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# Rebuilding Ukraine: Principles and policies

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## CHAPTER 5

# International trade and foreign direct investment

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### EXECUTIVE SUMMARY

Ukraine is a small open economy with high reliance on foreign trade and a generally favourable trade regime. In joining the WTO in 2008, Ukraine committed to low tariff protection and extensive non-discriminatory access to its service markets. The Association Agreement with the EU signed in 2014 resulted in further trade-related reforms bringing Ukraine's legislation and practices closer to the EU norms. That harmonisation has resulted in reduced non-tariff barriers in trade with the EU and created opportunities for better access to third markets.

Over the last decade, several structural changes in Ukraine's trade occurred. Ukraine has become a significant player in the global food market, becoming the second-largest supplier of grains after the United States and the dominant supplier of sunflower-seed oil. In parallel, Ukraine has emerged as a global IT service supplier, and the industry has continued to thrive despite the full-scale war. In imports, the country managed to reduce its energy imports substantially. Geographically, the EU has become the largest trade partner of Ukraine, while Russia lost most of its economic linkages.

While external trade is essentially a success story, foreign direct investment looks more like a failure. FDI inward flows have been small and insufficient to cover development and modernization needs even prior to the full-scale war. In principle, Ukraine offers legal protection and tax privileges to investors and has multiple agencies responsible for attracting FDI. In practice, however, poor performance on such fundamental issues as the rule of law, protection of property rights, and the fight against corruption have deterred investors.

The full-scale war has had a devastating impact on Ukraine's foreign economic links. During the spring of 2022, its goods exports almost halved, mainly because of the Russian blockade of Black Sea ports. The recent deal to allow the sea shipment of grains and related goods and fertilizers is important, but not sufficient to recover exports in full. Because of the blockade, trade has become increasingly concentrated on the EU, with its share jumping from 40% to over 70% of the total exports.

At the same time, the full-scale war has triggered a historic shift in Ukraine's relations with the EU. In June 2022, Ukraine became an EU accession candidate country. This important milestone in Ukraine's status within Europe will govern the country's reform path for the years to come. Given the significant transformational power of the preparation for the EU accession, we expect reconstruction and modernization to be realized within this dominant political objective.

However, a rapid post-war economic recovery is possible only if based on solid exports and significant foreign capital inflows. This means the country will have to complete fundamental reforms related to the rule of law and to property rights protection. These are preconditions for the EU accession talks and key to attracting foreign investment. In parallel, Ukraine will continue sectoral reforms allowing economic integration with the EU even before the country becomes an EU member state.

It is expected that the role of public-private partnerships and private money per se will dominate the post-war recovery. International donors' primary role in trade and investments is technical and financial assistance in reforms aiming at EU integration and the funding of (new) insurance schemes for exporters and investors. The costs of foreign technical assistance should be relatively modest (a few billion dollars), but the cost of insuring operational risk against a future resumption is obviously going to be very dependent on the nature of the peace.

## **1 UKRAINE'S TRADE AND FOREIGN DIRECT INVESTMENT: MAIN TRENDS AND POLICY RECOMMENDATIONS**

Ukraine is a small open economy with high reliance on foreign trade and a generally favourable trade regime. In 2021, the ratio of trade (exports plus imports) to GDP was 83% in Ukraine compared, for example, to 118% in Poland. By joining the WTO in 2008, Ukraine committed to low tariff protection and extensive non-discriminatory access to its service markets and has generally followed through on its commitments.

The Association Agreement with the EU signed in 2014 resulted in further trade-related reforms bringing Ukraine's legislation and practices closer to the EU norms, a considerable step forward. That harmonisation has resulted in reduced non-tariff barriers (NTBS) in trade with the EU and created opportunities for better access to third markets.

Since then, Ukraine has remained active in concluding free trade agreements, and as of January 2022, it has had 19 free trade agreements (FTAs) with 47 countries, covering over half of its trade in goods.



Over the last decade, Ukraine has become a significant player in the global food market, becoming the second-largest supplier of grains after the United States and the dominant supplier of sunflower-seed oil. Notably, Ukraine has been shipping genetically modified organism (GMO)-free plants, including maize and soybeans, which are in high demand in the EU.

Nevertheless, the country's participation in global value chains has remained limited. Ukraine is a supplier of raw materials (grains, iron ore) and intermediate goods such as sunflower-seed oil in bulk, various ferrous metals, ignition wiring sets and so on, but its role in final production remains modest. At the same time, Ukraine has emerged as a global IT service supplier, and the industry has continued to thrive despite the full-scale war.

While external trade is essentially a success story, foreign direct investment (FDI) looks more like a failure. FDI inward flows have been small and insufficient to cover development and modernisation needs even prior to the full-scale war. In principle, Ukraine offers legal protection for investors and has multiple agencies responsible for attracting FDI. In practice, however, poor performance on such fundamental issues as the rule of law, protection of property rights and the fight against corruption have deterred investors. Dealing with widespread corruption, a legacy of the country's Soviet past, has long stood as the number one development problem in Ukraine, although recent years have seen improvement, and there is hope that the full-scale war will prove a turning point, with EU ascendancy providing both strong motivation and political impetus for reform.

The full-scale war has had a devastating impact on Ukraine's foreign economic links. During the spring of 2022, its goods exports almost halved, mainly because of the Russian blockade of Black Sea ports. The recent deal to allow the sea shipment of grains and related goods and fertilizers is helpful but hardly sufficient to recover exports in full. Notably, the agreement does not cover other major export products such as metals and ores, nor does it cover imports. In August 2022, grain shipments reached about 2.5 million tonnes, more than doubling compared to spring months but still about half of pre-full-scale war levels. Despite elevated global grain prices, Ukraine's exports of goods in 2022 are likely to be at least one-third lower than a year ago.

Because of the blockade, trade has become increasingly concentrated on the EU, with its share jumping from 40% to over 70% of the total exports; the EU and Moldova are the only easily accessible trade partners at present. Trade with the EU increased even in nominal terms despite a general deep dive in overall trade value. IT exports have continued to grow despite the full-scale war; in the first half of 2022, computer services increased by 30% year-on-year.

The full-scale war has resulted in a historic shift in Ukraine's relations with the EU. In June 2022, Ukraine became an EU accession candidate country, setting specific and measurable goals for Ukraine's policy for a decade and defining a clear path for future reforms. The candidacy does not exclude the implementation of the 2014 Association

Agreement with its continuing integration benefits, but presages further and faster integration than seemed possible before the full-scale war. It is a major step for Ukraine, though to take full advantage of it, the country must continue to make steady progress on governance issues.

Apart from Ukraine's candidate status, the full-scale war – and the Russian blockade – has dramatically advanced plans for improved transport and logistic links between Ukraine and the EU. A significant expansion of transport corridors and an enhancement of crossing points are envisaged. The EU and Ukraine have already signed a temporary agreement ensuring better access to the EU for Ukrainian road carriers. Land shipping remains much more expensive than sea transport for most products, thus restoring port access to the Black Sea in full remains the most important factor in resuming Ukraine's successful pre-war trade progress. Nevertheless, over time the improved land logistics with the EU will have a major impact regardless. Following the baseline assumptions for this volume, we assume that full Black Sea access will be restored post-war but take into account the possibility of higher insurance rates, especially if low-grade hostilities leave lingering uncertainty.

Taking into account observed full-scale war damages and new potential growth areas, Ukraine's expected export pattern could include the following:

- **Preserving the leading role of grains and other agriculture and food products** in exports, which seems feasible given that in 2022, despite the full-scale war, the grain harvest is expected to be about two-thirds of the record-high 2021 harvest and only about 14% less than in 2020.<sup>1</sup> Moreover, the 2020 land market reform that removed a long-lasting moratorium on agricultural land sales had only just begun to have its impact before the full-scale war and is likely to continue to lead to further growth long after.
- **Recovering metal exports.** The bombings, the blockade and the loss of workers to the military and migration have led to a sharp reduction in metal exports in the near term. However, access to domestic iron ores, increased supply of metal scrap, trained personnel, established global market networks and expected strong domestic demand create grounds for the sector to recover in the long run, with new, more efficient plants being constructed to replace ones that have been destroyed. Of course, this also depends on how quickly the wartime diaspora returns.

1 According to Latifundist.com, grain harvest is expected at 54-56 million tonnes in 2022 (<https://latifundist.com/novosti/59952-analitiki-pidvishchili-prognoz-urozhayu-zernovih-v-ukrayini-na-2022-rik>). The Ministry of Agrarian Policy and Food stated that, as of 29 September 2022, Ukraine has already harvested 26 million tonnes of grains, almost competing threshing of wheat and barley (<https://minagro.gov.ua/news/v-ukrayini-rozpochalosya-zbirannya-kukurudzi>). The harvesting of maize has just started and can reach 30 million tonnes. Ukraine harvested 86 million tonnes of grains in 2021 and 65 million tonnes in 2020.

- **Expanding weapon exports.** Ukraine is likely to see an increase in weapons exports in the medium to long run when peace is restored. It had significant capabilities prior to the war, being the fourth-largest global arms exporter in 2012.<sup>2</sup> Since the Russian aggression in 2014, Ukraine's defence industry has reoriented towards domestic needs, and its share in global arms exports slipped from 2.5% in 2012–2016 to 0.7% in 2017–2021 (Wezeman et al 2022). Still, in 2021, Ukraine was the fourteenth largest global arms supplier. The war resulted in rapid development and increased credibility of Ukraine's weapons, creating post-war market opportunities.
- **Offering new innovative products.** Ukraine has proven extremely innovative in a number of new medical products and technologies related to caring for victims of war, and this, too, is likely to develop into a new export industry. For example, Ukrainian medical experts have achieved important advances in haemostatic or anti-burn medicines, and aside from the contribution to human welfare, there are possibilities for commercialisation and export.
- **Increasing energy exports.** Ukraine's development of the green energy sector, facilitated by the preparations for EU accession and as a likely condition of post-war aid, implies that exports of energy, including electricity and, later on, hydrogen, can turn Ukraine into a net exporter of energy products. The chapter in this book on energy provides more details.
- **Strengthening IT and business service exports.** The IT sector is expected to retain its leading role in Ukraine's service exports, being among the key sectors with limited exposure to security threats. Exports of business services such as consulting will also likely expand, continuing the pre-war pattern. At the same time, exports of transport services will probably stay suppressed and revenues related to transiting Russian oil and gas to Europe will likely vanish.

