the abandoned 'South Stream' is likely to reduce Ukraine's important transit revenue – see: Pirani, S. et al., 2014. 'What the Ukraine crisis means for gas markets', p. 12, <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/03/What-the-Ukraine-crisis-means-for-gas-markets-GPC-3.pdf>.

⁴¹ Techau, J., 2015. 'The Economic Great Game for Peace in Eastern Europe', <http://carnegieeurope.eu/strategieurope/?fa=60463>

⁴² Heyets, V.M. and Shinkaruk, L.V., 2014. 'Ukraine's Integration Options: Perspectives and Consequences', Kyiv, Ukraine: Institute of Economics and Forecasting, Academy of Sciences.

⁴³ Techau, *op.cit.*

⁴⁴ Interview with business representative and official.

voiced unwillingness to concede on DCFTA because allowing Moscow a say obviously would risk undermining the substance of the agreement.⁴⁵ According to Ukrainian officials, the initiative to postpone DCFTA came from Brussels but, as things turned out, the decision came as a relief due to the high short-term cost the implementation of the agreement would have had on the Ukrainian economy, which anyway would see no influx of foreign investment or increased domestic investment with continued hostilities in the east.

Moreover, sectors currently protected from free competition have more time to adjust. Although the government in Kyiv was unhappy with what could be perceived as making concessions to Russia under intimidation, the DCFTA suspension gives more time to prepare for tariff liberalization and the adoption of EU regulations.⁴⁶ Ukraine benefits from exporting duty-free to the EU, whereas this does not yet apply to EU goods flowing into Ukraine. The intervening period until 2016 is expected to see continuing talks with Russia over the concerns about trade compatibility that Moscow has raised and which Brussels has agreed to discuss, namely on technical barriers, sanitary regulations, and administrative customs procedures.

It goes without saying that Ukraine would benefit most from open and stable, let alone deepened and expanded, trade relations with both sides. Geopolitical overtones make policy towards co-existence or integration between European and Eurasian integration a politically sensitive undertaking. Kyiv's challenge, however, is to be in a constant effort towards a model that maximizes the possibility of association with both economic units. Ukraine as the most important geographical and functional center must avoid being caught in 'wall-building' practices between European and Eurasian integration. This requires engagement with the incompatibilities or conflicting interests that the two schemes pose.

Managing Eurasian Integration

DCFTA as such does not hinder continued privileged trade with Russia and Eurasia. However, as stated even by the EU Trade Commissioner, any transition in production carries along with it some degree of protectionism in terms of rules and regulations that affect external actors wishing to continue trade with this country. This applies also to the case of Ukraine and DCFTA.⁴⁷ Third-country trading partners have to adjust their standards to the reformed domestic regime. European standards are among the toughest in the world and are highly protective of consumers. Contrary to the producer-based Soviet industrial legacy, the EU internal market is based on the philosophy that consumerism is a driver of modernization.⁴⁸

Russian objections to DCFTA have ranged from confrontation against a 'doorknob' to NATO membership, to the negative impact on trade, investment, and economic growth in Russia and Eurasia, to uncertainty about the practical compatibility with the existing CISFTA. Critics argue that incompatibility concerns, including Russia's objections about intermediate goods (shifts from 'made in the EU' into 'made in Ukraine'), can be identified and managed on the

⁴⁵ Charap, S., 2014. 'The Ukraine Impasse', *Survival*, vol. 56 (5), p. 231-32.

⁴⁶ Interview with official; Cenusa et al., *op.cit.*;

⁴⁷ EU Trade Commissioner Karel de Gucht, seminar at Harvard University, John F. Kennedy School of Government, 'Trade and Geopolitics: TTIP, Ukraine and beyond', September 11, 2014. De Gucht added that trade has become an important geostrategic tool, probably more important than war.

⁴⁸ Interview with think tank researcher and official.

basis of existing WTO practices ('rules of origin') and political goodwill.⁴⁹ Others argue that technical trade barriers and sanitary regulations are matters for constructive discussion, if the overall political context is sufficiently conducive.⁵⁰ Part of the consumer-orientation is a focus on combating corruption in imports, e.g. by requiring a trail of documents of the origins of all goods and their component materials.

Business representatives indicate that Ukraine should be ready at all times to discuss standards and address the protectionist implications that arise from harmonization with EU legislation and requirements on an individual basis.⁵¹ On the other hand, such consultations must take place on the basis of the clear message that the substance of DCFTA cannot be changed. Kyiv must stick to the principle that AA/DCFTA is a bilateral agreement with Brussels and that, although postponed, the substance of the agreement will not be changed in accordance with Moscow's wish to reopen negotiations and obtain legally binding formulas. Constructive discussions on issues of incompatibility between integration schemes are pertinent for a managed transition they but must not give Russia legitimacy to slow down Ukraine's domestic reforms or obtain compensation for the loss of market shares; but should be based on actual data regarding the effect of both trade arrangements.⁵²

Ukrainian business and government representatives in particular express concern about the arbitrary application of CISFTA (article 18 and annex 6), which entitles the EEU, if subject to 'damage' from imports from another CIS state belonging to another regional trade agreement, to agree to cancel the tariff-free preferences with this state. In practice, this would mean reversion to a 'most favored nation' regime.⁵³ It is therefore necessary that Ukraine keep discussions linked not to the whole of DCFTA but to individual, valid concerns.⁵⁴ The issue of intermediate goods should be addressed following WTO practice. Barriers to trade stemming from Ukraine's adoption of EU technical standards and sanitary regulations replacing existing CISFTA standards ('GOST') need a temporary solution of mutual recognition within Ukraine's jurisdiction. A transparent dialogue and dispute resolution mechanism to forestall situations stemming from Ukraine's legislative harmonization with the EU could be established.⁵⁵ Ukraine at all times should be ready to engage in technical incompatibility issues and reaffirm its willingness to carry out free trade with EEU.⁵⁶

⁴⁹ Aleksashenko, S., 2014. 'For Ukraine, Moldova, and Georgia Free Trade with Europe and Russia Is Possible', <http://carnegie.ru/eurasiaoutlook/?fa=56074&reloadFlag=1>; Emerson, M., 2014. 'Russia's economic interests and the EU's DCFTA with Ukraine', <http://www.ceps.be/content/russia%E2%80%99s-economic-interests-and-eu%E2%80%99s-dcfta-ukraine>; Kremlin, 2014. 'Speech at the meeting of the Customs Union Heads of State with President of Ukraine and European Union representatives', <http://eng.kremlin.ru/transcripts/22851>; Popescu, N., 2014. 'EU's Neighbourhood Policy after Ukraine', <http://blogs.euobserver.com/popescu/>; Emerson, M., 2014. 'Trade policy issues in the wider Europe – that led to war and not yet to peace', p. 5, http://aei.pitt.edu/52717/1/WD398_ME_Trade_Policy_in_Wider_Europe_1.pdf.

