

# Eschewing Choice: Ukraine's Strategy on Russia and the EU

**Elena Gnedina and Evghenia Sleptsova\***

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## Abstract

Ukraine has long been castigated for its noncommittal attitude to cooperation with the EU, this being part of its 'multi-vector' foreign policy. Such a policy was widely attributed to the failings of domestic elites, which delay reform for fear of losing rents and power. The recent setback in EU-Ukraine relations, however, highlights more complex reasons behind this. First, a pro-European vector is not a self-evident choice for Ukraine, which is economically interdependent with both Russia and the EU. Second, the economic crisis has made the EU less attractive in the short term. In good times business was looking to Europe for opportunities to develop. But in times of crisis it is looking to Russia for cheap resources to survive. Despite these unfavourable short-term trends, an association agreement with the EU stands out as the only alternative that promises to put the shaky Ukrainian economy back on track towards long-term sustainable economic growth.

\* Elena Gnedina is a PhD researcher at Queen's University Belfast. Dr. Evghenia Sleptsova is Senior Associate at Country Insights Ltd, London. The paper is based on their interviews in Ukraine and PhD research (E. Gnedina, "Multi-vector foreign policies in Europe: Ukraine and Moldova between the EU and Russia, 1999-2009", Queen's University Belfast, work in progress and E. Sleptsova, *Exports from Ukraine to the EU: Macro-, micro- and political economy determinants*, University of Birmingham, 2011). They thank Michael Emerson, Nicu Popescu and Iryna Solonenko for their useful comments.

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# **Eschewing Choice: Ukraine's Strategy on Russia and the EU**

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## **Introduction**

Ukraine has long been standing at a crossroad between closer integration with either Russia or the EU without choosing either – known as ‘multi-vector’ foreign policy. EU-Ukraine relations ebbed and flowed, as periods of rapprochement gave in to fatigue and estrangement, with the same valid for Ukraine-Russia relations. The recent set-back in the EU-Ukraine negotiations is albeit a crucial turn in Ukraine’s foreign policy. The most apparent reason for this is the deterioration of political situation in Ukraine, after several opposition leaders, including former Prime Minister and an opposition leader Yulia Tymoshenko, have been imprisoned in what is believed to be Yanukovich’s attempt at weakening the opposition ahead of the 2012 parliamentary elections.

Despite this, the Ukrainian side declared a victory when the negotiations on the association agreement were announced finalised at the EU-Ukraine Summit on 19 December 2011. From the EU point of view, this was hardly a success. Earlier the EU officials made clear that only if the Ukrainian authorities improve their record on democracy, would the agreements be signed and ratified next year. This, however, failed to bring improvement to the situation in Ukraine, with Ukrainian court rejecting Tymoshenko’s appeal against conviction, after European leaders like Angela Merkel, Catherine Ashton and Herman van Rompuy lined up in her defence. Yanukovich’s failure to address EU’s concerns will be bad news for both Ukraine and the EU: as Ukraine may miss another chance to jump-start its political and economic modernisation, the EU may see Ukraine slide back to ‘soft’ authoritarianism and its own influence recede across the whole neighbourhood, as a result.

Most blame Viktor Yanukovich for the set-back in relations with the EU. However, the fact that the negotiations have been ridden with obstacles from their inception in 2007, indicates that more complex reasons are behind it. The policy of balancing between Russia and the EU reflects the preferences of the elites, who against the background of a still politically-passive and embattled population prefer status quo to reforms that would see their own monopoly on power and sources of enrichment curtailed. Another reason is more structural. The association agreement, and a deep and comprehensive free trade area agreement (DCFTA) linked to it, would make Ukraine’s economy closely integrate with the EU one. This is not a self-evident choice for a country that is economically interdependent with both Russia and the EU especially if integration with one may potentially damage relations with the other, which makes accommodation of both Russia and the EU a preferred option. A former Ukrainian high-level official summarised such reasoning: “Our country should be a bridge between Russia and the West. Like in medieval times, the owner of the bridge, who trades with and ensures the right of passage for both rivaling river banks, will prosper; the one, who trades only with one and closes the bridge for the other, will inflict a war upon himself.”<sup>1</sup>

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<sup>1</sup> Interview with a former Ukrainian high-level official, Kiev, 3 June 2010.

A third reason is contextual. Ukraine's choice is complicated by the dynamics of the global economy and political realities in Europe. Ukrainian business elites, who at the time of high economic growth looked into how to get access to markets and credits in the West, are now preoccupied with how to survive in adverse economic circumstances with few good news coming from the EU. The EU economy is stagnating and its attention is distracted by the debt crisis and the threat of the collapse of the eurozone with little time left for a more assertive policy towards Ukraine. Russia's economy, driven by relatively high commodity prices, is in a better shape. In 2010 it established a customs union, along with Belarus and Kazakhstan, and presses Ukraine to join. The Russian elites have plenty of energy and commodity revenues to spare on economic expansion and integration projects in the neighbourhood. As the 2008 crisis struck, Russian banks, along with the IMF, provided ample lending to the Ukrainian state and business, averting their collapse.

Yanukovich is, however, hard pressed to choose one side or the other. Both Russia and the EU have signalled that Ukrainian authorities have to make a choice. Despite unfavourable short-term trends, the conclusion of an association agreement with the EU, which rests upon the freeing of political opponents at home, would be a strong stimulus for putting the shaky Ukrainian economy back on track towards long-term sustainable economic growth.

## 1. Yanukovich – a status-quo advocate

Since he came to power in 2010, Yanukovich abstained from giving a clear signal as to which direction Ukraine should take, while consolidating power at home and defending the status-quo. The Constitutional court pronounced the constitutional reforms of 2004-2006 void, reinstating the 1996 Constitution and allowing Yanukovich to concentrate more power in his hands. Freedom of speech has been curtailed, as the presidential administration interfered with the editorial policies of major TV channels.<sup>2</sup> Human rights violations became more frequent, culminating in October 2011 when a Ukrainian court sentenced Yulia Tymoshenko to seven years in prison. In 2011 Ukraine has slid in performance in nearly all global rankings reflecting the current ruling elites' poor record in domestic reforms (Table 1).

Table 1. Ukraine's performance in global indices

	2011		2010	Preceded by
Freedom in the world	Partly free	↓	Free	-
Press freedom	131	↓	89	Iraq
Ease of doing business	152	↓	145	Liberia
Corruption perceptions	152	↓	134	Tajikistan
Global competitiveness	82	↑	89	Trinidad and Tobago

Yanukovich also sent ambivalent signals to both Russia and the EU. His first official visit in 2010 was to Brussels, where he confirmed his country's commitment to continued negotiations with the EU on the association agreement. In March 2010, in an unexpected manoeuvre, Yanukovich prolonged the lease of the Sevastopol naval base for the Russian Black Sea Fleet until 2042 in exchange for a gas price discount. Despite the ensuing

<sup>2</sup> Reporters Without Borders, "Disturbing deterioration in press freedom situation since new president took over", 15 April 2010 (<http://en.rsf.org/ukraine-disturbing-deterioration-in-press-15-04-2010,37027.html>).

rapprochement with Russia he has turned down President Putin's offer for merging Gazprom and Naftogaz. In an attempt at diversifying his foreign policy contacts Yanukovich visited China in September 2010. Although he secured some profitable deals, the plan for deeper economic cooperation has not been materialised.<sup>3</sup> After two years of uncertainty it is now evident that Yanukovich decided to stick to the old 'multi-vector' foreign policy – a policy of careful balancing between Russia and the EU used by the domestic elites as leverage in bargaining with Russia and the EU and for extending their room for manoeuvre with both external actors.

One of the reasons behind this choice is personality-related. Yanukovich is neither a democrat nor a reformer. He is convinced that his career and future rest on his monopoly on power, which he maintains by non-democratic means (lest, like Tymoshenko, he ends up in jail). Secondly, the stability of the regime depends on the support of the wealthy business elites, and Yanukovich's standing would be undermined were business elites able to shop around for favours from different political camps or, even worse, foreign patrons. The weakening of the opposition and the distribution of rents has already brought most bureaucratic and business elites into cahoots with the president, and dissent is virtually unseen in the corridors of power. In the words of one Ukrainian observer, "The current system of incentives is built in the way that loyalty is valued above everything. This manifests itself in the outcome that bureaucrats tend to lose any integral vision of state policy and think instead of preservation of their current positions as long as possible".<sup>4</sup> Too close a relationship with either Russia or the EU would disrupt this comfortable status-quo: political liberalisation would undermine Yanukovich's effort to clear the domestic scene off political opponents, while rapprochement with either regional power would erode Yanukovich's autonomy and influence vis-à-vis the business elites with some businessmen already appealing directly to Russia or the EU (see below).