As for imports, the short- and long-term structures will probably differ.

In the short term, Ukraine will need to import all petroleum-processing products as its production facilities have been destroyed. At present, for example, gasoline and diesel fuel must be hauled overland in trucks, which is highly inefficient. The same problem applies to many other products, as Ukraine is forced to replace the missing domestic production in sectors that have suffered substantial war devastation.

However, in the long run, the role of energy imports is likely to fall sharply in response to energy-efficiency measures and restored domestic production. At the same time, the reconstruction and modernisation needs will further boost imports of machines and equipment, which are already the largest import category.

2 [www.kyivpost.com/article/content/ukraine-politics/ukraine-worlds-4th-largest-arms-exporter-in-2012-according-to-sipri-321878.html](http://www.kyivpost.com/article/content/ukraine-politics/ukraine-worlds-4th-largest-arms-exporter-in-2012-according-to-sipri-321878.html)

Geographically, it seems plausible that trade will be more oriented toward the EU even after sea shipping is fully restored. That has been the experience of other countries that have joined the EU and is a natural byproduct of membership in a customs union. Nevertheless, the share of exports to the EU is likely to return closer to the pre-war levels as the demand for many Ukrainian products, particularly in agriculture, will stay mostly outside the EU.

Promising sectors for the future FDI inflows include:

- **Energy**, especially green energy, given the security risks associated with traditional energy sources and existing climate commitments.
- **Machines and equipment, including military equipment like drones.** Ukraine has its own products, but given ongoing security risks, it will welcome foreign investments into domestic production under the NATO standards.
- **Information technology and communication (ITC).** The sector has been developing intensively even despite the war and should become one of the key export drivers for the country.
- **Construction and construction materials.** The extensive reconstruction needs – given the scope of devastation – will make this sector a ‘Klondike’ for investors, both domestic and foreign. In addition, the development of modern infrastructure aligned with the EU standards will be the task for years, offering investment opportunities, also in a public-private partnership format (see the chapter on infrastructure for more details ).
- **Agriculture and food.** The sector is internationally competitive and has appeared to be quite resilient to security shocks.
- **Metal production.** The extensive devastation of existing production facilities, coupled with available resources and a trained labour force, make the sector recovery attractive.
- **Production of medical devices and pharmaceutical products.** The war experience has intensified innovation, making it attractive to potential investors.

The country’s EU candidate status and reconstruction needs are potentially an excellent attraction for foreign investors. However, as the experience of other former Soviet bloc countries illustrates, the full benefit will require addressing a number of concerns on top of the dislocation and destruction caused by the full-scale war. These concerns relate to deep-rooted problems – namely, the protection of property rights, the rule of law and the fight against corruption – and there is no magic bullet for them.

Moreover, both trade and FDI – and the economy in general – will depend on the availability of human capital (the return of refugees and/or inflow of migrants), infrastructure reconstruction and access to finance.



Given its candidate status, Ukraine should now bring European integration requirements into the frame of all its policy changes, including those related to reconstruction. EU membership entails the implementation of many norms still not embedded in the Ukrainian legislation. To ensure the efficient use of funds, these norms should be taken into account when planning the reconstruction. These can be, for instance, norms related to environmental protection, energy efficiency and construction.

Our recommendations on trade and investment policies include:

- **Implementing current EU-Ukraine Association Agreement opportunities.** This includes, for instance, the conclusion of the Agreement on Conformity Assessment and Acceptance (ACAA) of industrial products and the mutual recognition of equivalence for food products. The Association Agreement also envisions concluding special transport agreements that should allow the replacement of the temporary wartime agreement on road transport with a long-term deal opening access to the EU market for Ukrainian carriers. For telecommunications, postal, maritime and financial services, achieving internal market treatment will be essential. Further opening of the public procurement market, in addition to the access provided through the WTO Government Procurement Agreement, will be important.
- **Joining recent EU sectoral initiatives.** For instance, Ukraine is interested in joining the EU Digital Single Market<sup>3</sup> and taking part in the EU Green Deal<sup>4</sup> implementation.
- **Concluding further FTAs with a focus on countries with which the EU has negotiated, or is negotiating, FTAs,** such as Morocco, Tunisia and Algeria. These are countries in the Mediterranean region, and an FTA with them would allow better use of the Pan-European-Mediterranean Convention on preferential rules of origin (the PEM convention). Other potentially promising partners for FTAs are South Korea, India and Indonesia.
- **Completing fundamental reforms related to the rule of law and property rights protection.** This is the major priority not only to attract foreign investment but to promote long-term growth in general.
- **Introducing new risk-insurance schemes.** In anticipation of post-war tensions or, at a minimum, the tail risk of further tensions, a multi-donor fund to cover non-economic risks for foreign investors will be needed. There has been some

<sup>3</sup> <https://eufordigital.eu/discover-eu/eu-digital-single-market/>

<sup>4</sup> [https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal\\_en](https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en)

experimentation with such donor funds at the World Bank,<sup>5</sup> though the viability of this on the scale of Ukraine's economy may be difficult to secure. For better trade financing, the Export Credit Agency capitalisation by international donors will help to boost exports.

- **Further developing quality infrastructure,**<sup>6</sup> including rebuilding laboratories and other specialised facilities affected by the full-scale war, establishing new facilities and improving Ukrainian public servants' capacity in spheres related to quality control.
- **Establishing better transport and logistic links between Ukraine and the EU** for all transport means. For this, the development of intermodal transportation hubs in Ukraine is needed.

Successful implementation of these recommendations requires ongoing commitment and active involvement of Ukraine and its partners. Given the ongoing transformation of Ukraine's legislation and institutions in the country's preparation for EU membership, the EU role in implementing these recommendations is exceptionally high. This concerns not only financial and technical support but also the readiness to swiftly integrate Ukraine into sectors and spheres envisaged by the Association Agreement and sectoral deals.

## 2 BASIC TRADE FACTS: THE SITUATION BEFORE THE FULL-SCALE WAR IN UKRAINE

### 2.1 Statistics and trends

Ukraine is a small open economy dependent on foreign goods, services and capital markets.

Historically, Ukraine's trade openness (exports plus imports as a share of GDP) has fluctuated around 100%, though recently its exposure to foreign markets has fallen, with the trade-to-GDP share falling to 83% in 2021 compared to 108% in 2015. Still, Ukraine's trade openness is comparable with the EU average<sup>7</sup> and well above the world average (Figure 1).

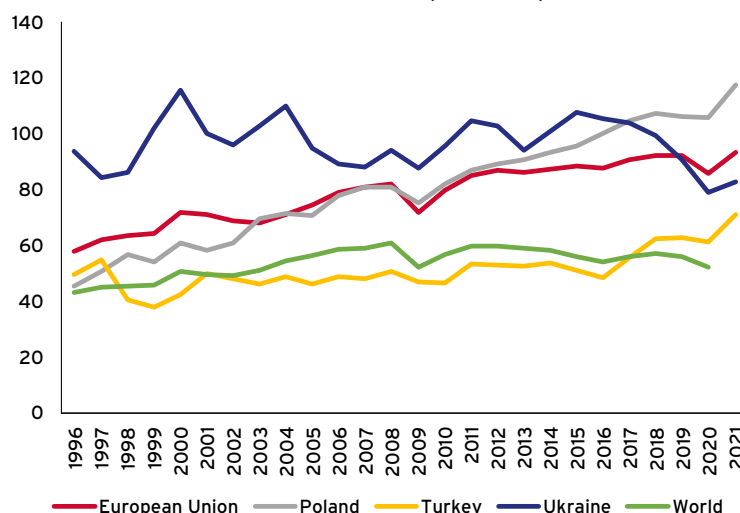
5 In September 2022, the Ministry of Economy and Multilateral Investment Guarantee Agency (MIGA), a part of the World Bank Group, announced plans for a pilot project for providing guarantees for foreign investors in Ukraine. The initial allocation for Ukraine is US\$30 (see [www.me.gov.ua/News/Detail?lang=en-GB&id=1885d3ee-e1fd-47bd-b44e-ec3cd42dd456&title=TheMinistryOfEconomyOfUkraineHasAgreedWithMigaToLaunchAMechanismForInsuranceOfInvestmentsDuringTheWar](https://www.me.gov.ua/News/Detail?lang=en-GB&id=1885d3ee-e1fd-47bd-b44e-ec3cd42dd456&title=TheMinistryOfEconomyOfUkraineHasAgreedWithMigaToLaunchAMechanismForInsuranceOfInvestmentsDuringTheWar)).

6 Quality infrastructure refers to the public and private institutional framework needed to implement standardisation, accreditation and conformity assessment services including inspection, testing, laboratory and product certification (see <https://europa.eu/capacity4dev/new-tbtprogramme-new/wiki/quality-infrastructure-1>).

7 Both intra-EU and extra-EU foreign trade are taken into account.

According to the balance of payments figures, in 2021, Ukraine exported US\$82 billion of goods and services and imported \$84 billion. Ukraine's trade remained below its 2012 peak value, despite a solid post-COVID-19 recovery fuelled by high global prices. While exports came close to peak 2012 values prior to the full-scale war, imports have remained at lower levels, partly due to a substantial reduction in fuel imports. In particular, Ukraine stopped importing natural gas directly from Russia at high prices, while imports from Europe were at market prices<sup>8</sup> and in lower volume.