⁵⁰ Cenusa et al., *op.cit.*, p. 4.

⁵¹ Interview with business representative.

⁵² Interview with official and business representative.

⁵³ Movchan, V. and Giucci, R., 2012. 'Changes in Russian trade regime and their implications for Ukraine', pp. 7-8, http://www.beratergruppe-ukraine.de/download/Beraterpapiere/2012/PP_03_2012_en.pdf.

⁵⁴ Interview with official.

⁵⁵ Adarov, A. et al., *op.cit.*, pp. 46-51.

⁵⁶ Interview with business representative.

Trilateral consultations among Brussels, Kyiv, and Moscow on the economic effects of DCFTA were put in place only in connection with the Vilnius Summit in November 2013, when they began at the technical level. Having previously been opposed to third country consultation in bilateral agreements, the EU Commission claimed it had ‘refined its thinking’.⁵⁷ The first ministerial meeting took place in June 2014. These consultations are more far-reaching than the formulas that Ukraine previously pursued (2011-13) for a compromise allowing the development of trade ties with EEU (first, liberalization of trade in goods, then trade in services and regulatory harmonization). The substance of the new consultations, according to the Ukrainian government, does not only include continuing talks over Russia’s before-mentioned trade concerns but also aim to develop bilateral Ukrainian-Russian legal instruments with the involvement of EU experts in consultations where necessary.⁵⁸

Russia’s adoption of EU and international standards in the process both of creating EEU and accessing the WTO has improved harmonization of trade regimes. From a technical perspective, these steps reduce incompatibility issues between Ukraine’s convergence with EU legislation and standards and rules established within the EEU regime.⁵⁹ The Ukrainian government says that it considers the trilateral consultative process, if it can deliver results, to be a nucleus for a more inclusive, multilateral dialogue leading to the establishment of a common economic area (similar to the ‘Lisbon to Vladivostok’ formula). With participation of the EU, Eastern Partnership states, Russia, and other EEU member states, this dialogue would be based on principles of mutual reduction of tariff duties, non-application of unilateral trade restrictions, and mutual recognition of technical standards, sanitary measures, and enhanced administrative customs cooperation.⁶⁰ This is simultaneously a correct – but very remote – prospect.

In Kyiv’s political climate, discussions with Russia are complicated by the history of long negotiations of DCFTA, the annexation of Crimea, and the blood spilled in the Donbas. However, the essence of the conflict is that Kyiv needs constructive discussions for the simple reason that it is vulnerable not only to sanctions but also Russian-supported separatism, financial claims, and energy supplies. Moscow, conversely, prefers a negotiated settlement to confrontation with Kyiv but it does not strictly need it.⁶¹ There is not only an economic but also a political rationale to working to solve or mitigate incompatibility on a trilateral basis under favorable circumstances.

Although EEU is correctly described as a Russian geopolitical project to be achieved by economic means,⁶² its multilateral composition may be exploited as opposed to having to deal with Russia alone. Both Kazakhstan and Belarus joined quite voluntarily, motivated by the desire to be economically linked with Russia; Armenia and Kyrgyzstan’s decisions were driven

⁵⁷ *Euractiv*, 2013. ‘EU ‘refines its thinking’ on its Ukraine-Russia relations’, <http://www.euractiv.com/europes-east/eu-refines-thinking-eu-ukraine-r-news-531992>.

⁵⁸ Interview with official.

⁵⁹ Dragneva and Wolczuk, *op.cit.*, pp. 7, 14-15.

⁶⁰ Interview with official.

⁶¹ Charap, S., 2015. ‘Why Ukraine must bargain for peace with Russia,’ <http://foreignpolicy.com/2014/11/26/why-ukraine-must-bargain-for-peace-with-russia/>.

⁶² Adomeit, H, 2012. ‘Putin’s Eurasian Union: Russia’s Integration Project and Policies on post-Soviet Space’, [http://www.khas.edu.tr/cms/cies/dosyalar/files/black_sea_04\(1\).pdf](http://www.khas.edu.tr/cms/cies/dosyalar/files/black_sea_04(1).pdf).

more by security benefits.⁶³ On a number of issues, EEU might be a more reasonable interlocutor than Russia because the smaller members are not driven by great power dreams or confrontation with Ukraine.⁶⁴ For instance, both Minsk and Astana said that they would not join Russia in activating punitive measures against Ukraine, leaving the question to Russia alone whether it would suspend CIS tariff preference⁶⁵ in flagrant breach of the principles of any serious customs union.⁶⁶

Ukrainian officials say that Russia acts on the basis of a Versailles-like great power complex.⁶⁷ Rapprochement with the Eurasian integration model is one way of trying to manage Russia's complex because it appeals to its ambition to act on the world stage as a center of a regional unit. Kyiv has an interest in working closely together with Brussels on this issue and in contributing to the EU getting more comfortable with working with EEU and developing a clearer relationship. Neither Kazakhstan nor Belarus is member of the WTO and Brussels cannot negotiate with a supranational regime it does not formally recognize. However, EEU has important practical sides and it has set course for deeper integration and further regulation with implications for external trade and investment in Eastern Europe.