Yanukovich's preference for status-quo is matched and facilitated by the low level of political activism among the Ukrainian population. Disappointed with the chaotic Yushchenko presidency and overwhelmed by bread-and-butter concerns the majority of the population has been cajoled by the current administration's promises of 'order' and 'stability' and remains divided over which integration vector Ukraine has to choose (see Table 2). There are also positive developments that, however, have had no structural political implications. 80.4% of Ukrainian students use Internet daily, only slightly fewer than in Russia (87.9%) and Poland (87.7%)<sup>5</sup>. Although small- and medium enterprises remain a small and politically non-organised segment of the society, they have made their voices heard protesting against the new tax legislation in November 2010. A wave of protests – by Chernobyl's liquidators, Afghan veterans, miners, and Tymoshenko's supporters – indicates that the situation may unexpectedly get out of control (as in the neighbouring Russia or

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<sup>3</sup> During his visit to Beijing in September 2010, Yanukovich secured contracts to build a railway connection between Kiev and Boryspil airport, on the construction of the Shchelkino steam-gas plant in Crimea, on the leasing of a drilling platform for Black Sea shelf exploration and on sales of jet engines for China's L-15 plane, which, according to Presidential Administration, will attract \$4 billion in Chinese investments. Cooperation agreements between the Chambers of Commerce and space industries have also been signed. See Kyiv Post, "World in Ukraine: Yanukovich touts visit to China as breakthrough", 30 September 2010 (<http://www.kyivpost.com/news/guide/world-in-ukraine/detail/84556/>) and Interfax, 2 September 2010, [www.interfax.com.ua/eng/main/47317/](http://www.interfax.com.ua/eng/main/47317/)).

<sup>4</sup> From email correspondence with a Ukrainian expert, 27 December 2012.

<sup>5</sup> Gorshenin Institute, "Students – an image of the future", April 2011 ([http://gorshenin.eu/annuals/5\\_students-an\\_image\\_of\\_the\\_future.html](http://gorshenin.eu/annuals/5_students-an_image_of_the_future.html)).

Middle East). As put by a Ukrainian blogger: ‘People have already lost trust in the authorities, but have not yet learnt to trust each other’.<sup>6</sup>

Table 2. Foreign policy preferences of the Ukrainian population in October 2011 (%)

	KIIS	Razumkov Centre
Integration with the EU	33	43.7
Integration with Russia, Belarus and Kazakhstan	45	30.5
Neither the EU nor the Customs Union	13	9.3
Difficult to say	8	16.4

Note: The polls were conducted by the Kiev International Institute of Sociology and Razumkov Centre with margins of error of 3.5% and 3.7%, respectively.

Source: Ukrainskaya Pravda, 14 December 2011

(<http://www.pravda.com.ua/articles/2011/12/14/6837097/>).

The room for manoeuvre is, however, dangerously narrow for President Yanukovich both at home and in foreign policy. Yanukovich’s eschewing of choice sits uneasily with increasingly active Ukrainian civil society, while the stifling political environment and economic stagnation, coupled with low upward social mobility, few job prospects, and growing economic inequality, may lead to the mobilisation of a larger segment of the society. Meanwhile, both Russia and the EU made it clear that Ukraine should prioritise one integration vector over the other. If the process of signing the Association Agreement and the DCFTA is ruptured, Ukraine’s image at home and abroad will surely be damaged. Negotiations with Russia have also reached a dead end, as Ukraine seems not to be ready to enter the Customs Union. China, which as an emerging regional player could have provided some wriggle room for the authorities, does not consider Ukraine a priority and has established only limited economic cooperation with Ukraine. As one observer correctly pointed, ‘Ukraine’s foreign policy is thus a double bluff, and the true danger is that its architect does not grasp the implications of this, and will find himself very soon with no options.’<sup>7</sup>

## 2. Foreign trade: more ambivalence

Ukraine’s ambivalence in foreign economic policy is not only linked to Yanukovich’s unwillingness to limit his monopoly on power, but also to some economic trends that make a pro-European policy a less evident choice for the elites.

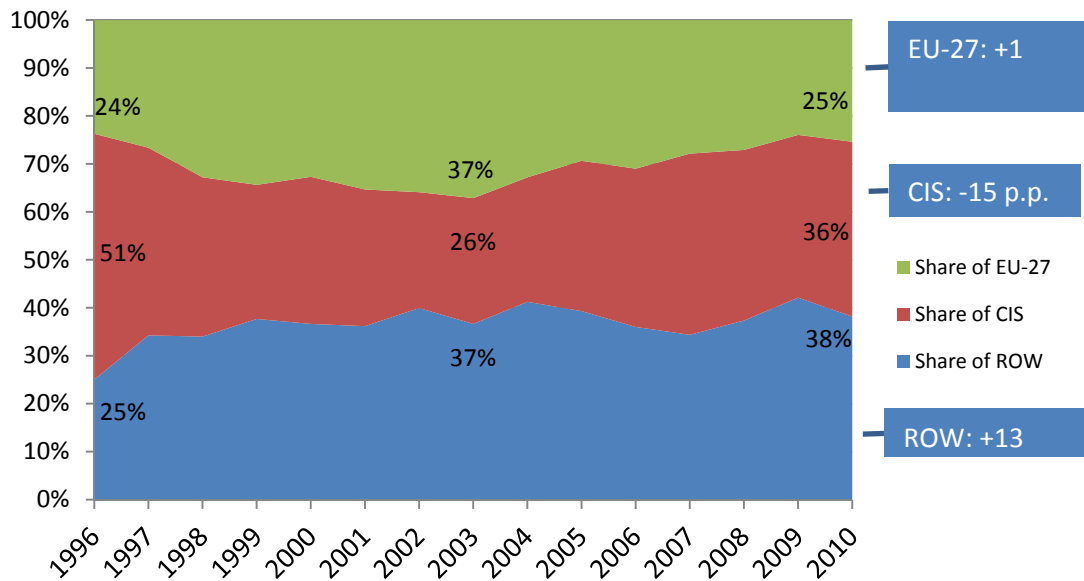
Until 2007 Ukraine’s economy had been dynamically growing, mostly driven by the booming global commodity demand. Since early 1990s Ukrainian exports have undergone significant geographic reorientation, with the share of exports to the CIS falling from 51% in 1996 to 36.5% in 2010. The share of the EU-27 in total Ukrainian exports had been growing until 2005, when it reached 30%; however, after 2005, despite Ukraine and the EU committing to deepening political and economic cooperation, actual economic cooperation did not follow suit. By the end of the decade the CIS regained some of its positions, while the share of exports to the EU has shrunk to the level of 1996 (25%). Middle East and North

<sup>6</sup> I. Kravchuk, “Moi chetyre realnosti Evropeiskoi integratsii”, 16 December 2011 (<http://www.groupua.org/?p=1625>).

<sup>7</sup> T. Snyder, “Ukraine’s Last Chance”, *New York Review of Books*, 9 November 2011 (<http://www.nybooks.com/blogs/nyrblog/2011/nov/09/ukraines-last-chance/>).