FIGURE 1 FOREIGN TRADE IN GOODS AND SERVICES (% OF GDP)



Note: Includes both intra-EU and extra-EU foreign trade

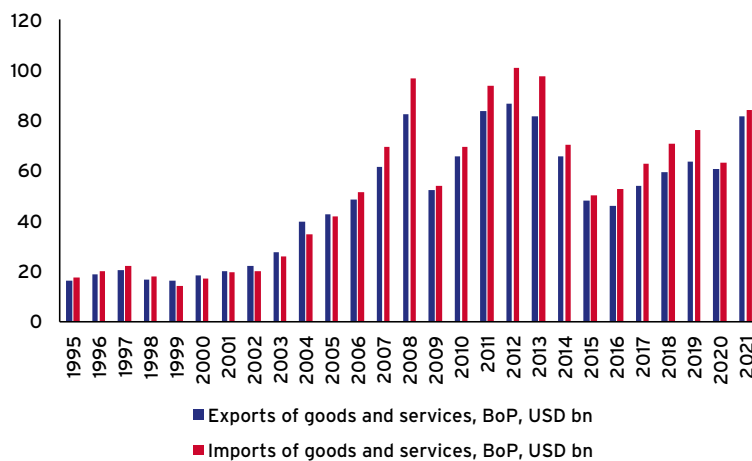
Source: <https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS>; trade in goods and services

Ukraine has had a negative trade balance in most years since 2006 (Figure 2). This trade deficit would be perfectly sustainable if it were coupled with strong FDI inflows. However, in Ukraine debt flows have dominated and the ongoing negative trade balance has been a recurrent source of vulnerability, leading to serial IMF programmes.

Trade in goods has been dominant for Ukraine's economy, with services accounting for only about one-fifth of total trade. In 2021, according to the balance of payments, Ukraine's goods exports amounted to \$63 billion, while service exports were \$18 billion. In imports, the respective figures were \$70 billion for goods and \$14 billion for services.

<sup>8</sup> The gas contract between the state-owned energy companies Naftogaz (Ukraine) and Gazprom (Russia) signed in 2009 envisaged excessively high gas prices, a 'take-or-pay' clause and prohibition of re-exports, ballooning Ukraine's fuel imports up. In 2014, Naftogaz and Gazprom entered into mutual arbitration at the Stockholm Chamber of Commerce. Since November 2015, Ukraine has stopped purchasing gas directly in Russia and switched to purchases from multiple European suppliers. This has allowed cheaper natural gas imports compared to the Gazprom contract. In 2017, Naftogaz won the Stockholm arbitration against Gazprom. Thus, Gazprom's market power abuse was confirmed.

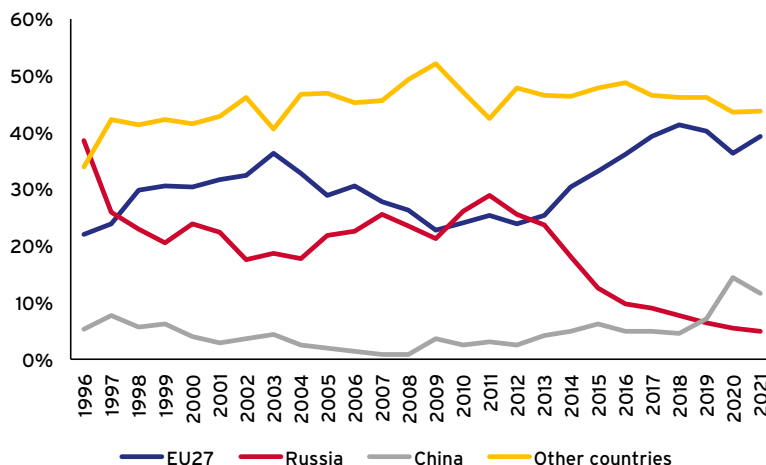
**FIGURE 2 UKRAINE'S EXPORTS OF GOODS AND SERVICES, BALANCE OF PAYMENTS (BILLIONS OF CURRENT US\$)**



Source: <https://data.worldbank.org/indicator/BM.GSR.GNFS.CD>; <https://data.worldbank.org/indicator/BX.GSR.GNFS.CD>

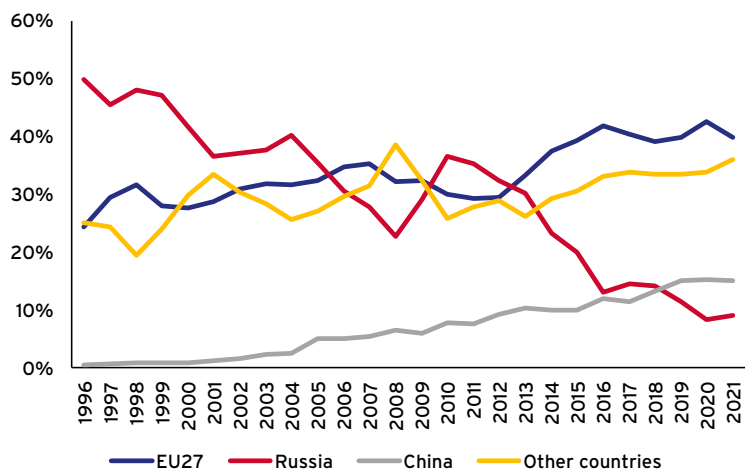
The last pre-full-scale war years significantly changed the geographic composition of trade as Ukraine reoriented from Russia towards the EU and Asia (Figures 3 and 4). The decline in trade with Russia accelerated dramatically after Russia's 2014 occupation of Crimea and a part of Donbas. In 2020, Ukraine doubled its goods exports to China amid COVID-driven reduced demand in the EU; however, in 2021, the EU partly regained its share.

**FIGURE 3 UKRAINE'S EXPORTS OF GOODS (% OF TOTAL)**



Source: Ukrstat, <https://ukrstat.gov.ua/>; authors' calculations.

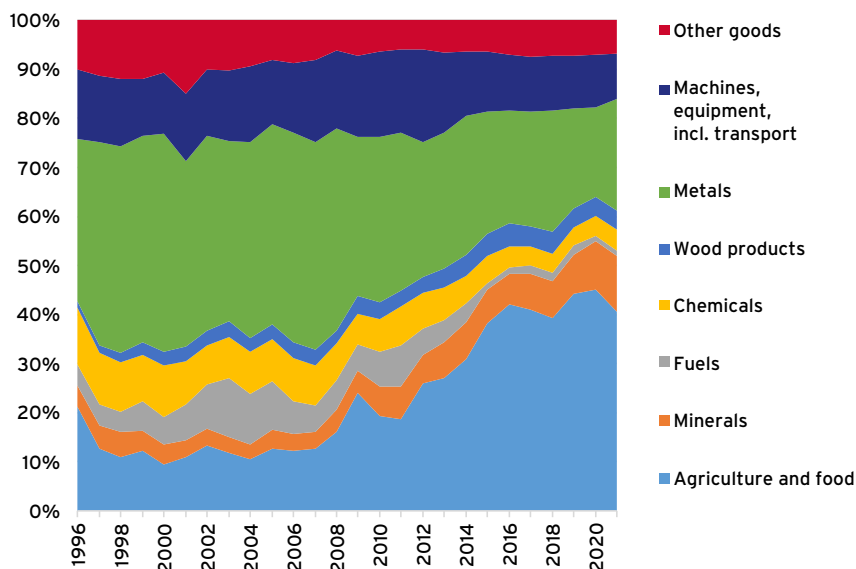
FIGURE 4 UKRAINE'S IMPORTS OF GOODS (% OF TOTAL)



Source: Ukrstat, <https://ukrstat.gov.ua/>; authors' calculations.

In terms of product composition, agriculture and metals have traditionally been the two largest export categories for Ukraine. However, they switched roles over the last decade (Figure 5). While metal exports did not fully recover after the 2008–2009 crisis, exports of agriculture and foods progressed steadily (Figure 6).

FIGURE 5 UKRAINE'S GOODS EXPORT STRUCTURE (% OF TOTAL)



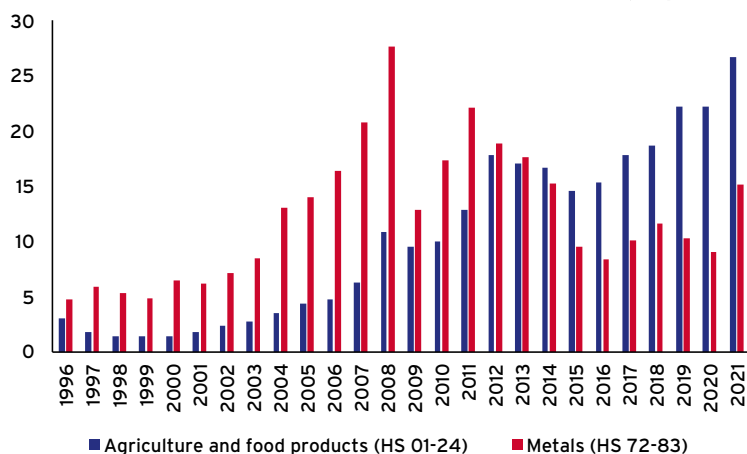
Source: World Integrated Trade Solution (WITS), authors' calculations



In 2021, Ukraine exported \$27 billion worth of agriculture and food products, making it the second largest exporter of grains after the United States and the largest global exporter of sunflower seed oil (Movchan 2022). Ukraine was also among the top ten exporters of soybeans and poultry. Notably, Ukraine has been shipping GMO-free plants, including maize and soybeans, which are in high demand in the EU.