Moscow secretly admires the EU as an integration model as shown by its ambition to replicate the European experience in Eurasia.⁶⁸ Rapprochement must be made contingent on Moscow relaxing its pressures against its neighbors, exploiting its urge to be recognized as an equal partner in a European economic space. Kyiv's diplomatic efforts should be invested in making Moscow understand that steps towards a deeper working relationship from Brussels will come only through a negotiated settlement about Ukraine, the strategically most important country bordering the two integration schemes. Steps towards political recognition should be saved for future leverage or a great bargain. Time for serious negotiations will come soon enough when DCFTA with Ukraine is scheduled to enter into force by 2016 at which time it will be seen whether Russia again threatens to use the trade weapon.

Thinking in a longer perspective, it is important to keep in mind that Russia is alone among the major powers in the world in not seeking to integrate economically with any major economic bloc. Russia's choice to restrict itself to EEU is only a marginal extension of its own economy. This should give rise to concern for the Russian economy. If Russia wants to break out of economic stagnation and its dependency on energy exports, there will be a time when it will want deeper integration into the global economy.

The Ukraine crisis has pushed Russia closer to a Eurasian identity and towards cultivating closer economic and security ties with Beijing. However, European enterprises are more likely to be the kind that Russian enterprises need for technology transfer and supply-chain linkages.

⁶³ Balci, B. and Kassimova, E., 2015. 'How Central Asian Republics Perceive the Emerging Eurasian Union', <http://carnegieendowment.org/2015/01/24/how-central-asian-republics-perceive-emerging-urasian-union>; Shumylo-Tapiola, O., 2012. 'The Eurasian Customs Union: Friend of Foe of the EU?', <http://carnegieeuropa.eu/publications/?fa=49548>.

⁶⁴ Popescu, N., 2014. 'Eurasian Union: the real, the imaginary and the likely', p. 21-22, http://www.iss.europa.eu/uploads/media/CP_132.pdf.

⁶⁵ Interview with business representative.

⁶⁶ Emerson, *op.cit.*, pp. 6-7.

⁶⁷ In reference to German revanchism that grew out of the First World War settlement – interview with official.

⁶⁸ Shumylo-Tapiola, *op.cit.*, p. 5.

For this reason, though Russia would likely never want a DCFTA-like arrangement, it might seek the reduction of technical trade barriers for key industrial sectors (modeled on the EU-South Korea free trade agreement).⁶⁹ Trilateral consultations may be seen as a platform or mechanism for sectoral windows of opportunity between Europe and Russia.

Diversification of Trade

The Ukrainian government and the business community in Kyiv say that the country would be less susceptible to trade sanctions or the threat thereof if trade were diversified away from Russia to other markets. They indicate that such contingency planning is a long process that must start now despite Russian threats of retaliatory steps.⁷⁰ Russia's coercive actions push Ukrainians away from the concept of Russian brotherhood and toward independent nationhood anchored in European values.⁷¹ The parliamentary elections in Ukraine in October 2014 compared to the previous elections in 2012 testified to a clear westward slide in the mentality of the Ukrainian people.

On the other hand, the encouragement of redirection of trade entails certain risks in a country that is increasingly polarized along ethno-linguistic lines as the conflict (whether frozen or open) drags on in the east. Ukraine walks a fine line not only at the international level but also in the struggle for national coherence where economic relations and conditionality have domestic repercussions. The next parliamentary and presidential elections are likely to express disappointment with the pace of reform and the country's economic situation. The challenge for the Ukrainian government is to manage the orientation towards European markets without fueling Ukraine's regional tensions through political instrumentalisation of the choice between east and west.⁷²

Russia remains an appealing market for Ukrainian businesses for at least three reasons: the competition and standards are lower compared to the EU market;⁷³ businesses have to deal with only one bureaucracy as opposed to various national administrations; and there is the advantage of a shared language and common cultural denominators.⁷⁴ Ukraine's eastern regions overall are more economically dependent on Russia than the rest of the country but the main problem is the absence of an export market substitute.⁷⁵

The separatist-controlled territory in Donetsk and Lugansk (Donbas) has seen a destruction of parts of its industrial capacity and transport infrastructure and a return to previous links with Ukraine proper is unlikely. However, the main industries in the eastern regions not controlled

⁶⁹ Emerson, *op.cit.*, pp. 11-12.

⁷⁰ Interview with official, business representative, and chamber of commerce representative.

⁷¹ Interview with official and think tank researcher.

⁷² Interview with business representative; Razumkov Centre, 2013. 'Ukraine's National Security through a Prism of Cooperation with International Organisations', p. 6, http://razumkov.org.ua/eng/files/category_journal/Zhrnl_6_2013_e_site.pdf. Notable instances include the governor of Dnepropetrovsk (proposal to confiscate separatist properties) as well the mayor of Kharkov, who was attempted assassinated.

⁷³ Interview with think tank.

⁷⁴ Interview with business representative.

⁷⁵ Ryzhenkov, M. et al., 2014. 'Ukrainian exports to Russia: Sector and regional exposure', http://www.ier.com.ua/en/publications/policy_briefing_series/?pid=4522; The Ukraine Week, 2014. 'Breaking Away From Eurasia', <http://ukrainianweek.com/Economics/115448>.

by separatists rely on their integration into Russian supply chains, even after partial disruption in trade as a consequence of the conflict, and cannot easily be cut off.⁷⁶ These are the regions of Dnepropetrovsk, Zaporizhzhya, Poltava, Sumy, Kharkov, and the government-controlled parts of Donetsk and Lugansk, whose industries consist of iron and steel, metals, heavy machinery, transport equipment, railways, and aircraft. These are vulnerable to reorientation of trade because there has been no investment in diversified production facilities or transport infrastructure.⁷⁷

Integration into European supply chains and adoption of European standards, moreover, must be seen as more than technical processes. Not only are there social consequences of cutting trade ties eastward but also political costs of regulatory convergence with the EU in the southern and eastern parts of Ukraine. People here want to maintain economic and cultural ties with Russia and support of a ‘European choice’ is lower, though increasing (surveys indicate that only in the Donbas does a majority support EEU membership).⁷⁸ There is a political vacuum in the southern and eastern parts of Ukraine still controlled by Kyiv with little popular backing of either the government coalition or the successors of the Party of the Regions. Odessa and Kharkov stand out as divided regions and cities, showing that the eastern part of Ukraine is not uniform in its rejection of ‘Novorossiya’.⁷⁹

Ukraine’s situation differs from, e.g., Georgia, whose widespread support for integration with the EU puts it in a better position to reduce its economic reliance on Russia.⁸⁰ The issue touches the core of the ‘winner-take-all’ mentality characterizing Ukraine’s political culture since independence, calling instead for a managed transition addressing the concerns of sectoral interests linked to the country’s regional imbalances. The political vacuum in southeastern Ukraine is not replaced by pro-Russian sentiments but regional alienation.