Africa (MENA), as well as Turkey, became major export destinations outside the EU and the CIS (see Figure 1).<sup>8</sup>

Figure 1. Geographic distribution of Ukrainian exports, 1996-2010

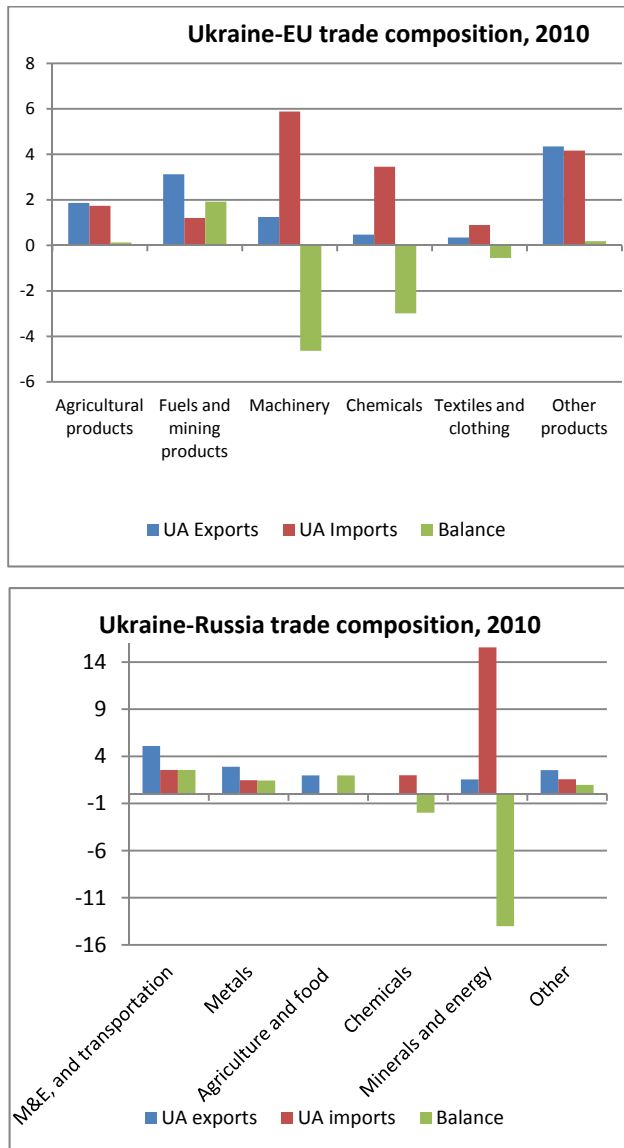


Source: UN Comtrade Database for 1996-2008, Ukrainian State Statistics Agency for 2009-2010.

Ukraine also remains dependent on both Russia and the EU for crucial imports. It buys medium- and high-technology products (machinery, chemicals and transport equipment) from the EU-27, which indicates that trade with the EU contributes significantly to the modernisation of Ukraine's economy. In exchange Ukraine exports products of low to medium degree of processing (metals, agricultural products and fuel) to the EU, its higher value-added exports remaining relatively uncompetitive on advanced markets (see Figure 2). Russia, on the other hand, is the main destination market for Ukrainian medium- and high-technology machinery, electronic equipment and transportation. On the other hand, it is the main supplier of oil and gas to Ukraine, making it vulnerable to Russia's political pressure, often accompanied by threats of disruption of gas supply. The fact that Ukraine is one of the most energy-intensive economies in the world makes it even more vulnerable to global price shocks and to the stability (or instability) of political relations with Russia.

<sup>8</sup> A number of factors may be responsible for this. The statistics of Ukraine's exports to the EU may have been exaggerated in the past. Having introduced customs administration reforms and closed down special economic zones, the previous leadership effectively curtailed some of the tax evasion schemes, which may have reduced declared exports of machinery and equipment to the EU-27 (OECD, 2007). Political instability that characterized the whole period of Yushchenko's presidency could have also negatively affected trade.

Figure 2. Commodity composition of trade with the EU-27 and Russia, 2010 (\$ bn)



Source: European Commission (2011) [trade.ec.europa.eu/doclib/html/113459.htm](http://trade.ec.europa.eu/doclib/html/113459.htm), Ministry of Economy of the Russian Federation (2011), [www.economy.gov.ru](http://www.economy.gov.ru)

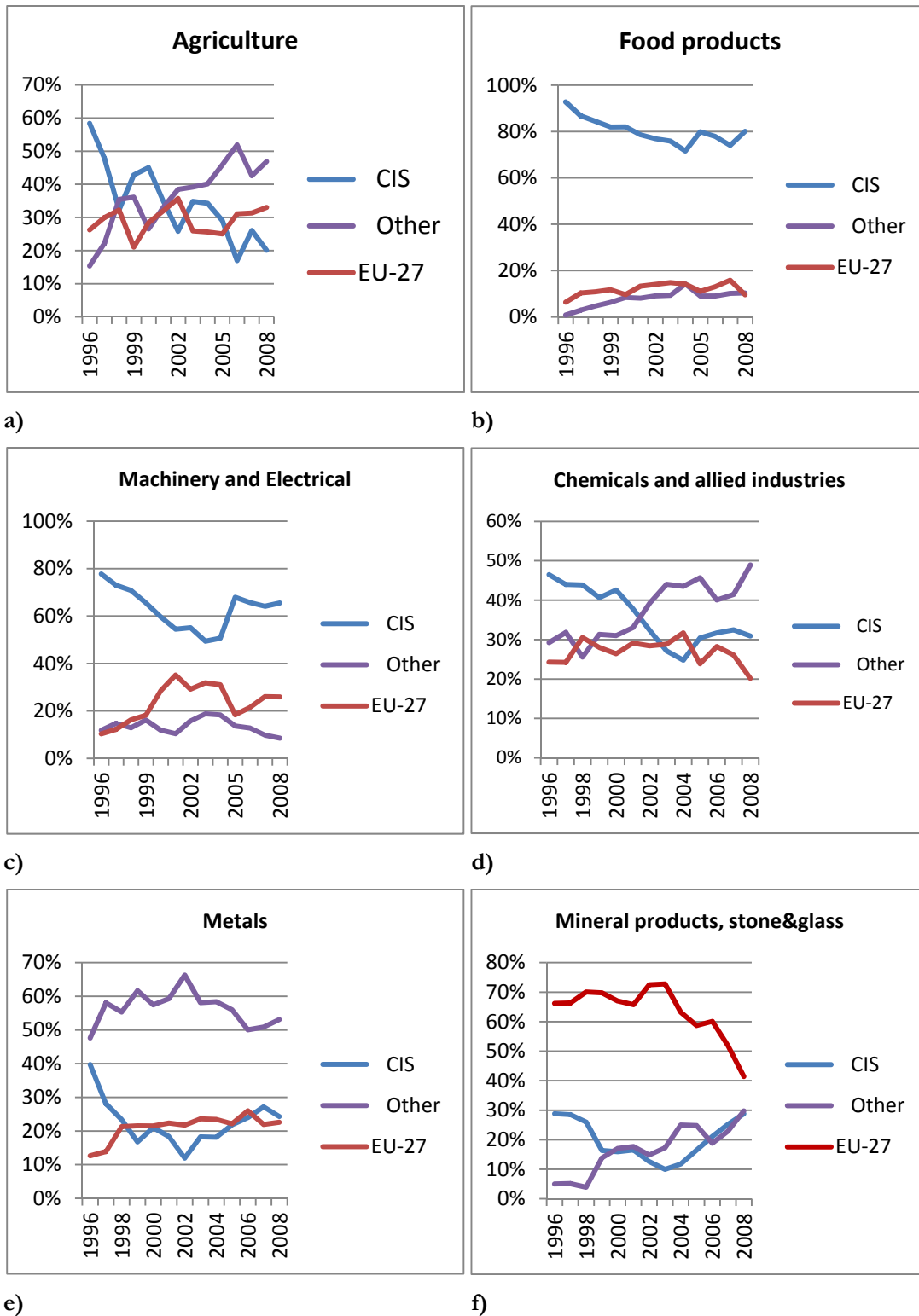
The EU and Ukraine's efforts to stimulate trade and investment in several specific areas have had only limited effect. In October 2006 Ukraine and the EU signed a Memorandum of understanding on a dialogue on agricultural issues; however, agricultural exports to the EU have grown only insignificantly. Ukraine mainly exports agricultural products to markets other than the EU or the CIS, in particular the MENA countries,<sup>9</sup> while food products are predominantly exported to the CIS (See Figure 3a and b). As shown in Figure 3, in the past 5-7 years Ukraine increased exports to the CIS of mineral products, wood and paper mostly at the cost of the EU-27. Metallurgy exports, Ukraine's most important source of export revenues, have traditionally been going to the rest of the world (i.e. countries other than CIS