The agrifood export expansion was backed by a strong increase in yields for all key crops. This productivity improvement was triggered by major sectoral reforms from the late 1990s to the early 2000s, when the government dissolved the collective farms and introduced private ownership of agricultural land. The 2020 land reform (see the discussion below) is expected to boost production and exports further, though its full effect has been delayed by the full-scale war.

**FIGURE 6 UKRAINE'S EXPORTS OF AGRIFOOD PRODUCTS AND METALS (US\$ BILLIONS)**

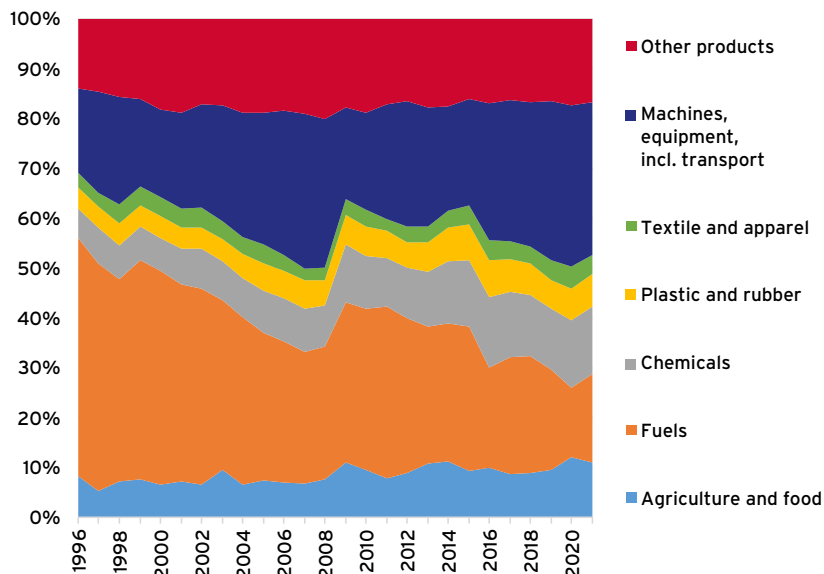


Source: WITS, authors' calculations.

Metal exports amounted to \$15 billion in 2021, having fallen by almost 50% since the peak in 2008. After 2008, Ukraine's metallurgy started to lose international competitiveness due to a failure to upgrade highly outdated technologies, in part due to difficulty in attracting FDI. Other adverse shocks included the loss of production assets and mineral deposits due to Russia's aggression in 2014, heightened international trade protection measures (anti-dumping and safeguards) and elevated prices for inputs, including iron ores, metal scrap, and energy.

In imports, the key structural changes are the reduced imports of energy products and the expanded role of machines and equipment, including transport equipment (Figure 7). Both changes are important. The lower imports of energy reflect major reforms in this sector (see the chapter on energy Tatyana Deryugina and co-authors), while the increase in capital goods imports signals growing demand for technical modernisation.

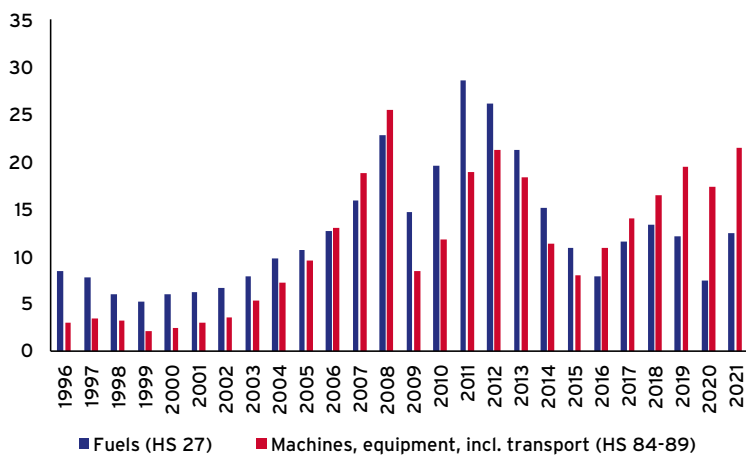
FIGURE 7 UKRAINE'S GOODS IMPORT STRUCTURE (% OF TOTAL)



Source: WITS, authors' calculations

In 2021, Ukraine imported \$12 billion in fuel, compared to \$29 billion at its peak in 2011. Despite this sharp drop in trade, many challenges remain. Although Ukraine stopped buying natural gas from Russia, it continued importing petroleum-processed products from Russia and Belarus and coal from Russia. Ukraine also continued importing nuclear rods from Russia, though it was gradually reducing this dependence.

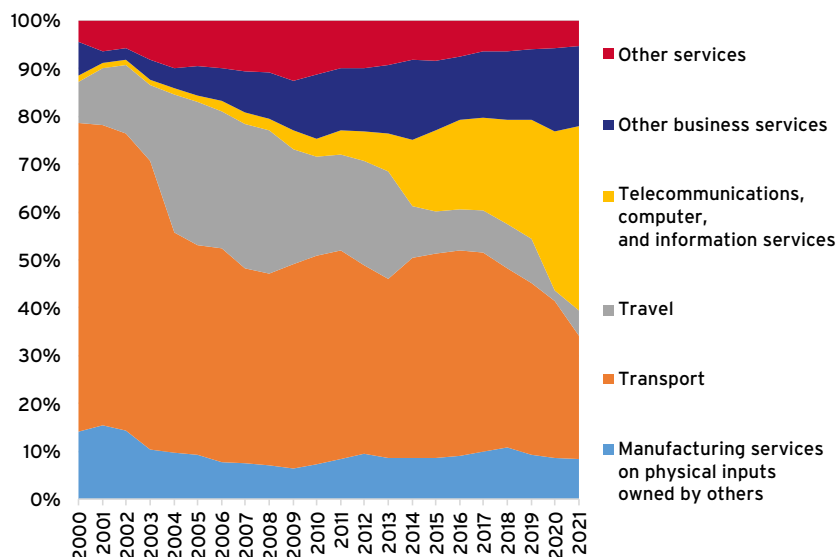
FIGURE 8 UKRAINE'S IMPORTS OF FUELS AND MACHINES AND EQUIPMENT (US\$ BILLIONS)



Source: WITS, authors' calculations.

In services trade, the structural changes have been remarkable, and services are an area that continues to show great promise. The positive change was a swift development of the ITC sector and its exports; its share of Ukraine's service exports increased from 1% in 2000 to 39% of the total in 2021, when exports reached \$7 billion (Figure 9).

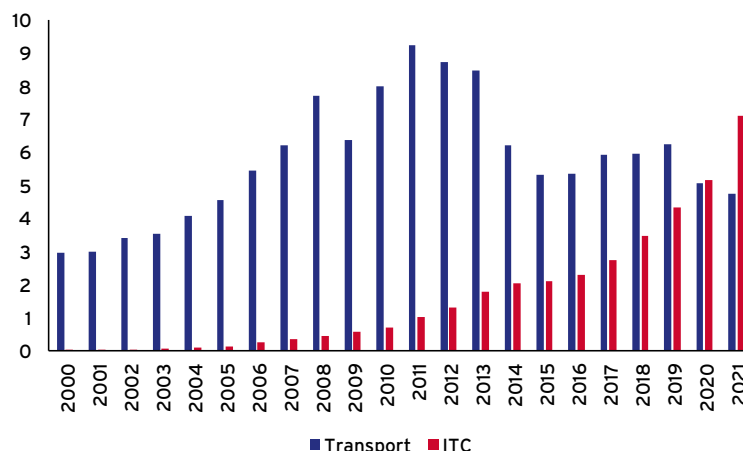
FIGURE 9 UKRAINE'S SERVICES EXPORT STRUCTURE (% OF TOTAL)



Source: National Bank of Ukraine, authors' calculations.

But there have also been setbacks. Ukraine has faced reduced exports of transport services since 2014 caused by several shocks, many of them related to the Russian aggression against the country. Ukraine's pipeline transit revenues have notably reduced since 2014 and one may expect further declines, although the outlook is highly uncertain. Since 2014, Ukraine has also suffered from the loss of access to Crimea and the truncated transit between Russia and the EU through Ukraine by rail and roads. The war escalation in February 2022 resulted in the loss of access to Azov Sea ports and the blockade of Black Sea ports (the latter being partly removed in July thanks to the so-called 'grain deal' described below). Again, the baseline scenario for this book is that access will be substantially restored post-war. Nevertheless, the deficit of road permits for Ukrainian cargo transport to the EU has been another factor. In 2020, these shocks were topped by COVID-related transport disruptions, especially for passenger transportation. Revenues from travel exports (tourist and business visitors) also dropped after Russia occupied and annexed Crimea and were further hit by the COVID-19 crisis.

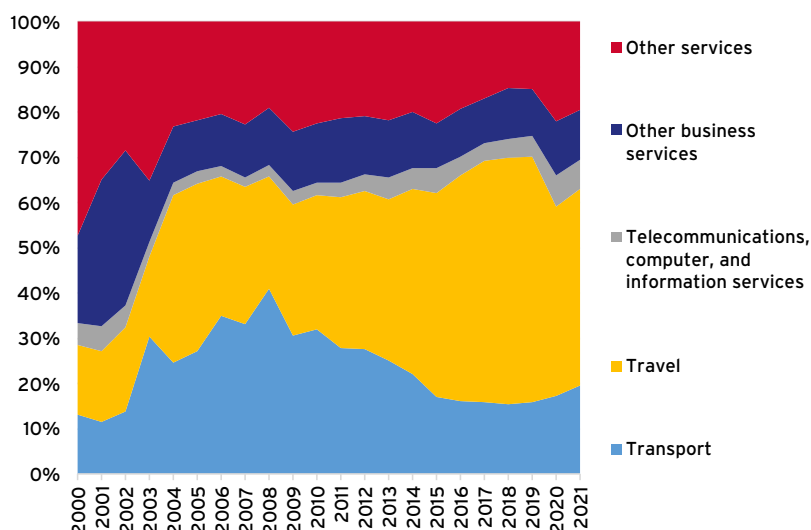
FIGURE 10 UKRAINE'S EXPORTS OF TRANSPORT AND ITC SERVICES (US\$ BILLIONS)



Source: National Bank of Ukraine.