According to the business community in Kyiv, there is a huge educational burden involved in businesses having to keep themselves informed about the complex set of rules and regulations that follow DCFTA and convergence with the comprehensive EU acquis.⁸¹ Negotiations over DCFTA have been highly technocratic, conducted in narrow official circles, with little effort by the Ukrainians to grasp or provide information about the burden for the state institutions themselves or businesses (let alone winning over the general public), despite the profound implications for all parties.⁸²

⁷⁶ Interview with business representative.

⁷⁷ Adarov, A. et al., *op.cit.*, pp. 67-68.

⁷⁸ Tyshchenko, Y., 2015. ‘The Ukrainian Crisis: between the Identity Policy and Confrontation to the ‘Russian World’’, pp. 2-4, <http://www.frstrategie.org/barreFRS/publications/notes/2015/201505.pdf>.

⁷⁹ Toal, G. & Loughlin, J., 2015. ‘What people in southeast Ukraine really think of Novorossiya’, <http://www.washingtonpost.com/blogs/monkey-cage/wp/2015/05/25/what-people-in-southeast-ukraine-really-think-of-novorossiya/>.

⁸⁰ Paradoxically so, especially after the facto loss of its breakaway republics – see Merabishvili, G., 2014. ‘Triangular Geopolitics in Europe’s Eastern Neighbourhood,’ http://aei.pitt.edu/57978/1/CEPS_Commentary_GM_Triangular_Geopolitics.pdf.

⁸¹ Interview with business official and think tank researcher.

⁸² Sherr, J., 2013. ‘Ukraine and Europe: Final Decision?’, http://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Russia%20and%20Eurasia/0713pp_sherr.pdf.

A national decision to embark on the path-breaking task of Europeanization imitating the successful convergence path of the Central and East European countries calls for a higher degree of public involvement in the implications of high-level agreements. Public apathy or even cynicism as to the ability to effect reform at the central level is widespread in Ukraine. This is not only a concern for enterprises, which will have to adjust to a changed business environment, but also for Ukrainian statehood more broadly, given the country's regional diversity and legacy of detachment from decisions taken centrally in Kyiv.

(IV) FROM IMPLOSION TO ECONOMIC GROWTH

The issue of domestic repercussions of international trade agreements leads to the second, inter-related issue of a national modernization strategy. Ukraine is uncomfortable as it is, exposed to two competing integration projects but even more as an underperforming state dependent on external support and market demands. Ukraine must prove resilient in an unstable position as a periphery state by translating its important domestic resources into national growth. The crisis, somewhat ironically, also represents an opportunity for reforms (business climate, state institutions) to curb strong vested interests.

Applying Horizontal Measures

A World Economic Forum report has pointed out that Ukraine needs a comprehensive economic development strategy that not only targets quick wins in 'strategic sectors' (agribusiness, metallurgy) but also improves the investment climate for small and medium-sized enterprises (SME) struggling to become part of the system.⁸³ Ukraine benefits from an educated workforce and a large market size but the country suffers from a poor institutional framework characterized by red tape, lack of transparency, corruption and patronage.⁸⁴ Ukraine's investment climate ranks 76th out of 144 countries in global competitiveness.⁸⁵ The number of small companies declined under Yanukovich, probably reflecting a worsening business environment. New, more competitive companies find it difficult to enter the Ukrainian market.

The government in Kyiv may end up in the situation of falling back on an alliance with big businesses as a way out of the economic crisis. Agriculture is predicted as a strategic sector because of population growth around the world and soaring middle class consumers in emerging markets. New Chinese commitments to invest in Ukraine testify to this tendency.⁸⁶ Kyiv may therefore be tempted to implement a top-down process that transforms agriculture

⁸³ World Economic Forum, 2014. 'Scenarios for Ukraine: Reforming Institutions, Strengthening the Economy after the Crisis', pp. 30-31, http://www3.weforum.org/docs/WEF_ScenariosSeries_Ukraine_Report_2014.pdf

⁸⁴ World Economic Forum, 2013. 'The Global Competitiveness Report 2013-2014: Full Data Edition', p. 30-31, http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2013-14.pdf.

⁸⁵ World Economic Forum, 2015. 'Global Competitiveness Index', <http://reports.weforum.org/global-competitiveness-report-2014-2015/economies/#economy=UKR>.

⁸⁶ China in March 2015 signed a memorandum stipulating that Ukraine will receive \$15 billion over 15 years to build housing and attendant infrastructure conducive to corn exports. This number deserves comparison with the IMF loan of \$17.5 billion – see: Daly, J.K.C., 2015. 'Ukraine Conflict Benefits China', *Eurasia Daily Monitor*, vol. 12 (62).

into a highly productive and industrialized food value chain.⁸⁷ Agribusiness as a national flagship sector may be an answer to achieving a basic level of economic development, addressing immediate budgetary concerns, and may even give Ukraine geopolitical weight as an agricultural powerhouse.