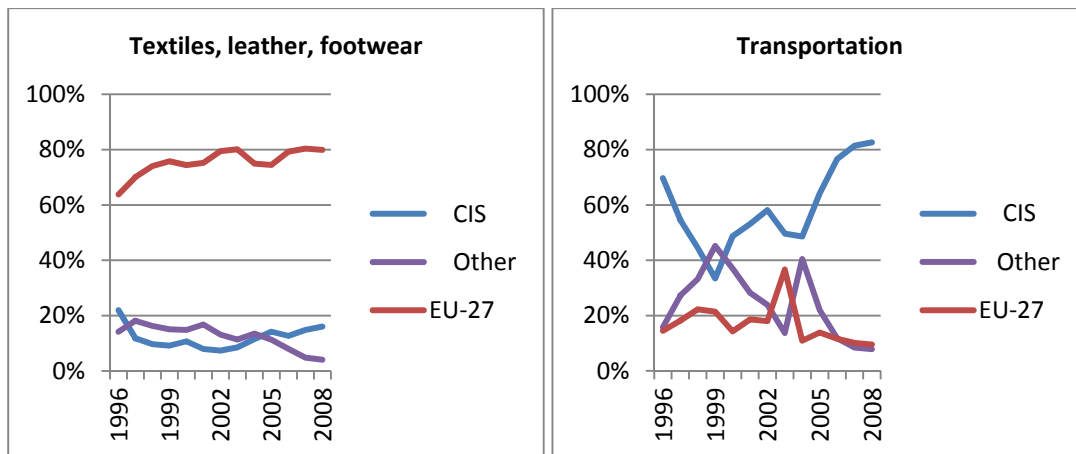
<sup>9</sup> Echoing the macro-level trade data, Oleh Bakhmatyuk, the owner of a quickly developing and successful agricultural holding *Avangard* has recently outlined his priorities: "Our company bets on two markets – that of China and Middle East. (...) If I were the Ukrainian leadership, I would bet on them too". See O. Bakhmatyuk, interview in *Ukrainskaya Pravda*, 27 October 2011 (<http://www.pravda.com.ua/rus/articles/2011/10/27/6707208/>).



or EU-27). Nevertheless, since 2002 Ukraine's metallurgy exports to the CIS have grown, while exports to the EU-27 have remained flat at around a fifth of total world exports in this industry.

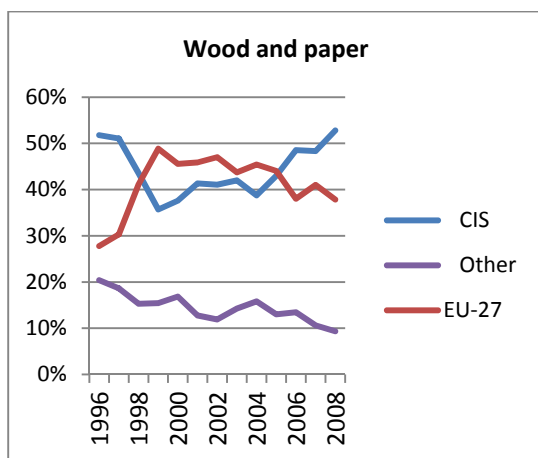
Figure 3. Commodity distribution of Ukrainian exports by regions, 1996-2008 (% of total)





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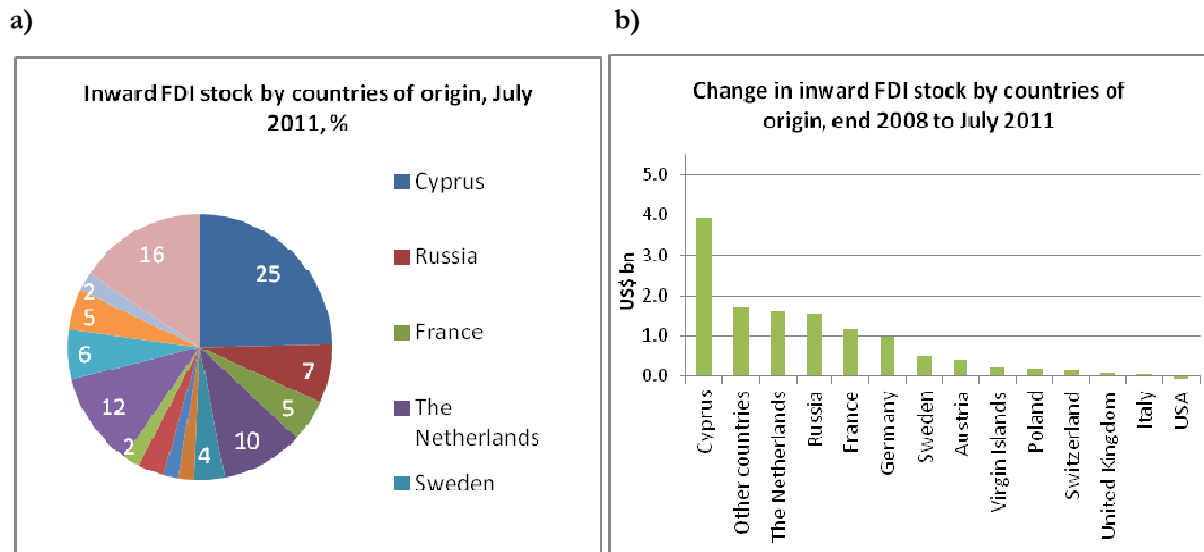
i)

Source: UN Comtrade Online Database.

FDI from the EU, along with imports of machinery and equipment, have always been a major channel of modernisation of the capital stock, technological transfer and R&D in Ukraine. In terms of foreign direct investment, EU-27 accounts for almost 80% of total inward FDI in Ukraine as of end-2010 (Figure 4a). However, 25% originates from Cyprus, and more comes from Dutch and British Commonwealth off-shore zones, a large portion of which originates from Russia and Ukraine itself.<sup>10</sup> Russian businesses and banks have considerably increased their investments in Ukraine in the recent years, making major acquisitions in metallurgy, banking, telecommunications, transportation and other sectors (Figure 4b). However, even without Cyprus and other off-shore zones, the EU accounts for over a half of total inward FDI.

<sup>10</sup> Source: Ukrainian State Statistics Committee (<http://www.ukrstat.gov.ua/>).

Figure 4. Regional structure of FDI in Ukraine (cumulative stock)



Source: Ukrainian State Statistics Agency (<http://www.ukrstat.gov.ua/>).

On the whole Ukraine enjoys a high degree of economic interdependence with both Russia and the EU, but given the current short-term trend of growing trade with Russia and the CIS, economic integration into the EU single market does not seem to be a self-evident choice for the Ukrainian elites. These diverging trends point to the need for Ukraine to strike a balance between cooperation with the EU on the one hand, and with Russia and the CIS, on the other. However, trade and investment trends are not the only factor in Ukraine's choice of foreign economic policies. Political considerations and business interests of influential financial-industrial groups play an equally important role.

### 3. 2008 economic and financial crisis: Survival, not growth

Until recently Ukraine's choice of economic integration with the EU seemed to rest on a broad consensus of the Ukrainian business elites that they could increase their revenues only if they can get greater access to the EU market. Back in 2004 Viktor Pinchuk, a Ukrainian oligarch, argued: 'New times create new horizons [for Ukraine] and therefore new tasks for us, the national business. (...) We, Ukrainian businessmen, can and should build a bridge between Ukraine and Europe. It is in our interest to make everything possible to integrate Ukraine into European structures'.

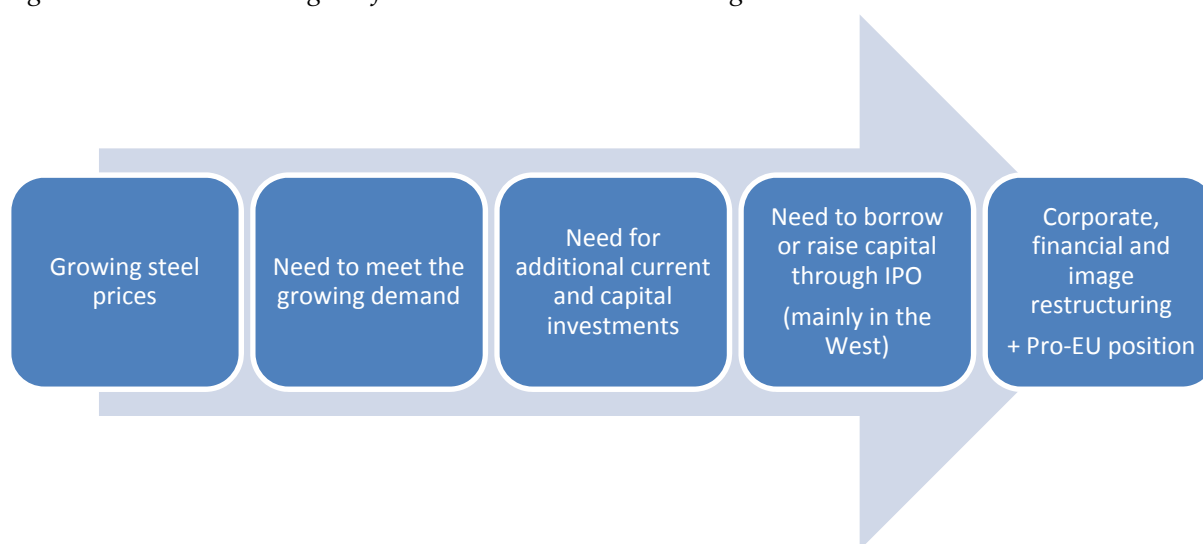
This consensus traced its origins to Ukraine's economic growth in early 2000s. During this period, Ukrainian mining and metallurgical sector, due to the booming global commodity prices on steel and steel products, has brought about significant growth to the Ukrainian economy and helped it enter a sustainable recovery path after a deep recession of 1990s. In this 'growth' mode, the financial-industrial groups that ran a variety of businesses in banking, metal, chemical, retail and agricultural sectors, displayed interest in reaching out to new markets and upgrading and expanding their production capacities. They also increasingly looked for additional financial resources through either borrowing or IPOs that made them eye cooperation with the EU.