In imports, the major change before the full-scale war was the increased role of travel, as Ukrainians discovered relatively cheap Turkish and Egyptian resorts (Figure 11). The visa-free regime with the EU introduced in 2017 was another factor stimulating travel. The COVID-19 outbreak sharply limited travel in 2020, but in 2021 the sector started to revive. As a result, in 2021, imports of travel services were worth \$6 billion, compared to a peak of \$8 billion in 2019 (Figure 12).

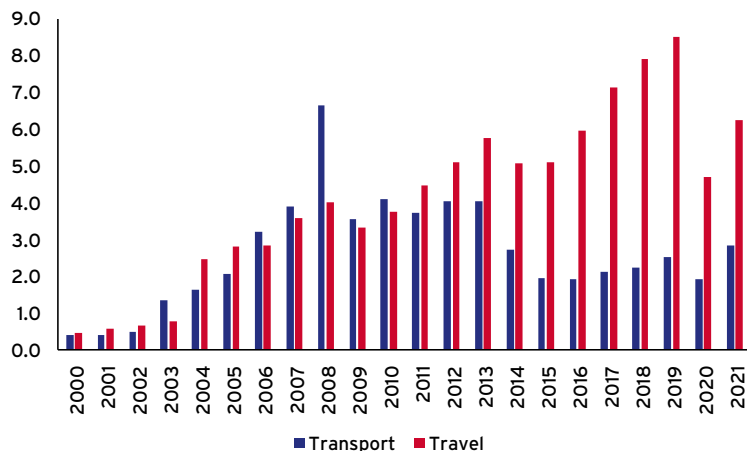
FIGURE 11 UKRAINE'S SERVICE IMPORT STRUCTURE (% OF TOTAL)



Source: National Bank of Ukraine, authors' calculations.

Along with exports, imports of transport services have also fallen since 2014 due to the disruption of trade with Russia after its aggression.

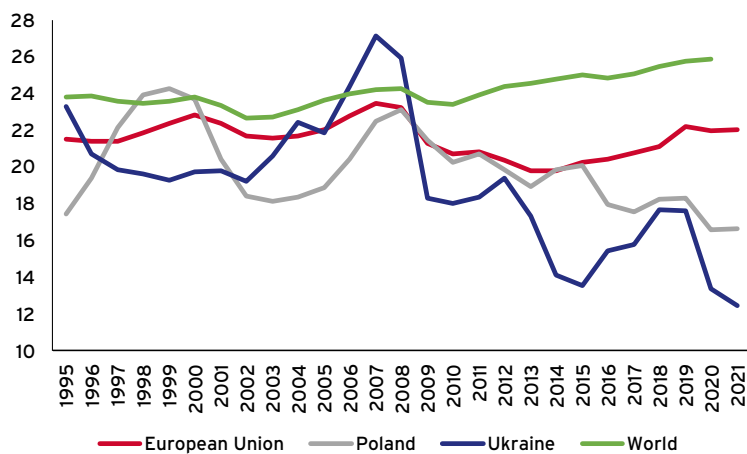
FIGURE 12 UKRAINE'S IMPORTS OF TRANSPORT AND TRAVEL SERVICES (US\$ BILLIONS)



Source: National Bank of Ukraine.

Despite its favourable geographic location, well-educated labour force and rich natural endowments, Ukraine's capital stock is not representative of its long-run potential. The share of gross fixed capital accumulation in GDP has been on a downward trend since the mid-2000s, falling to 12% of GDP in 2021, which is less than half the world average (Figure 13).

FIGURE 13 UKRAINE'S GROSS FIXED CAPITAL FORMATION (% OF GDP)



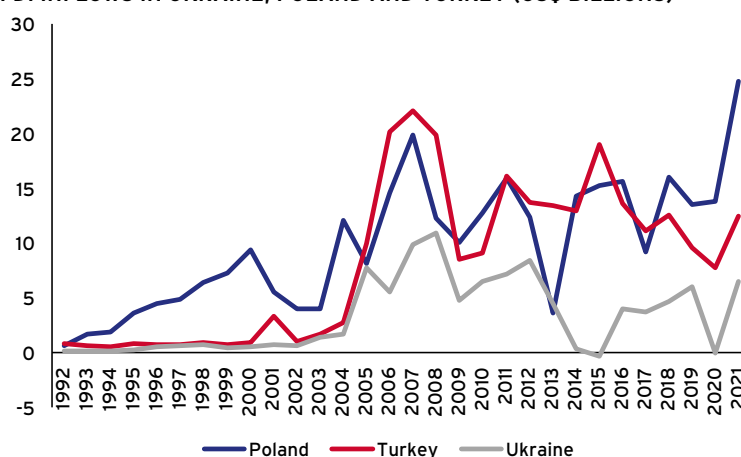
Source: <https://data.worldbank.org/indicator/NE.GDI.FTOT.ZS>

The primary source of investment for enterprises is self-finance as the banking system has remained underdeveloped and the stock market is close to non-existent. As we have already emphasised, the role of foreign capital in capital investments is also very low, ranging from 1% to 3% over the last decade.



FDI inflows into Ukraine have been very volatile and quite limited compared to its neighbours, such as Poland or Turkey. After comparable inflows in the early 1990s, both Poland and Turkey have since managed to attract far more FDI. In Ukraine, the largest FDI inflows were registered before the 2009 global crisis, although they were still lower than in Poland (Figure 14). In 2014–2015 and 2020, Ukraine's FDI inflows were close to zero or even negative.

FIGURE 14 FDI INFLOWS IN UKRAINE, POLAND AND TURKEY (US\$ BILLIONS)



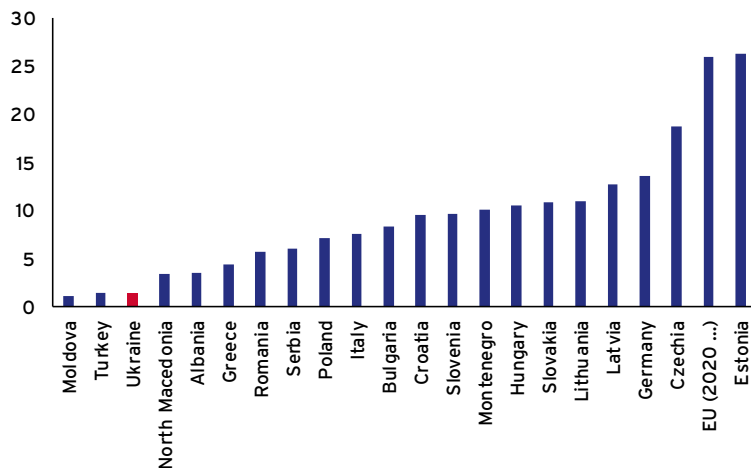
Source: UNCTAD, <https://unctadstat.unctad.org/wds/TableView/tableView.aspx>

As of the end of 2021, Ukraine's inward FDI stock (the cumulative flow of FDI accounting for depreciation) constituted \$64 billion. This implies that Ukraine has one of the lowest levels of FDI stock per capita among the EU member states and candidate countries. Ukraine's FDI inward stock was \$1,400 per capita in 2021, exceeding only that of Turkey and Moldova. Poland had an FDI per capita stock of \$7,100 in 2021, while the EU average was \$25,900 (Figure 15).

The structure of the FDI inward stock has changed over the last decade (Figure 16). In the 2000s, the main sectors with FDI were financial services (primarily banking) and metal production. The latter included the largest case of open privatisation with foreign participation, namely, the re-privatisation of the Kryvorizhstal steel plant to ArcelorMittal in 2005. However, there was no further major FDI into metal production, while many foreign banks left the country in the 2010s,<sup>9</sup> diluting the shares of these two sectors in the FDI stock. As of 2021, the trade and extractive industries became the sectors with the largest FDI stock.

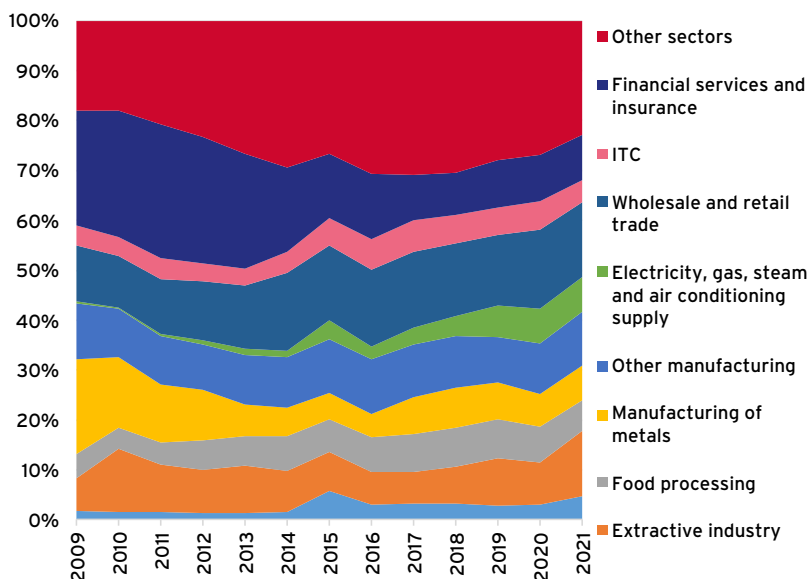
<sup>9</sup> The number of foreign banks in Ukraine started to decline before 2014, following a peak in 2010–2011. As of 1 January 2011, there were 55 banks with foreign capital. This number fell to 49 by 1 January 2014 and to 35 by 1 January 2020. As of 1 January 2022, 33 banks with foreign ownership were in the country (see [https://bank.gov.ua/files/stat/Osn\\_Pok\\_2001-2015.xlsx](https://bank.gov.ua/files/stat/Osn_Pok_2001-2015.xlsx) for 2001–2015 and [https://bank.gov.ua/files/stat/Indicators\\_Banks\\_2022-09-01.xlsx](https://bank.gov.ua/files/stat/Indicators_Banks_2022-09-01.xlsx)).