However, staking on high international demand and high prices for commodities would have a medium-term resilience effect at best and perpetuate external dependency at worst. A strategy of picking a champion is not likely to leave room for a holistic economic development strategy, nor is it likely to break with the culture of corruption. It is crucial that Ukraine focus on a long-term strategy of domestic mobilization involving a broad range of business sectors. The multiplier effect on the Ukrainian economy of growth generated from strategic sectors will fail in the absence of broader efforts to improve the country's business environment.⁸⁸

The business community in Kyiv highlights the need for Ukraine to implement a business strategy that is horizontal (comprehensive, addressing broader problems hampering enterprise activity) rather than vertical (sector-specific, top-down approach). Although there are overlaps between vertical and horizontal support, it is a useful distinction for the problems that Ukraine faces. Horizontal support is necessary if the business environment is generally bad, which provides the foundation for market failures. High entry barriers for new businesses and the absence of competitiveness are a major hindrance to growth in Ukraine, in no small part because monopolies and oligopolies have no incentives to invest.⁸⁹

Horizontal measures are more effective in terms of likely success than sectoral measures generally speaking.⁹⁰ Picking quick wins in strategic sectors short of a cross-sector spill-over usually fails as a development strategy because markets will find new equilibria and investors will go elsewhere once the venture is over. Also, quick wins will not create the lasting high-skilled jobs that Ukraine needs. The existing literature underlines the importance of institutions that ensure secure private property for investment incentives and economic performance – in contrast to extractive institutions, which concentrate power in the hands of a few and nourish fear of expropriation or extortion.⁹¹

The conditions for SMEs deserve a particular focus as one of the most productive areas of state support. SMEs grow their employment faster than big businesses and they play an important role in innovation and technology adoption for society at large. Official data on this does not exist but estimates say that the share of the SME sector in Ukraine's GDP amounts to only 10-15 per cent.⁹² SMEs complain about high entry barriers, especially as start-ups are most

⁸⁷ Government support of sanitary and phyto-sanitary (SPS) measures in fulfilment of DCFTA, notably the establishment of laboratories, may overlap with support of agriculture as a sector – interview with think tank researcher.

⁸⁸ *Ibid.*

⁸⁹ World Bank, 2010, *op.cit.*

⁹⁰ Interview with think tank researcher.

⁹¹ World Economic Forum, 2014, *op.cit.*, p. 14; interview with think tank researcher.

⁹² UNDP, 2014. 'New project to promote entrepreneurship and SMEs development in Chernobyl affected areas', <http://www.ua.undp.org/content/ukraine/en/home/presscenter/articles/2014/10/10/new-project-to-promote-entrepreneurship-and-smes-development-in-chernobyl-affected-territories/>; Konrad Adenauer Stiftung, 2014. 'Emerging Entrepreneurship and SME Policy Development in BSEC after the Economic Crisis', p. 27, http://www.kas.de/wf/doc/kas_30711-1522-12-30.pdf?120411092405; interview with business representative.

vulnerable within their first three years. Kyiv for this reason is under pressure from a number of western supporters and creditors to develop a comprehensive business development strategy, which would improve conditions for SMEs suffering from unfair competition. International practice provides a template for targeting training, direct support, or loan guarantees.

Improving the business climate is not a question of merely ‘setting market forces free’ but of putting in place appropriate government measures steering the process of addressing market failures. There is an inherent conflict between the purpose of a particular public support measure and the wider goal of promoting free and fair market competition.⁹³ However, it goes without saying that existing state support in Ukraine must be revisited, shifting away from big businesses and gradually being replaced by deregulation in line with EU standards assessing needs and potential impact of anti-monopoly measures.⁹⁴

Think tank researchers indicate the ideal model as one in which the state provides financial support allowing the start-up of small enterprises following the East German example after reunification – on the other hand, this is hardly realistic given Ukraine’s fiscal crisis.⁹⁵ Others indicate the necessity to consolidate the banking system, i.e., close banks that serve the purpose of inside crediting (a process already initiated by the National Bank of Ukraine). The re-creation of a sustainable sector in which real banks resume lending is crucial for SMEs to gain economic foothold. Ukraine may also need an investment insurance system against military losses or political instability.⁹⁶

While SMEs have suffered from growing corruption and inefficiency, oligarchs are generally interested in keeping a version of the status quo, which protects their interests. To expect Ukrainian oligarchs and their political allies to work for economic reform in the name of the national interest is an illusion.⁹⁷ Any serious change must start with gradual but persistent change in vested interests and the unhealthy mixture of business and politics, notably predominant in the legislature.⁹⁸ Oligarch-owned industries are the biggest sources of inefficiency, having survived for decades not only on an uncompetitive environment but also on underpriced energy. The gas price subsidy is commonly viewed as a direct subsidy of oligarchs.⁹⁹ The oligarchic system remains after the Euromaidan despite a reshuffling of power between them.¹⁰⁰

On the other hand, some recent events – driven mainly by external imperatives – indicate the beginning of a weakening of certain oligarchs. Following the requirements of its creditors

⁹³ ‘Study on State Support to Undertakings in Ukraine’, p. 21, http://eupublicprocurement.org.ua/wp-content/uploads/2015/03/State-Support-Study_ENG.pdf.

⁹⁴ Interview with think tank researcher.

⁹⁵ Interview with think tank researcher and business representative.

⁹⁶ Interview with business representative and think tank researcher.

⁹⁷ Trenin, D., 2015. ‘Europe’s Nightmare: Ukraine’s Massive Meltdown’, <http://carnegie.ru/2015/04/10/europe-s-nightmare-ukraine-s-massive-meltdown/i68z>.

⁹⁸ Adarov et al., *op.cit.*, p. 2.

⁹⁹ Sutela, *op.cit.*, p. 13.

¹⁰⁰ Kononczuk, W., 2015. ‘Oligarchs After The Maidan: The Old System In A ‘New’ Ukraine’, http://www.osw.waw.pl/sites/default/files/commentary_162_0.pdf; Koscinski, P. and Vorobiov, I., 2014. ‘Do Oligarchs in Ukraine Gain or Lose with an EU Association Agreement?’, https://www.pism.pl/files/?id_plik=14485.

(IMF, EU), Ukraine has been compelled to commence a series of anti-monopoly measures and legal challenges to the privatization of companies that occurred under Yanukovich. Ukraine's challenge is to focus on the most critical cases of anti-competitive practices because it may otherwise overextend or impose an excessive burden on the economy as a whole.¹⁰¹ The dismissal of Kolomoyskiy, known as Ukraine's most powerful oligarch, as governor of Dnepropetrovsk after he attempted by force to retain control of a major state-owned company, is important news in this game. It remains to be seen whether the struggle shows the vector of policy between the state power and oligarchs¹⁰² or merely between oligarchs themselves.¹⁰³ The Ukrainian government, however, is under huge pressure from international creditors, western governments, and pro-Euromaidan voters, who monitor the development closely.