Rinat Akhmetov is but one example of a Ukrainian oligarch, who followed this trajectory. His company System Capital Management (SCM) more than doubled its assets from \$5.2

billion to \$11.4 billion between 2004 and 2006.<sup>11</sup> The SCM acquired three metallurgical plants – two in Italy and one in the UK, launched a distribution company in Geneva, and acquired a coal mining company in the US.<sup>12</sup> He has also drawn up vast modernization plans, involving mid-term projects ranging from \$0.5 billion for Mariupol Metallurgical Plant to \$4 billion for SCM.<sup>13</sup> Several large Ukrainian companies listed their shares on European stock exchanges since 2005, most notably Ferrexpo, whose share prices increased by over 140% in less than a year since flotation in mid-2007. Industrial Union of Donbass, Interpipe and SCM's Metinvest were all planning to follow suit, as their owners embarked on public relations campaigns aiming to improve their image abroad and inside the country.

Along with the need to meet the growing global demand for commodities, large Ukrainian businesses were interested in improving access to export markets, and therefore *trade liberalisation* – both within WTO and with the EU – gained momentum on Ukraine's political agenda. Pragmatic interest of metallurgy-dependent financial-industrial groups, in particular in the abolition of import quotas by the EU, along with Yushchenko's administration push for reforms, has been credited for a breakthrough in WTO accession negotiations in 2005 and their finalisation in 2008. The broad logic behind this major transformation process is presented in Figure 5 below.

Figure 5. Economic strategies of the Ukrainian business in a 'growth' mode



The 2008 financial and economic crisis has, however, changed the priorities of the Ukrainian business. Whereas at the times of growth they favoured greater cooperation with the EU, at the times of crisis they were mostly worried about survival. As a result, the search for cheap resources and credits became a major priority for most Ukrainian enterprises. As one expert close to the Party of Regions summarised: 'In good times everybody was looking to Europe for cheap capital to develop; now everybody is looking to Russia for cheap resources to survive'.<sup>14</sup>

<sup>11</sup> System Capital Management ([www.scm.com.ua](http://www.scm.com.ua)).

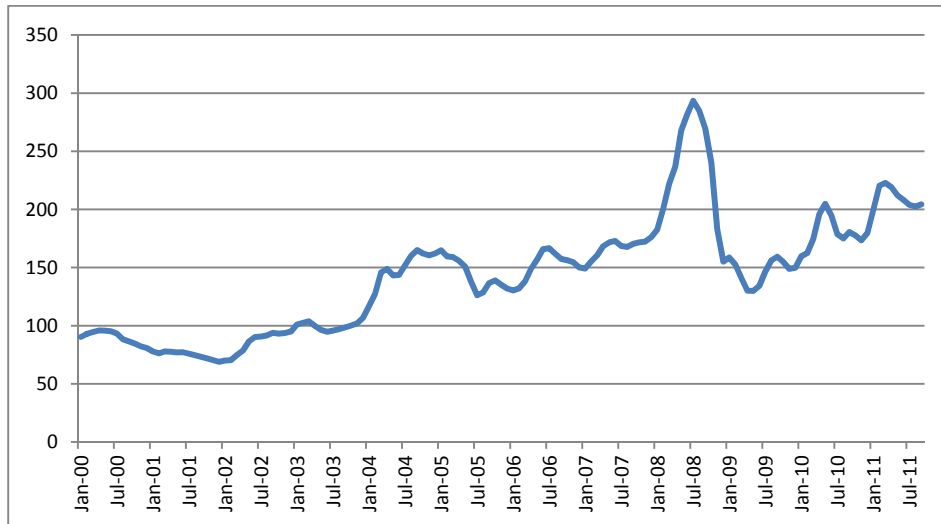
<sup>12</sup> Tochka.net, "Smotrite chto vkhodit v SKM Rinata Akhmetova", 17 November 2010 (<http://finance.tochka.net/10520-smotrite-chto-vkhodit-v-skm-rinata-akhmetova-interaktivnaya-karta/comments/desc>).

<sup>13</sup> Ukrrudprom, "Stalnye mashiny", 12 March 2007 (<http://ukrrudprom.com/digest/dstaln120307.html>).

<sup>14</sup> Interview with an expert close to the Party of Regions, 18 May 2010.

In a matter of months, between June and October 2008, global steel prices fell by almost 60 percent (See Figure 6). Due to both lower steel prices and weakening world demand for Ukrainian goods, particularly in the advanced economies, Ukrainian exports plunged by 49% in January 2009 year-on-year, leaving some Ukrainian enterprises on the brink of bankruptcy. These enterprises had major difficulties in servicing and refinancing their debts on Western markets, their financial situation further aggravated by Ukraine's low credit ratings and the West's liquidity problems.<sup>15</sup> At the time of drying up liquidity in the West, the biggest Ukrainian holdings such as Akhmetov's Metinvest, Pinchuk's Interpipe, Grigorishin's Energostandard received credits from Russian banks.<sup>16</sup>

Figure 6. Global steel price index, 2000-2011



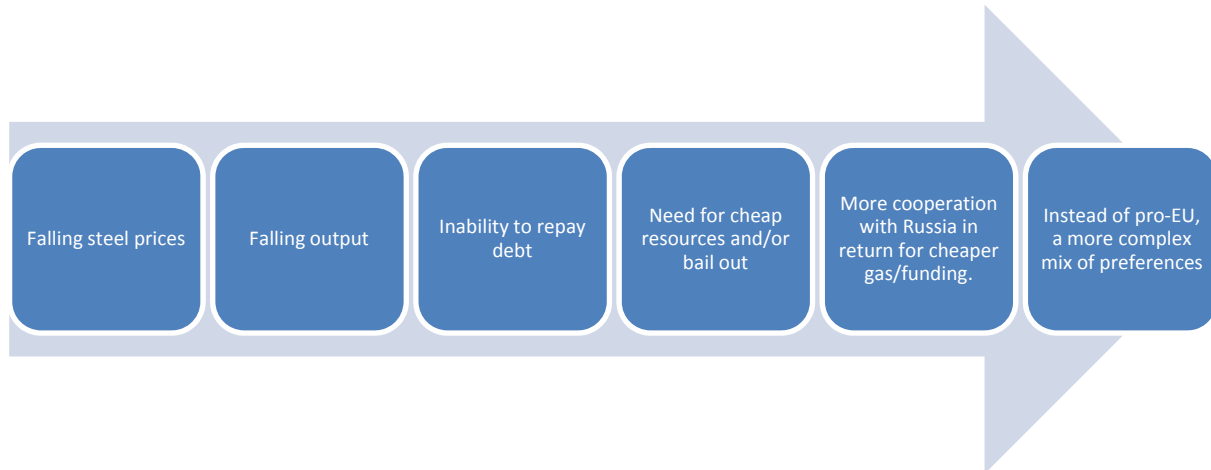
Source: [www.cruspi.com](http://www.cruspi.com)

In this 'survival mode', instead of unequivocal support for cooperation with the EU, the Ukrainian business has set out to pursue a mix of economic strategies, shown in Figure 7. They looked for short-term cooperation with Russia that recovered quicker from the economic crisis than the EU and was willing to underwrite the recovery of the Ukrainian economy conditioned upon greater cooperation between two states. They still see greater access to the EU market as an attractive long-term perspective that, however, cannot help them in addressing the problems created by the crisis.