FIGURE 15 FOREIGN DIRECT INVESTMENT STOCK PER CAPITA, 2021 (US\$ THOUSANDS)



Source: UNCTAD, <https://unctadstat.unctad.org/wds/TableViewer/tableView.aspx>

FIGURE 16 FOREIGN DIRECT INVESTMENT STOCK BY SECTOR, 2009 - 2021 (% OF TOTAL)



Note: For 2009-2014, the structure of FDI is reported as of January 1 of the next year; for 2015-2021, the structure is reported as of December 31 of the current year.

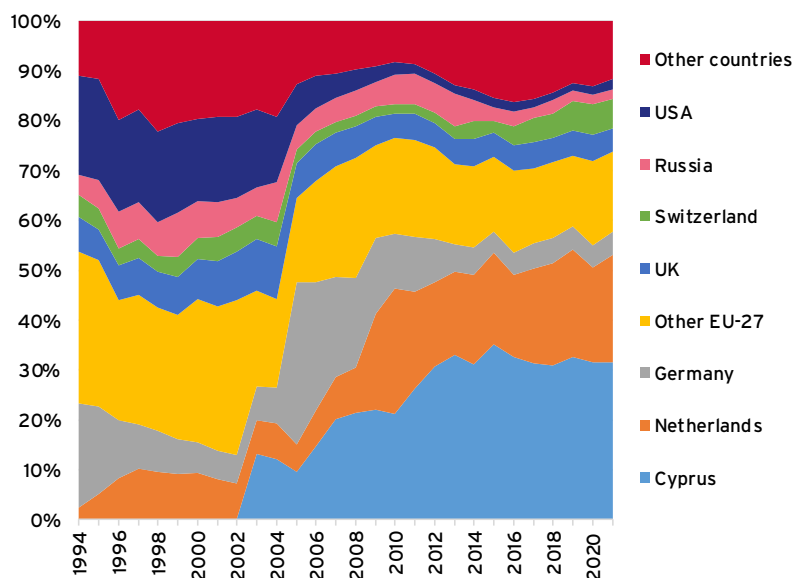
Source: Ukrstat for 2009-2014; National Bank of Ukraine for 2015-2021; authors' calculations.

Since the early 2000s, the EU has been the primary source of FDI into Ukraine. In 2021, the EU27 accounted for 74% of the inward FDI stock. Cyprus and the Netherlands are the dominant partners, supplying 53% of the stock. However, the fact that these two countries are the largest sources of FDI is problematic, as these inflows include round

tripping, potentially related to tax evasion. According to the National Bank of Ukraine (NBU) estimates, round tripping accounted for almost a quarter of FDI in 2010–2020,<sup>10</sup> with the largest volumes of FDI round tripping registered for Cyprus, the Netherlands, Switzerland and Austria.

Notably, the role of Russia as a source of FDI has always been very moderate, at about 6% on average in 1994–2014 and shrinking to 2% of total FDI stock in 2015–2021 (Figure 17).

**FIGURE 17 FOREIGN DIRECT INVESTMENT STOCK BY SOURCE, 1994-2021 (% OF TOTAL)**



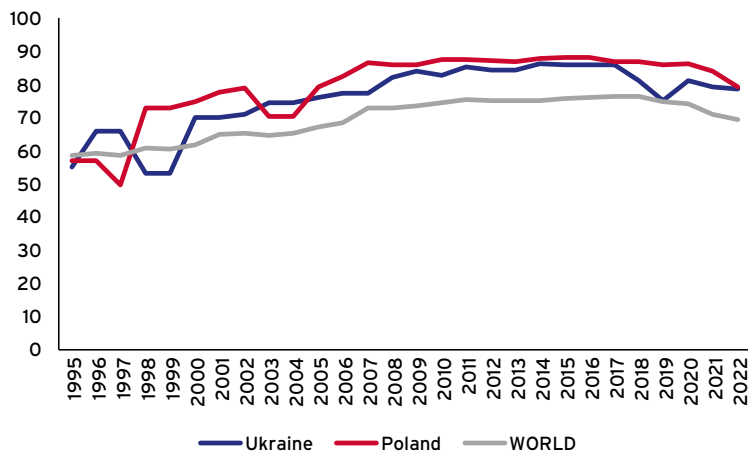
Note: For 1994–2014, the structure of FDI is reported as of January 1 of the next year; for 2015–2021, the structure is reported as of December 31 of the year

Source: Ukrstat for 1994–2014; National Bank of Ukraine for 2015–2021; authors' calculations.

According to international assessments, Ukraine scores highly in foreign trade policy and practices, while its investment policy performance is unsatisfactory. For instance, Heritage Foundation assessments of Ukraine's trade freedom have ranged between "free" and "mostly free" since the early 2000s, while its investment freedom has been evaluated as "repressed" since 2002. Since 2014, Ukraine's investment freedom has improved but is still "repressed" (Figures 18 and 19).

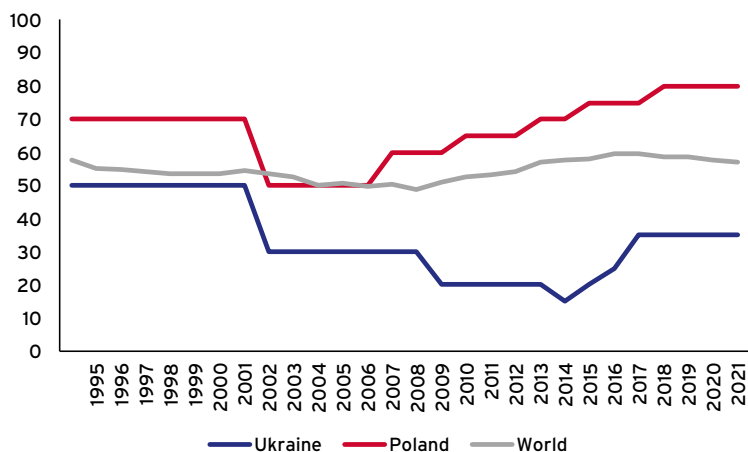
<sup>10</sup> <https://bank.gov.ua/en/files/rRSNvteXHvOavxA>

FIGURE 18 HERITAGE FOUNDATION TRADE FREEDOM INDEX



Note: Below 50 = repressed; 50 to 60 = mostly unfree, 60 to 70 = moderately free, 70 to 80 = mostly free, over 80 = free.  
 Source: <https://www.heritage.org/index/visualize?cnts=ukraine|poland&src=ranking>

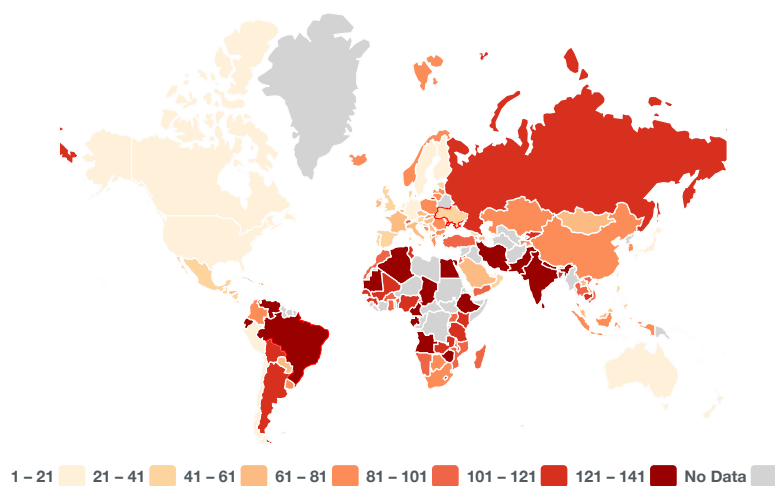
FIGURE 19 HERITAGE FOUNDATION INVESTMENT FREEDOM INDEX



Note: Below 50 = repressed; 50 to 60 = mostly unfree, 60 to 70 = moderately free, 70 to 80 = mostly free, over 80 = free.  
 Source: <https://www.heritage.org/index/visualize?cnts=ukraine|poland&src=ranking>

According to the World Economic Forum (2019), Ukraine was ranked 32 out of 141 countries in trade openness (Figure 20), on a par with many EU member states and even surpassing Poland and Bulgaria. It is noteworthy that Ukraine's ranks for the trade openness sub-components (prevalence of non-tariff barriers, trade tariffs, complexity of tariffs and border clearance efficiency) were lower, ranging from 43rd to 91st.

FIGURE 20 TRADE OPENNESS ACCORDING TO THE WORLD ECONOMIC FORUM, 2019



Source: <https://govdata360.worldbank.org/indicators/he082f372>

In particular, the country is ranked 90th out of 141 countries for border clearance efficiency. Ukraine's mediocre performance in border clearance is confirmed by the OECD Trade Facilitation Indicators, where Ukraine lags behind Poland in nine out of eleven spheres. Ukraine scores higher than Poland in the involvement of the trade community, but lower in many functional indicators related to formalities and also in border cooperation (Table 1).