One business official indicates that business oligarchy can prove advantageous in the long run, if it is in the style of late-19th century U.S. tycoons, who began public investment toward the end of their career.¹⁰⁴ While oligarchs may be allowed to keep their wealth, reform implying gradual erosion of their political power is likely to be conflict-ridden and hampered by government representatives' proneness to corruption and general state weakness. Mobilization of SMEs, conversely, has been small-scale or focused more on narrow interests, with the exception of the 'Tax Maidan' in 2010, when SMEs protested against a new tax code (however, unsuccessfully), and with the exception of the Euromaidan. A nation-wide SME platform is underway but will need time and organization to develop.¹⁰⁵

SMEs in principle have an ally in DCFTA, not only as a competitiveness-promoting framework but also because it attributes a specific role to business communities and non-state actors in strengthening or creating new market ties bottom-up (SME Direct Support Facility).¹⁰⁶ This is supposed to strengthen an otherwise limited support of SMEs in the Eastern Partnership Region.¹⁰⁷ Business representatives express concern, on the other hand, that especially SMEs are unable to afford the educational element of DCFTA. Businesses that are well prepared will benefit from the transition to European supply chains.

The dispersion of business focus may therefore have to be accompanied by a centralized system that helps to inform businesses and consumers of the implications of this change, especially in regard to highly technical issues such as sanitary measures (agriculture and food labeling) or customs (procedures of food declaration). This informational support is especially important for the rural districts and for regional rebalancing. Communication is needed the

¹⁰¹ Guitton, J., 2015. 'Ukraine desperately needs an efficient competition authority', *KyivPost*, June 3, <http://www.kyivpost.com/opinion/op-ed/jocelyn-guitton-ukraine-desperately-needs-an-efficient-competition-authority-390159.html>.

¹⁰² Ukraine's Finance Minister called the case as 'drawing a line in the sand' – see CNN, 2015. 'Ukraine finance minister on tackling a war-torn economy', <http://transcripts.cnn.com/TRANSCRIPTS/1503/27/ampr.01.html>.

¹⁰³ *Stratfor*, 2015. 'In Ukraine, Oligarchs' Ambitions Divide Kyiv', April 8.

¹⁰⁴ Interview with business representative.

¹⁰⁵ Pishchikova, K. and Ogryzko, O., 2014. 'Civic awakening: The impact of Euromaidan on Ukraine's politics and society', pp. 7-8, http://fride.org/download/WP_124_Civic_awakening.pdf.

¹⁰⁶ Manoli, *op.cit.*, p. 63; interview with government official.

¹⁰⁷ Kaca, E., 2015. 'The Forgotten Fifth Element: Support of Entrepreneurship in the Eastern Partnership Region', http://www.pism.pl/files/?id_plik=19131.

other way round as well, enabling consultations with organized business interest to influence DCFTA implementation.¹⁰⁸

Corruption and State Institutions

Getting ‘stuck in transition’ is a common post-Soviet feature, with economies largely privatized but marred by deep systemic disorder regarding rule of law and corruption. Ukraine has become an outstandingly bad example of this disorder.¹⁰⁹ Corruption is directly related to state fragility in that it allows economic activity to slide into or remain in the shadow economy, which perpetuates uncompetitive practices and evades taxation.¹¹⁰ Ukraine’s need to cultivate a broader revenue base goes hand-in-hand with support for rule of law, which could facilitate productivity in the private sector and enforce taxation.

Estimates say that the Ukrainian shadow economy makes up around 40-50 percent of GDP, one of the highest numbers in the world.¹¹¹ Ukraine finds itself in a vicious circle in which corruption and absence of functional administrative institutions allow businesses to stay in the shadow economy. The IT sector serves as the clearest example because Ukraine has a large pool of qualified programmers but many of them work in the shadow economy, providing services for other countries in the world.¹¹² As the tax base has narrowed, any attempt to increase state revenue has meant heavy taxation of what can be taxed – to the detriment of business growth in the official economy, including export activity. A large shadow sector biases economic structures in favor of the non-tradable sectors and inhibits human capital development.¹¹³ If Ukraine wants to increase the basis for its national revenue, it must address the broader question of dysfunctional state institutions and absence of rule of law.

The primary problem lies with a culture of corruption at all levels, and it is the rule rather than the exception. Business leaders complain that the problem in Ukraine is not only the systemic but also the ‘dysfunctional’ character of corruption, i.e. unpredictability in dealing with the system. The judiciary and the state administration are a matter of last resort to settle disputes. Ukraine stands in contrast to, e.g., Kazakhstan, where bribes are also frequently given but where interaction is more predictable.¹¹⁴ According to the World Bank’s ‘Doing Business’ index, Ukraine at 96 out of 189 countries scores lower than Kazakhstan (77) and Russia (62), and it scores especially low when it comes to starting and closing a business, registering properties, and paying taxes.¹¹⁵

Ukraine must work not so much for the introduction of new legislation as for the enforcement of established rules. Previous tax code amendments in Ukraine have shown that implementation is the main problem: the biggest issue in gaining investment trust is not

¹⁰⁸ *Ibid.*

¹⁰⁹ Emerson, *op.cit.*, p. 4.

¹¹⁰ Sutela, *op.cit.*, pp. 1, 4, 19.

¹¹¹ *Economist*, 2014. ‘Why is Ukraine’s economy in such a mess?’, <http://www.economist.com/blogs/freeexchange/2014/03/ukraine-and-russia>.

¹¹² World Economic Forum, 2014, *op.cit.*, p. 11.

¹¹³ Adarov et al., *op.cit.*, p. 72; Sutela, P., 2012. ‘The Underachiever: Ukraine’s Economy Since 1991’, p. 4, http://carnegieendowment.org/files/ukraine_economy.pdf.

¹¹⁴ Interview with business representative.