<sup>15</sup> E. Segura, *The Impact of the Global Liquidity Crisis on Ukraine and the Road to Economic Recovery*, SigmaBleyzer, December 2009 (<http://www.sigmableyzer.com/File/economic/The%20Impact%20of%20the%20Global%20Liquidity%20Crisis%20on%20Ukraineand%20the%20Road%20to%20Economic%20Recovery.pdf>).

<sup>16</sup> Business.ua, "Biznes Ukrainskih oligarhov kredituyut rossiiskie banki", 28 March 2011 ([http://www.business.ua/articles/money/Biznes\\_ukrainskih\\_oligarhov\\_kredituyut\\_rossiiskie\\_banki-13400/](http://www.business.ua/articles/money/Biznes_ukrainskih_oligarhov_kredituyut_rossiiskie_banki-13400/)) and InvestGazeta, "Pochemu rossiiskim bankam ne vezet", 22 July 2011 (<http://www.investgazeta.net/finansy/pochemu-rossijskim-bankam-ne-vezet-161654/>).

Figure 7. Economic strategies of the Ukrainian business in a 'survival' mode



Dmytro Firtash, an influential oligarch advocating greater cooperation with Russia, has thrived in the post-crisis environment. Since the second half of 2010 he gained almost full control of Ukrainian fertilizer manufacturing industry, after allegedly receiving a credit of \$1 billion from Gazprombank.<sup>17</sup> As gas constitutes up to 70% of total costs in the fertilizer industry, Firtash concentrated on negotiating the reduction of the imported gas price with Russia and contracting gas from Central Asia.<sup>18</sup> Nevertheless, driven by the long-term interest in greater access to the world market, he claims that once he finishes the consolidation of assets in the chemical sector 'our second step could be organizing Ukrainian products distribution in Europe.'<sup>19</sup>

Rinat Akhmetov continued his business expansion in the West by acquiring a coal mining company in the US and joining European coal industry association EURACOAL. He certified his Hartsyzsk-produced pipes in the EU to export them to the EU market. He also took steps to become a major supplier of electricity to Eastern Europe (Slovakia, Romania, Hungary, Poland) through his DTEK holding (Donbass Fuel and Energy Company), after having successfully lobbied for the liberalisation of the electricity export in Ukraine.<sup>20</sup> Partly because his company has already invested in modernisation in line with the EU requirements, Akhmetov reportedly tried to salvage the agreements with the EU during his personal meeting with Swedish and Polish foreign ministers Carl Bildt and Radoslaw Sikorski in Donetsk in November 2011.<sup>21</sup> Nonetheless, Akhmetov also looked to expand business links with Russia: In 2010 Russian Transneft made a big order to the Khartsyzk plant, which increased its output three-fold since then.<sup>22</sup> Although his business maintained a more

<sup>17</sup> Vedomosti, "Ukrainu udobrili dengami Gazprombanka", 9 September 2011 ([http://www.vedomosti.ru/companies/news/1361218/ukrainu\\_udobrili\\_dengami\\_gazprombanka](http://www.vedomosti.ru/companies/news/1361218/ukrainu_udobrili_dengami_gazprombanka)).

<sup>18</sup> Firtash-owned chemical plants allegedly buy gas directly from Turkmenistan and pay \$170 per thousand cubic meters.

<sup>19</sup> The Day weekly digest, "Dmytro Firtash: If we are strong, we will be reckoned with" (<http://www.day.kiev.ua/218573>).

<sup>20</sup> DTEK, "DTEK signed contracts with Ukrenergo to access interborder connection grids to export electricity in 2011", 20 December 2010 (<http://www.dtek.com/en/media-centre/press-releases/details/dtek-signed-contracts-with-ukrenergo-to-access-interborder-connection-grids-to-export-electricity-in-2011>).

<sup>21</sup> Kyiv Post, "Akhmetov enthusiastic after European ministers visit Donetsk", 24 November 2011 (<http://www.kyivpost.com/news/politics/detail/117550/>).

<sup>22</sup> Minprom, "Poltory truby", 18 May 2011 (<http://minprom.ua/articles/67727.html>).

European outlook, he also looks favourably at economic cooperation with Russia and the rest of the CIS arguing that "Business is awaiting new opportunities... and if we expand our opportunities, we will be stronger and bigger. And Ukraine should be open to everyone, including to Russian business, and it can only win from this"<sup>23</sup>.

The poor financial health of many Ukrainian enterprises led to a flurry of acquisitions by Russian investors. Industrial Union of Donbass, one of the largest steelmakers in Ukraine (and 29<sup>th</sup> largest in the world) sold 50% plus two shares in its main metallurgical business to the Russian Evraz Group. Russian "Bryansk Machine Building plant" acquired Luhanskteplovoy, one of the world's largest rail locomotive producers. Rosatom bought Ukrainian Energomashspetsstal, specializing in machine building in the nuclear energy sector.<sup>24</sup> Ukrainian businessmen entered into competition with Russian investors over debt-burdened Ukrainian assets. For instance, the sale of Zaporizhstal, one of Ukraine's largest steel plants, has been contested in court between a group of unnamed Russian investors and one of Akhmetov's companies.<sup>25</sup> Firtash is expected to lock horns with Russian investors over the Odessa Port Plant.<sup>26</sup>

Whereas the crisis has not diminished the Ukrainian business' interest in long-term cooperation with the EU, the opportunities that cooperation with Russia provided at the time of crisis were too attractive for Ukrainian business to ignore. Victor Pinchuk, who prior to the crisis was one of the most ardent supporters of Ukraine's integration with the EU, described Ukraine's shifting priorities: "The centre of the world economy is shifting to Asia. Europe occupies much less space now. The future of the world, however, does not belong only to Asia. Russia's ambitious modernisation programme, in combination with its resource potential, could produce an unpredictably strong effect."<sup>27</sup> The situation can still change. Although by 2011 global steel prices recovered to the pre-crisis level, the European debt crisis and uneven recovery in the US pushed the prices down again (See Figure 6). Just as financial standing of Ukrainian financial-industrial groups started to improve, it is again in a shaky territory. Should the EU find a way out of its crisis and resume recovery, Ukrainian business elites might again favour economic integration with the EU.

#### 4. Russia's offer: Customs Union with Belarus and Kazakhstan

On 1 January 2010 Russia, Belarus and Kazakhstan announced the establishment of the Customs Union and invited Ukraine to join the organization. The Customs Union members

<sup>23</sup> Flot 2017, "Akhmetov: Ot prihoda rossiyskogo kapitala Ukraina tolko vyigraet", 18 May 2010 (<http://flot2017.com/show/news/23970>).

<sup>24</sup> RBK Ukraina, "Rossiyskii 'Atomenergomash' priobrel ukrainskuiu 'Energomashspetsstal'", 24 December 2010 (<http://www.rbc.ua/rus/top/show/rossiyskiy-atomenergomash-priobrel-ukrainskuyu-energomashspetsstal--24122010183500>).

<sup>25</sup> Luxe Holdings later filed and won a suit in London High Court over an unlawful termination of the deal. London South East, "UK Court Freezes Midland's Proceeds from Zaporizhstal Sale", 27 July 2010 ([http://www.lse.co.uk/sharecast-news-article.asp?ArticleCode=3598780&ArticleHeadline=UK\\_Court\\_Freezes\\_Midlands\\_Proceeds\\_From\\_Zaporizhstal\\_Sale](http://www.lse.co.uk/sharecast-news-article.asp?ArticleCode=3598780&ArticleHeadline=UK_Court_Freezes_Midlands_Proceeds_From_Zaporizhstal_Sale)) and Ukrainskaya Pravda, "Akhmetov zashel v 'Zaporoshstal'", 8 July 2011 (<http://www.pravda.com.ua/rus/news/2011/07/8/6370179/>).

<sup>26</sup> The Day weekly digest, "Dmytro Firtash: If we are strong, we will be reckoned with" (<http://www.day.kiev.ua/218573>).

<sup>27</sup> V. Pinchuk, interview with Korrespondent, 6 November 2010 ([http://pinchukfund.org/ru/about\\_pinchuk/interviews\\_and\\_articles/3327/?PAGEN\\_4=2](http://pinchukfund.org/ru/about_pinchuk/interviews_and_articles/3327/?PAGEN_4=2)).

proceeded with agreeing on liberalising trade within the Customs Union and on the common tariff scheme that would equalize the tariffs on the Customs Union borders.