TABLE 1 OECD TRADE FACILITATION INDICATORS

	Ukraine	Poland
A Information availability	1.050	1.857
B Involvement of the trade community	1.667	1.625
C Advance rulings	1.000	1.909
D Appeal procedures	1.625	1.455
E Fees and charges	1.583	2.000
F Formalities - documents	0.778	1.875
G Formalities - automation	0.667	1.538
H Formalities - procedures	0.800	1.852
I Internal border agency cooperation	0.500	1.364
J External border agency cooperation	0.636	2.000
K Governance and impartiality	1.222	2.000

Note: The Trade Facilitation Indicators (TFIs) take values from 0 to 2, where 2 designates the best performance that can be achieved.

Source: <https://sim.oecd.org/Default.ashx?lang=En&ds=TFI&d1c=eca&d2c=ukr&cs=asiap>



## 2.2 Previous reforms and policies

As noted in the introduction, Ukraine has quite a liberal trade regime. The country's average applied most favoured nation (MFN) duty is 4.4%, compared to 5.2% in the EU and 10.7% in Turkey, though the United States has even lower duties at 3.4% on average (Table 2).

**TABLE 2 SIMPLE AVERAGE MFN IMPORT DUTIES APPLIED BY UKRAINE, THE EU, THE UNITED STATES AND TURKEY, 2021**

	Ukraine	EU	US	Turkey
<b>All products</b>	<b>4.4</b>	<b>5.2</b>	<b>3.4</b>	<b>10.7</b>
<b>Agricultural products</b>	<b>9.1</b>	<b>11.7</b>	<b>5.2</b>	<b>41.1</b>
Animal products	10.6	17.0	2.2	101.1
Dairy products	10.0	39.5	19.4	128.4
Fruit, vegetables, plants	9.7	10.9	4.6	33.5
Coffee, tea	5.7	5.9	3.3	31.9
Cereals & preparations	12.4	14.5	3.1	34.2
Oilseeds, fats & oils	8.3	5.7	7.2	13.1
Sugars and confectionery	19.4	24.3	14.9	92.4
Beverages & tobacco	7.4	19.9	18.1	36.5
Cotton	1.4	0.0	3.5	0.0
Other agricultural products	5.4	3.1	1.0	10.5
<b>Non-agricultural products</b>	<b>3.7</b>	<b>4.1</b>	<b>3.1</b>	<b>5.8</b>
Fish & fish products	2.5	11.5	0.7	34.5
Minerals & metals	3.2	2.0	1.7	3.4
Petroleum	0.8	2.5	1.9	3.2
Chemicals	3.1	4.5	2.8	4.7
Wood, paper, etc.	0.3	0.9	0.5	1.0
Textiles	3.8	6.5	7.9	6.5
Clothing	11.3	11.5	11.6	11.5
Leather, footwear, etc.	5.5	4.1	3.9	4.1
Non-electrical machinery	2.1	1.8	1.2	1.8
Electrical machinery	3.7	2.1	1.4	2.8
Transport equipment	5.8	4.7	2.9	4.7
Manufactures, n.e.s.	5.5	2.1	2.1	2.6

Source: WTO.

Ukraine, similarly to many other countries, protects its agriculture and food market by imposing higher duties compared to those applied to industrial goods. The average applied MFN duties on agricultural products in Ukraine is 9.1%, more than twice its industrial duties. The highest duties are levied on imports of sugar, the import duty on which outside the tariff rate quota<sup>11</sup> is set at 50%. The second highest import duty is applied on imports of sunflower seed oil, at 30%.

Nevertheless, in general, in Ukraine, only 1.1% of agricultural tariff lines apply MFN import duties exceeding 25%, and none exceeds 50%. For comparison, 8.6% of EU agricultural tariff lines apply MFN import duties of between 25% and 50%, 2.9% of tariff lines have duties from 50% up to 100%, and 0.5% have duties over 100%.

Ukraine's tariff schedule has a high level of transparency and predictability. First, Ukraine has all its tariffs bound, with the bound rate<sup>12</sup> at 5.8% on average, slightly above the average EU bound rate of 5.3% on average. For comparison, Turkey has 49.5% of unbound tariffs for agriculture and 17% for non-agricultural products. Second, Ukraine predominantly uses ad valorem tariffs, with non-ad valorem tariffs in only 1.1% of agricultural tariff lines and none for industrial products. The EU applies non-ad valorem tariffs for 31.6% of agricultural tariff lines and for 0.5% of non-agricultural tariff lines (Table 3).

**TABLE 3 BOUND MFN IMPORT DUTIES BY UKRAINE, THE EU, THE UNITED STATES AND TURKEY, 2021**

	Ukraine	EU	US	Turkey
<b>Bound import duty, all products</b>	<b>5.8</b>	<b>5.3</b>	<b>3.3</b>	<b>28.9</b>
Agricultural products	11.0	12.6	4.5	61.8
Non-agricultural products	5.0	4.1	3.2	17.2
<b>Share of bound duties:</b>				
Agricultural products	100%	100%	100%	50.5%
Non-agricultural products	100%	100%	100%	43.0%

Source: WTO.

<sup>11</sup> A tariff rate quota (or tariff quota) is a two-tier tariff setting different rates depending on the traded amount. The rate within the quota is lower than the rate outside the quota. It is an instrument of partial liberalisation, allowing access to the market without clear-cut quantitative restrictions.

<sup>12</sup> The bound rate is the maximum MFN import duty a WTO member state can apply to other members. The bound rates are committed in a country's accession schedule. The bound rate generally cannot be exceeded without compensating the affected parties. Any member is free to apply lower MFN rates than bound rates.

As a part of its WTO commitments, Ukraine established only one non-tariff quota – on sugar – which accounts for only 0.3% of Ukraine's agricultural tariff lines, and thus de facto does not use this protectionist tool. The EU, for instance, applies quotas to 13.5% of its agricultural tariff lines, and the United States applies quotas to 5.9%. Relatedly, Ukraine is greatly reducing the required paperwork for trade in services, another form of NTB.

Generally, Ukraine does not have licensing of international trade. The list of products subject to quantitative restrictions is minimal. In 2021, Ukraine banned exports of silver, gold and precious metal scrap, licensed exports of anthracite, and established quotas and licenses on trade in ozone-depleting substances in line with the Montreal Protocol.<sup>13</sup> (Again, we are referring to the pre-full-scale war regime, which should be resumed when the peace is restored – the baseline in this book. During the full-scale war there have, of course, been more restrictions, though arguably far less than there should have been, for example, on the use of scarce foreign exchange for the importation of luxury cars.)

Ukraine applies technical regulations broadly in alignment with EU and international norms. Inspection of the standard importer's conformity declaration confirms compliance with these regulations' mandatory requirements. For example, the importer is required to use a third-party conformity assessment only for high-risk products. Importantly, the list of documents required for moving goods across the border does not include the declaration of conformity. However, the importer must have it to place the product on Ukraine's market.

Most standards are aligned with international or European standards. In all cases, in line with the WTO Agreement on Technical Barriers to Trade (TBT), standards are voluntary, i.e. businesses can choose whether to produce under the formal standard, in many cases providing the presumption of conformity with mandatory safety requirements embedded in technical regulations or to comply with technical regulations directly, without referring to a particular standard (important for innovative products).

As noted earlier, Ukraine has already concluded 19 free trade agreements with 47 countries, including the EU, the European Free Trade Association (EFTA), the United Kingdom, Canada, Israel, North Macedonia, Montenegro, Georgia, most CIS states and, in January 2022, with Turkey.<sup>14</sup> That covers 58% of Ukraine's trade in goods in 2021.

<sup>13</sup> <https://zakon.rada.gov.ua/laws/show/1329-2020-%D0%BF#Text>

<sup>14</sup> The full list of Ukraine's FTA partner countries includes 27 EU member states (Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden), four EFTA member states (Iceland, Lichtenstein, Norway, Switzerland), Georgia, Moldova, Armenia, Azerbaijan, Belarus, Uzbekistan, Tajikistan, Turkmenistan, Kyrgyzstan, Kazakhstan, North Macedonia, Montenegro, Canada, Israel, the United Kingdom and Turkey (the latter agreement was signed in 2022 and is still to be ratified)

Ukraine joined the Pan-European-Mediterranean Convention on preferential rules of origin, allowing diagonal cumulation<sup>15</sup> among the participants of the Convention, with which Ukraine has FTAs including the EU, EFTA, Georgia, Moldova, Israel, North Macedonia and Turkey.

Since the launch of the Deep and Comprehensive Free Trade Agreement (DCFTA) provisional implementation in 2014, Ukraine has implemented many necessary reforms aimed at reducing non-tariff barriers to trade. The major changes have occurred in the spheres of industrial and food safety, customs, public procurement, protection of intellectual property rights, financial markets, digital services, transport, energy, and environment (see the Appendix for details). In line with the Association Agreement, Ukraine has been preparing for extensive economic integration with the EU.

The legal framework for FDI has also been sufficiently attractive. The framework law on foreign investments regime was adopted back in 1996 and then amended several times. It established key guarantees, including a national treatment regime, state guarantees and the right to remit profits.<sup>16</sup> In 2019, a new law on concessions aligned with international practices was adopted, which improves creditor rights protection and resolves previous legal hurdles that prevented the concession development in the country.<sup>17</sup>

In 2021, several laws provided extensive tax privileges to invest. First, the Verkhovna Rada (Ukraine's parliament) adopted the law on state support for investment projects with significant investments in Ukraine, known as the law on 'investment nannies'. It envisaged:<sup>18</sup>

- state guarantees on stable legislation for 15 years;
- compensation for losses caused by state agencies; and
- state support of up to 30% of the amount of significant investments by exemptions from corporate income and land taxes, VAT and import duties on equipment, and simplified land lease with the pre-emptive right for the acquisition of such land.