¹¹⁵ World Bank, 2015. ‘Doing Business’, <http://www.doingbusiness.org/data/exploreconomies/ukraine>.

legislation itself, but the fact that it is violated and ignored in practice as a consequence of absence of rule-of-law and corruption within state authorities.¹¹⁶ The coalition government has announced tax simplification (from currently 22 to 9 codes), anti-shadow economy measures (reducing social contributions on salaries; fighting shadow cash circulation), and reducing the tax burden of SMEs.¹¹⁷ However, the actual application of the new tax code will be the real test for progress towards reversal of economic shadow activity and the increase of state revenue. Rather than designing new strategies, administrative resources must be concentrated to drive implementation forward.

As earlier mentioned, the adoption of DCFTA for the moment is a mere signal to international investors that business conditions may improve in Ukraine. This is so because DCFTA, when implemented, promises a change in institutions linked to the legal convergence with the EU acquis in key sectors, which will contribute to tackling the country's widespread corruption problems. The devaluation of the hryvnia is currently a stimulus to exports, allowing Ukrainian producers to compete on price in saturated European markets. Ukrainian businesses must therefore exploit the interval until DCFTA enters into force to gain the trust of European and global investors and accustom producers to tougher market competition, including on the domestic market.¹¹⁸

Ukraine needs reliable institutions that can steer long-term policy and infuse trust among government, business, and society. Clarity is of the essence, meaning that Ukraine must start to look strategically at its economic development without changing policy every six months. The primary problem has not been the lack of contestation of power, though Ukraine grew more authoritarian under Yanukovich, but rather that politicians have found it difficult to resist populist measures such as short-term fiscal handouts (pensions, subsidies) in their quest for re-election.

The country needs stability in the political environment, through external conditionality or through internal leadership provided by a consolidated group of reformers, or (preferably) a mixture of both. Priorities expressed by Ukrainian businesses and think tank representatives are relevant in that 'reverse conditionality' i.e. Ukraine itself defining what it believes it can achieve within a certain time frame, may bring the country closer to actually delivering.¹¹⁹ Its constraints (budgetary and other) highlight Ukraine's need to focus on a few critical, rather than many, reform objectives.

The \$17.5 billion IMF Agreement is conditional on structural reform in business climate and investment attraction, including de-monopolization (Anti-Monopoly Committee, energy sector restructuring) and anti-corruption enforcement (National Anti-Corruption Bureau). It also pertains to drastic energy price increases (280 per cent for gas, 66 per cent for heating) to reach international levels by 2017.¹²⁰ The EU has shown unprecedented support to Ukraine but its

¹¹⁶ Shevchenko, N. and Otten, T., 2014. 'Tax Code of Ukraine: Development, impact and application issues', p. 8, http://www.ier.com.ua/files/publications/Policy_Briefing_Series/PB_08_2014_en.pdf.

¹¹⁷ Government Portal, *op.cit.*, p. 6.

¹¹⁸ Interview with business and think tank representative.

¹¹⁹ Charap and Mylovanov, *op.cit.*

¹²⁰ International Monetary Fund, 2015. 'Request for Extended Arrangement under the Extended Fund Facility [...]', <https://www.imf.org/external/pubs/ft/scr/2015/cr1569.pdf>.

failure to deliver on reform will amplify Ukraine fatigue. Change that disadvantages powerful domestic groups would be unlikely to happen in the absence of an existential crisis. It is Ukraine's last best chance to deliver and, realizing this, weakness can prove to be a strength.

(V) CONCLUSION

There is a gap to be bridged between economic foresight and security studies in addressing the causes of the Ukraine crisis. This study set out to unite the two schools of thinking to reach a policy-relevant assessment of conditions maximizing Ukraine's geo-economic positioning and moving it forward as a self-sustaining entity. The protracted hostilities in eastern Ukraine arguably relegate trade to a secondary priority on political agendas but the issue will have lasting impact on the settlement of the crisis, which in origin and in essence is about Ukraine's position in an Eastern Europe increasingly divided along geo-economic lines. The findings of the research paper are summarized as follows:

- Addressing the uncertainties connected to Ukraine's legal and regulatory convergence with the EU has economic rationale. Kyiv at all times should be ready to reaffirm free trade with EEU and engage on technical incompatibility issues on an individual basis, preferably on a trilateral basis involving Brussels. There is an equal political rationale in developing such working relations, provided that they do not allow Moscow mystify to undermine the substance of DCFTA, and insofar as EEU is bound for deeper integration with implications for Eastern Europe. Exploring geo-economic viability also puts Kyiv in a better position to balance its own regional imbalances during the domestic transition process.
- Ukraine must focus on national growth as a generator of resilience against its unstable periphery status, Russia's economic and military aggression notwithstanding. Enabling sustained growth (multiplier effect) is a combination of productivity in 'strategic sectors' and the application of horizontal measures to improve the business environment (strengthening SMEs and application of rule-of-law). Persistent external conditionality can alter domestic balances of power away from the oligarchic deadlock but Ukraine must take ownership of its national vision.

The analysis has shown the international economic dimension both as a source of Ukraine's weakness and as an impetus for improvement. Ukraine must change the conditions that have led successive governments to revert to a multi-vector foreign policy defined as the temptation to opt for whatever short-term benefits could be obtained from either west or east.¹²¹ Kyiv must understand that its most existential issue is not to choose a side but to make the economy work and consider whatever instruments will suit that purpose. A Ukraine whose domestic forces are in equilibrium is less sensitive to changes in the external environment.

The government crisis of 2013-14 should serve as the most vivid lesson for Ukraine of the costs related to being caught in external bidding to 'win it over'. One must keep in mind that Ukraine's dependency on international creditors since the Euromaidan government came into power has gone from high to extreme. At the end of February 2015, the exchange rate of the

¹²¹ Interview with think tank representative.

hryvnia dropped dramatically because markets reacted to the fact that Ukraine was rapidly running out of foreign currency reserves. Stability was achieved only when the IMF program gained credibility in March. The situation underlines Ukraine's need to curb and ultimately break free of its financial dependency.