In order to lure Ukraine into the Customs Union, Russia offered to reduce the gas price – something that Ukrainian elite tried but failed to achieve earlier – promising that Ukraine could save up to \$8-11 billion over several years. Russia also offered a variety of industrial cooperation projects (although few have been launched so far). *Sberbank* came forth with a proposal to finance the completion of new power blocks at Ukraine's Khmelnytsky Nuclear Power Plant (approximately €4-5 billion); Russian-Ukrainian joint ventures started exploring the possibilities for natural gas extraction from coal deposits and development of the Pallas field in the Black Sea.<sup>28</sup> Some industries (machine-building, air-, ship- and spacecraft-building), as Russian officials promised, would be able to benefit from the Customs Union by exploiting economies of scale from integrated production and sales processes. Russian counterparts also maintained that as part of the Customs Union Ukraine would have more leverage in free trade area negotiations with the EU.

Not only did Russia promise significant cooperation benefits to Ukraine, it also tried to raise the costs of Ukraine choosing to sign the DCFTA with the EU. The Customs Union has already adopted a range of trade restrictions in relation to exports from third countries on products such as milk,<sup>29</sup> potatoes, sugar, caramel, buckwheat etc, which would hit Ukraine's economy hard.<sup>30</sup> Russia also targeted Ukrainian business with sanctions in an attempt to mobilize support for the Customs Union. Among other things, Russia established a lower quota on Ukraine's steel pipe exports, while 'Helicopters of Russia' Holding threatened to renounce the joint production of helicopter engines with Ukrainian 'Motor Sich'. Although in July 2010 Russia lifted its five-year ban on Ukrainian poultry, only a small number of Ukrainian enterprises were allowed to export their produce to Russia after Sergei Dankvert, head of Russia's agency for veterinary and phytosanitary standards, had criticised Ukraine's plans for harmonisation of standards with the EU.<sup>31</sup>

Although membership in the Customs Union would certainly bring some economic benefits to a number of Ukrainian businessmen, mostly in the form of *ad hoc* economic deals, on a macroeconomic level according to various estimates the benefits for Ukraine would be either close to zero (approximately 0-0.7% of GDP growth)<sup>32</sup> or even negative (-0.5% of GDP in the medium term and -3.7% of GDP in the long term).<sup>33</sup> By integrating with less economically

<sup>28</sup> Interview with an expert from the Ukrainian Club of Agrarian Business, 1 June 2010.

<sup>29</sup> LB.ua, "TS ogranichil import myasomolochnoy produktsii iz Ukrainy", 13 July 2011 ([http://economics.lb.ua/food/2011/07/13/105787\\_TS\\_ogranichil\\_import\\_myasomolochnoy.html](http://economics.lb.ua/food/2011/07/13/105787_TS_ogranichil_import_myasomolochnoy.html) 13 July 2011).

<sup>30</sup> Deutsche Welle, "Rossia ogranichivaet export ukrainskoi stali", 28 June 2011 (<http://www.dw-world.de/dw/article/0,,15194807,00.html>); LB.ua, "Rossiysko-ukrainskaya torgovaya vojna", 26 July 2011 ([http://economics.lb.ua/state/2011/07/26/107729\\_Rossiyskoukrainskaya\\_torgovaya\\_vo.html](http://economics.lb.ua/state/2011/07/26/107729_Rossiyskoukrainskaya_torgovaya_vo.html)); Korrespondent, "Rossia uvelichila antidempingovye poshliny na import ukrainskih trub", 9 February 2011 (<http://korrespondent.net/business/economics/1184364-rossiya-uvelichila-antidempingovye-poshliny-na-import-ukrainskih-trub>); Rossisko-Ukrainskii Forum, "Oleg Soskin: Kiev poteriaet \$5 milliardov ot vvedenia kvot v Tamozennom soiuzе na ukrainskie trubы", 25 July 2011 (<http://rusukrforum.com/posts/457-oleh-soskin.html>).

<sup>31</sup> Analytical agency Agriculture, "Russia lifted a ban on poultry imports from Ukraine", 2 July 2010 ([www.agriagency.com.ua/comments/7776.html](http://www.agriagency.com.ua/comments/7776.html)).

<sup>32</sup> L.V. De Souza, "An initial estimation of the economic effects of the creation of the EurAsEc customs union on its members", *Economic Premise*, World Bank, January 2011, p. 47.

<sup>33</sup> V. Movchan and R. Giucci, "Kilkisna otsinka variantnoyi integratsii Ukrayiny: glyboka ta vseosyazhna zona vilnoyi torhivli z ES chy mytnyi soyuz z Rosiyeyu, Bilorussiu ta Kazakhstanom",



and technologically developed countries, with higher import tariffs with the rest of the world, Ukraine risks impairing its prospects for economic modernization. It would also have to revise its agreements with the WTO members, which would cancel out the positive effect of trade liberalisation and possibly trigger compensation claims from other WTO members.<sup>34</sup> Secondly, it would suffer trade diversion as goods that have been imported under lower tariffs from third countries in the past would become pricier on the domestic market.<sup>35</sup> Whereas low energy prices seem to be an attractive offer for Ukrainian elites and could provide some relief to embattled population and businesses, they would generate no 'dynamic' efficiency gains and would hamper the conversion of Ukrainian enterprises into modernised and energy-saving ones.

Importantly, if Ukraine becomes a member of the Customs Union, the benefits that Russia promises may not materialise at all. In the past Russia's foreign trade policy has very often been determined by the political priorities of the moment rather than formal free trade agreements. Despite the multitude of bilateral trade agreements between Russia and the CIS states, Russia regulated access to its market depending on the state of political affairs with one or another country with disagreements resulting in 'trade' and 'energy' wars (e.g. Ukraine, Georgia, and Moldova). As Russia and Ukraine may disagree on the ends of the Customs Union – Russia pursues political, while Ukraine mainly economic objectives – there is no guarantee that Russia would stop using economic pressure in the future.

Although in the current circumstances business elites seem to be more inclined to cooperate with Russia, especially in the economic sector, it is very unlikely that they would support Ukraine's membership in the Customs Union. While such attitude would mostly be driven by pragmatic short-term considerations of not ceding too much power to a supranational body led by Russia, most of them do not realise that the achievement of their long-term goals, such as modernisation and energy efficiency of their enterprises and competitiveness on advanced markets, ultimately depends on the transformation of the whole Ukrainian economy, which, in the foreseeable future, will only be feasible through deeper integration with the EU (at least not until Russia starts political and economic modernization).

## 5. Deep and Comprehensive Free Trade Area: Still attractive

Despite recent political developments, including the case of Yulia Tymoshenko, the association and free trade area agreements were on virtually all matters of substance finalised at the 2011 EU-Ukraine summit. But because the EU conditioned the signing and ratifying of the agreements on the Ukrainian authorities improving their record on democracy (maybe in early 2012), EU-Ukraine cooperation can unravel any moment. The outcome of the summit may suggest that the EU is wary of the consequences that the rupture

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German Advisory Group and Institute for Economic Research and Policy Consulting ([http://www.ier.com.ua/files/publications/Policy\\_papers/German\\_advisory\\_group/2011/PP\\_05\\_2\\_011\\_ukr.pdf](http://www.ier.com.ua/files/publications/Policy_papers/German_advisory_group/2011/PP_05_2_011_ukr.pdf)).

<sup>34</sup> V. Movchan, R. Giucci and K. Kutsenko, "Trade Policy in Ukraine: Strategic Aspects and Next Steps To Be Taken", Policy Paper PP/02/2010, German Advisory Group and Institute for Economic Research and Policy Consulting, p. 7 ([http://www.beratergruppe-ukraine.de/download/Beraterpapiere/2010/PP\\_02\\_2010\\_new\\_Format\\_eng.pdf?PHPSESSID=38dc3e1fc63a31a274dc253eb4f351bd](http://www.beratergruppe-ukraine.de/download/Beraterpapiere/2010/PP_02_2010_new_Format_eng.pdf?PHPSESSID=38dc3e1fc63a31a274dc253eb4f351bd)).