The good news for Ukraine is that war in the Donbas has given powerful impetus to a Ukrainian nationhood that can entail a positive mobilization of society.¹²² The prospect of Ukraine splitting into two parts, each of which would join one of the competing economic blocs, looks remote.¹²³ AA/DCFTA provides a long-term sense of direction but different philosophies prevail among reformers often inspired by their foreign experience, e.g., looking to the 'Polish' or the 'Georgian' reform model. These are useful to a point but Ukraine needs a self-tailored model to develop through a mixture of strategic vision and trial and error. Implementation can succeed if Ukraine can finance reforms and if the external urgency produces sufficient incentive or even fear of what otherwise will happen to the country. The pro-European government is working against time because the electorate is likely to look for alternatives to Ukraine's dire economic situation.

The Russo-Ukrainian conflict has shown that governments are concerned about the geopolitical implications of their economic choices. Economic opportunity, loss, or uncertainty shapes political change. The entry into force of DCFTA scheduled for 2016 is itself a political decision influenced by Russia's stance regarding CISFTA suspension, the expected shocks caused to the Ukrainian economy, stability in its macro-financial environment, and the perception of losing face when confronted with Russian demands. The effects of DCFTA are riddled with uncertainty, with some predicting a fundamental redesigning of the politico-economic map of Eastern Europe.¹²⁴ Conversely, the involvement of business communities does not create the basis for an alternative 'bottom-up path' to alleviate politicization and securitization by governments of trade liberalization. The only remaining certainty is that the situation will not move beyond retrenchment without genuine political buy-in from Kyiv, Brussels, and Moscow.

Meanwhile, it is clear that Russia's annexation of Crimea and military incursions in the Donbas have pushed the possibility of east-west negotiations or concessions in the strategic-military realm far over the horizon. Most western countries believe that the previously numerous partnerships with Russia have broken down. Moreover, Moscow is no longer promoting pan-European security designs as it attempted to do between 2008 and 2011. The events in Ukraine affect the posture of the East European states as the events have pushed national security to the top of governments' priority lists looking to either NATO or Russia.¹²⁵

The securitization of foreign policy gives all the more reason to explore the possibility of political compromise or dialogue in the economic real to mitigate the scenario of two

¹²² Interview with think tank researcher.

¹²³ Trenin, D., 2014. 'The Great Clash Explained: What Drives Dangerous Tensions between the West and Russia', <http://nationalinterest.org/feature/the-great-clash-explained-what-drives-dangerous-tensions-11936>.

¹²⁴ Manoli, *op.cit.*, p. 70.

¹²⁵ Inayeh, A., 2014. 'The Regional Impact of the Ukraine Crisis: Overview and Conclusions', p. 4, http://www.gmfus.org/wp-content/blogs.dir/1/files/mf/1404920650Inayeh_UkraineCrisisRegionalOutlook_Jun14_web.pdf

competing integration blocs and volatility in the border states between them. This calls for a decoupling of economic integration from the question of military integration pertaining to whether Ukraine should accept lethal weapons and push for enhanced NATO cooperation. Kyiv has a clear interest in confining the conflict to the economic area insofar as the crisis describes Russia's competence in keeping Ukraine incompetent.¹²⁶ Kyiv (still with western support, not to forget) has an interest in 'victory' and 'defeat' being defined as its own economic success or failure.

Shifting the conflict to the military chessboard, conversely, requiring material or physical backing from western militaries, would be shifting to a position of weakness. Ukraine can receive no weapons or protection from NATO countries that Russia is not able or willing to match by supporting the separatists or sending in its own troops.¹²⁷ Russia acts from a position of decline, compelling it to be less risk-averse and thus more dangerous.¹²⁸ Kyiv and its western supporters have an interest in managing Russia's rivalry chiefly in an economic context in which the long-term trend is in their favor. Russia's punitive measures are effective and harmful in the short run but its methods accelerate the erosion of its ties and soft power among post-Soviet states – this applies not only to Ukraine but also to Moldova and Georgia, which have effectively diversified their political and economic relations.

The Ukraine crisis must be recognized as a historical juncture, perhaps marking the end of the 'post-Cold War order' in Europe, because Russia has decisively broken out of this order. No matter if it is an expression of the West's failure to integrate Russia or Russia's failure to integrate with the West, the split is the culmination of more than 20 years of incompatible or unenthusiastic efforts to promote a Euro-Atlantic space without lines of division. The breakdown in east-west relations gives all the more reason to focus on Ukraine's key role in the center and as a source of the current conflict. Ukraine in 2013-15 differs from Georgia in 2008 and one must work with the specifics of each case. This research paper has made the case for a political economy crisis that Kyiv has the potential to manage in the midst of undeniable geopolitical constraints.

Trilateral dialogue on the economic-security nexus must be upheld, the political situation notwithstanding. The Swiss Chairmanship in 2014 emphasized the need to use the OSCE as a mechanism for verification of commitments and confidence building under the trilateral talks.¹²⁹ Pragmatic frameworks and transparent dispute mechanisms addressing core interests of trade, energy, and investment centered on Ukraine (rather than discussions about 'common spaces'), are relevant to a joint understanding of the economic relationship among Brussels, Moscow, and Kyiv and the outcome of the East European Great Game.¹³⁰ Kyiv may even

¹²⁶ Interview with business representative.

¹²⁷ Allison and Simes, *op.cit.*

¹²⁸ Nye, J., 2015. 'The Challenge of Russia's Decline', <http://www.project-syndicate.org/commentary/russia-decline-challenge-by-joseph-s-nye-2015-04>.

¹²⁹ Burkhalter, D., 2015. 'More Economic and Environmental Cooperation for More Security in Europe', <https://www.news.admin.ch/message/index.html?lang=en&msg-id=54386>. Note that the economic dimension of the Helsinki Final Act ('second basket') provides an accepted, though under-played, foundation for political efforts at enhancing commercial exchanges, industrial cooperation, and economic projects of common interest.

¹³⁰ Leigh, M., 2014. 'A New Neighborhood Strategy for Europe', <http://www.gmfus.org/archives/ideas-for-europes-new-leadership>; Techau, *op.cit.*

convince Brussels that preparations for a long cold crisis must involve possibilities for cooperation with EEU as part of the bargain.