<sup>35</sup> This can trigger unexpected negative consequences. For instance, the expectation of higher import tariffs on cars as of July 2011 in Belarus triggered a full-blown crisis, through a record demand for second-hand cars and the ensuing high demand on foreign currency, pushing down the exchange rate of Belorussian ruble that Belorussian central bank could no longer maintain.

of the negotiations would have for both Ukraine and the EU, and therefore has chosen to leave the agreements on the table. The success of cooperation will ultimately depend on the Ukrainian elites' ability to adopt a longer-term perspective, as the gains from integration into the club of most economically and technologically advanced countries would be considerable but long-term. The biggest positive effect of the DCFTA, along with the Ukrainian business' own security and wealth, would depend on Ukrainian domestic system undergoing the minimum necessary transformation.

The benefits of the DCFTA range from greater trade openness due to the elimination of trade and non-trade barriers to the reform of domestic institutions that will bring about better business and investment climate, greater trade diversification and improved economic competitiveness. The DCFTA would offer Ukrainian business access to the EU market that, according to various estimates, would bring net welfare gains between 2% to 7% of GDP. These gains would be higher if trade in agricultural and food products is liberalised and if Ukrainian goods conform to SPS standards. According to the preliminary information, the EU market would remain partially protected for 'sensitive' goods such as barley, maize, wheat, caramel, meat and poultry, which account for a substantial part of Ukraine's exports.<sup>36</sup> However, the majority of agricultural and food products, as well as most other exports, will receive tariff-free access to the EU market and therefore can grow significantly in the medium-term.

The economic benefits to the Ukrainian economy could be two to three times as large if institutional and regulatory reforms, modelled on the EU legislation, are implemented.<sup>37</sup> These reforms are expected to improve business and investment climate and cut corruption and red tape, which have been plaguing the Ukrainian economy and deterring foreign investment for two decades. The quality of life of the Ukrainian citizens would improve, as greater trade openness means that cheaper and better quality products will find their way to the domestic market while pushing Ukrainian business to invest in innovations and quality controls. Should the DCFTA succeed, judiciary independence, the introduction of labour standards, and better environmental protection would serve the interests of the population at large. Therefore, should the reforms be implemented in Ukraine, they would give new impetus to Ukraine's international competitiveness and economic growth. According to latest estimates, a deep and comprehensive FTA, inclusive of regulatory reforms, can bring about welfare gains of 4.3% of GDP in the medium-term and 11.8% in the long term.<sup>38</sup>

Undoubtedly the DCFTA would not be hassle- or cost-free. First, the Ukrainian elites are unlikely allies of greater transparency and reform and are expected to resist the implementation of the agreement on many levels. Furthermore, both the state and some

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<sup>36</sup> Kommersant.ua, "Perevodnyi period: ZST s Evrosoiuzom sozhdadut ne ranee 2013 goda", 11 February 2011 (<http://kommersant.ua/doc.html?docId=1583276>); Interfax, "Kyiv and EU to discuss in Brussels on March 2-3 obstacles to creating free trade zone", 24 February 2011 (<http://www.interfax.com.ua/eng/main/61860/>).

<sup>37</sup> Static effects imply changes in output, trade flows and employment purely as a result of changes in tariff barriers to trade. Dynamic effects, in contrast, occur as a result of improved institutional performance and economic governance or the curbing of corruption, which in the Ukrainian context are the most important deterrents to trade and investment. ECORYS Netherlands BV and CASE Ukraine (2007), *Global Analysis Report for the EU-Ukraine TSIA*. Ref: TRADE06/D01, p. 75.

<sup>38</sup> V. Movchan and R. Giucci, "Kilkisna otsinka variantiv regionalnoyi integratsii Ukrayiny: glyboka ta vseosyazhna zona vilnoyi torhivli z ES chy mytnyi soyuz z Rosiyeyu, Bilorussiu ta Kazakhstanom", German Advisory Group and Institute for Economic Research and Policy Consulting, 2011 ([http://www.ier.com.ua/files/publications/Policy\\_papers/German\\_advisory\\_group/2011/PP\\_05\\_2\\_011\\_ukr.pdf](http://www.ier.com.ua/files/publications/Policy_papers/German_advisory_group/2011/PP_05_2_011_ukr.pdf)).

commercial enterprises would need to face moderate to high costs of the adaptation to the EU legislation (e.g. SPS standards, company law, state aid regulations and environmental legislation) in the short term. Moreover, progressive liberalisation would inevitably lead to the toughening of domestic competition, particularly for certain sectors, as more competitive European companies start operating in Ukraine, reducing profit margins for some Ukrainian firms or even forcing them out of business.<sup>39</sup> The long-term nature of the gains associated with the DCFTA, along with the populist effect produced by specific industries' resistance to liberalisation, may make the DCFTA less attractive in the short-term. However, the DCFTA stands out as the only alternative that promises reform and economic growth in the long-term.

## Conclusions

In 2010, Yanukovich argued that Ukraine "will be integrating with that side, which will provide interesting offers from the economic point of view, from the country's development point of view. And not before we carefully consider all the options".<sup>40</sup> Two years on, the Ukrainian elites have not yet sent a clear message, let alone adopted a clear strategy as to what integration vector they would like to pursue.

Ukraine's current policy of eschewing choice between Russia and the EU rests on a complex balance of interests in Ukraine's domestic politics. First, the political elites are reluctant to liberalise the political and economic system, and this is unlikely to change in the foreseeable future. Second, a pro-European vector is not a self-evident choice for Ukraine, which is economically interdependent with Russia and the EU and increasingly diversifies economic ties towards other regions. Third, at the times of the global economic crisis the business elites came to favour cooperation with Russia that provided short-term solutions to their problems of survival, albeit still seeing Ukraine's economic integration with the EU as a favourable but long-term priority. Finally, Russia, one of Ukraine's major economic partners, opposes Ukraine's European integration and offers Ukraine to join the Customs Union – an alternative regional organisation. All these factors make Ukrainian elites inclined to preserve the status-quo both in domestic and foreign policies – that is, avoiding integration with either Russia or the EU.

While the room for manoeuvre for Ukraine is getting smaller, cost-benefit analysis points out that although the Customs Union membership may bring short-term benefits, it is unlikely to bring Ukraine efficiency and competitiveness gains in the long-term. Joining the Customs Union might even have negative dynamic effects for Ukraine through locking it in trade among less technologically advanced partners. Moreover, any agreement today does not guarantee that Russia would maintain low import gas price and low tariffs in the future, as Russia's trade policy tends to be contingent on the state of political relations between Russia and its partners. Past record gives little ground to believe that in the future Russia will lead a 'fairer play'.

The benefits of integration with the EU are larger, but long-term and dependent on successful institutional transformation of the state and the economy. The agreements with the EU promise not only trade liberalisation but also a major overhaul of Ukrainian

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<sup>39</sup> ECORYS and CASE (op. cit., see footnote 37) estimate that industries such as processed rice and sugar, transport, water transport and air transport, as well financial services and insurance will experience substantial absolute losses in output.

<sup>40</sup> V. Yanukovich, Interview with Ukrainian BBC, 13 May 2010 ([http://www.bbc.co.uk/ukrainian/lg/ukraine/2010/05/100513\\_yanukovich\\_marta\\_oh.shtml](http://www.bbc.co.uk/ukrainian/lg/ukraine/2010/05/100513_yanukovich_marta_oh.shtml)).

institutions (such as judiciary, law enforcement, competition), which will facilitate economic modernisation and deeper integration into the global economy and will benefit the population at large. The former entails improvement of the business and investment climate, industrial and product upgrading, access to the largest market in the world, as well as general benefits of more advanced democracy and human rights.

Even if the association and DCFTA agreements are signed and ratified, there is a risk that they would remain unimplemented, as the Ukrainian elites are used to pick and choose the most beneficial provisions for implementation, while ignoring the costlier commitments. In these circumstances, the EU's strategy towards Ukraine should rest on four main premises: 1) delivering a clear and systematic message to the Ukrainian authorities, including identifying the scope and 'red lines' of engagement, and considering the possibility of adopting sanctions against officials involved in the most egregious violations of human rights; 2) systematic evaluation of Ukraine's progress on the implementation of reforms; 3) appealing for support to specific groups (e.g. youth, small and medium business, etc.) through more active engagement and targeted public diplomacy campaigns) and, finally, 4) support for civil society and people-to-people contacts through widening the aims and breadth of cooperation with Ukrainian civil society and moving towards free movement of people between Ukraine and the EU.



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