15 Diagonal cumulation is a rules of origin provision in the preferential agreement allowing one country to consider products originating from a partner country as its domestic products when determining the originating status for preferential treatment in the third country. Thus, a producer in country A may process a product using materials imported from country B and export this product to country C under the label "made in country A", getting the preferential treatment in country C.

16 <https://investmentpolicy.unctad.org/investment-laws/laws/253/ukraine-law-on-the-regime-of-foreign-investments>

17 <https://cms.law/en/ukr/news-information/ukraine-s-new-concession-law>

18 <https://ukraineinvest.gov.ua/incentives/investment-projects-with-significant-investments/>

Second, the law on industrial parks was extended.<sup>19</sup> The incentives for initiators, managing companies and participants of industrial parks include credit interest rates compensation, exemption from corporate profit tax and VAT and import duties on imported new equipment, compensation for connecting to the electricity grid, and so on. The industrial parks aim to attract investments into manufacturing, ITC, R&D and recycling.<sup>20</sup> A special tax regime has been established for IT companies participating in Diia.City, a virtual economic zone.<sup>21</sup>

While tax preferences play a role in attracting investors, preferential treatment generates substantial corruption risks, especially when coupled with rule of law deficiencies. Ukraine has had a dismal experience in the past with special economic zones, which ended up being used chiefly for tax evasion.<sup>22</sup> Therefore, success of the fundamental reforms in the rule of law domain remains the precondition for the success of these special investment regimes (more on this in the chapters on business environment, corruption and governance).

The 2020 land reform is supposed to become another important factor for the country's economic development. The moratorium on sales of agricultural land lasted for almost two decades, hampering the sector development and feeding the grey land market and corruption. The agricultural land market was launched in July 2021,<sup>23</sup> although with significant limitations on the size of land plots and ownership per person until 2024. Moreover, foreigners remained prohibited from owning agricultural land in Ukraine. Still, the European Bank for Reconstruction and Development (EBRD) expected that the reform would unlock \$40–50 billion for agro-business lending.<sup>24</sup>

## 2.3 Challenges

### *Trade*

Despite the substantial progress, many issues in Ukraine's and its partners' foreign trade regimes still required attention before the full-scale war.

Some policy challenges are external and thus largely dependent on Ukraine's trade diplomacy and its partners' readiness to liberalise. A clear example of an external barrier is the fact that Ukrainian business still faced **tariff rate quotas on the EU market** under the DCFTA. That meant only partial liberalisation of market access for several key Ukrainian agricultural and food products (Taran 2020) (this barrier was temporarily

19 <https://zakon.rada.gov.ua/laws/show/1710-20#Text> (in Ukrainian).

20 <https://ukraineinvest.gov.ua/incentives/industrial-parks/>

21 <https://ukraineinvest.gov.ua/incentives/it/>

22 <http://ojs.econindustry.org/index.php/ep/article/view/188/230> (in Ukrainian).

23 <https://zakon.rada.gov.ua/laws/show/552-IX#Text>

24 <https://www.reuters.com/article/us-ukraine-ebd-reform/ebd-ukraine-land-reform-to-unlock-40-50-billion-for-agribusiness-lending-idUSKBN19S1IX>

removed in 2022). The use of safeguard barriers on Ukraine's metal exports by the EU and the United States is another example of a particularly important external NTB to Ukrainian exporters. Although this barrier was also temporarily removed for a year, at present it is still set to return.

The **untapped opportunities of the Pan-European-Mediterranean Convention** (PEM Convention) on preferential rules of origin are partly attributed to the limited number of FTAs with the PEM Convention members. The conclusion of new FTAs will allow better use of the convention to promote the integration of Ukrainian companies into regional value chains.

However, many issues can and should be addressed by Ukraine jointly with its partners.

In particular, although Ukraine has made significant progress in reforming its product safety regulatory and institutional framework, the reforms have not been completed. This means that many opportunities for the **further reduction of NTBs in goods trade**, and thus trade costs, are still to be captured. NTBs entail costs of compliance with mandatory requirements and the costs of conformity assessment confirming that a product satisfies these requirements. Thus, the reduction of trade-related costs could be achieved through lower expenses on compliance, conformity assessment, or both. Harmonisation with EU standards helps reduce the costs of compliance. However, without mutual recognition of conformity certificates – through the ACAA for industrial goods and recognition of equivalence for food products – businesses cannot enjoy full access to the EU market. Both Ukraine's reform efforts and the EU's efforts in verifying and confirming the progress are required to remove these barriers.

In transport, Ukraine needs to obtain **more road transport permits from the EU member states**. Since 2017, Ukraine has been facing an aggravated problem of access to the EU market by road due to the deficit of permits.<sup>25</sup> That was, in effect, an NTB that the EU placed on Ukraine's goods. At the same time, Ukraine has reformed its permit distribution system to avoid artificial shortages and improve the traceability of permits. In July 2022, a temporary road transport agreement removed this barrier, but it can be reinstated if the agreement's safeguards are enacted.

In service trade, the DCFTA contains many **reservations regarding market access and national treatment of Ukraine's service providers** by EU member states; in contrast, access to Ukraine's service market has been very liberal.<sup>26</sup> The legal and institutional alignments with the EU allow for overcoming these barriers.

<sup>25</sup> See Saha et al. (2019) for the situation in 2017–2019 and Movchan et al. (2022) for the 2021 update

<sup>26</sup> See the chapter on services in Emerson et al. (2021).

The forthcoming EU **Carbon Border Adjustment Mechanism** (CBAM) imposing additional trade costs on partners to avoid carbon leakages and encouraging partners to use carbon pricing policies matching those of the EU<sup>27</sup> is another example of required mutual efforts. The mechanism will be put in place in 2026, although reporting commitments start from 2023. The CBAM will be applied to several product categories including electricity, iron and steel, fertilizers, aluminium and cement. The pre-full-scale war assessments of the CBAM impact showed that Ukraine could lose about 0.1% of its GDP annually due to the mechanism.<sup>28</sup> To avoid the CBAM, the country has to implement a carbon-pricing mechanism. Ukraine has been preparing for these changes, but extensive EU assistance is needed.

In **customs**, long queues of trucks on the Ukraine-EU border have been endemic. The Ukrainian customs service has been under reform for years, but complaints about queues and smuggling remain. However, as discussed below, the full-scale war and the urgent need to improve the efficiency of land border crossing fostered the changes.

The **protection of intellectual property rights** (IPR) is another area requiring Ukraine's continuous attention. For many years, the country has had limited access to the Generalized System of Preferences (GSP) in the United States due to problems with IPR protection.

**Export financing** has also remained among the unresolved issues for years. The Verkhovna Rada adopted the law on a Export Credit Agency (ECA) in 2017,<sup>29</sup> and several years later the ECA was established.<sup>30</sup> However, its functioning remained truncated due to legal deficiencies in its design (Janus 2021). The law on the ECA was significantly revised in March 2022 after the war escalated. The positive changes, including the increase in its statutory capital and placement of the institution under the supervision of the National Bank of Ukraine, increase the chances for the eventual success of the agency (Janus 2022). The establishment of an internationally trusted Supervisory Board to replace the one dismissed in November 2021 is still expected.

### *Investment*

We have already noted that inward FDI flows are weak and an area where Ukraine needs major improvements.

At present, Ukraine's labour goes into the EU in cyclical migration rather than having EU capital come to Ukraine. In principle, Ukraine's labour should be an attractive asset for inward FDI investment. Ukraine has a well-educated and large labour force, while the average wage is quite low. However, with the introduction of visa-free travel to the EU and the increased ease of obtaining work permits in Poland and other Central European

27 [www.consilium.europa.eu/en/press/press-releases/2022/03/15/carbon-border-adjustment-mechanism-cbam-council-agrees-its-negotiating-mandate/](https://www.consilium.europa.eu/en/press/press-releases/2022/03/15/carbon-border-adjustment-mechanism-cbam-council-agrees-its-negotiating-mandate/)

28 [https://kse.ua/wp-content/uploads/2021/12/211115-KSE\\_CBAM\\_for-publication.pdf](https://kse.ua/wp-content/uploads/2021/12/211115-KSE_CBAM_for-publication.pdf) (in Ukrainian).

29 <https://zakon.rada.gov.ua/laws/show/1792-19#Text> (in Ukrainian).

30 [www.eca.gov.ua/](http://www.eca.gov.ua/)

neighbours, investors have a choice. They can build a plant in Ukraine and face all the associated challenges of its imperfect business climate, or they can open a plant in near-border areas of Poland or Slovakia, with much better business climates and access to finance, and bring employees from Ukraine on a shift basis.

As emphasised earlier, the key obstacles to investment are the **rule of law, protection of property rights and corruption** (more on this in the chapters on business environment, corruption, and institutions). According to the American Chamber of Commerce in Ukraine survey presented in September 2021, “93% of businesses stated that implementation of real and effective judicial reform, the rule of law, fair justice, and eradication of corruption is #1 strategic step Ukraine’s Government should take first to achieve economic growth, improve the business climate, and attract FDI”.<sup>31</sup> The European Business Association echoes these findings. In a December 2021 survey, it reported that a weak judicial system (cited by 87% of CEOs participating in the survey), a high level of corruption (85%) and the shadow economy (76%) remain the top barriers to the development of business.<sup>32</sup>

While the war with Russia and the occupation of Ukraine’s territories in 2014–2015 have been among the important factors deterring investment, they have not been dominant. For instance, already in 2017 the EBA survey showed that the “military conflict with Russia” was only number four among barriers to investment, surpassed by corruption, lack of trust in the judicial system and state capture.<sup>33</sup>

**Large-scale privatisation** as a way to attract foreign investors has remained largely unsuccessful. The only positive case is the second privatisation of Kryvorizhstal to Mittal Steel for \$4.7 billion back in 2005. Mostly, privatisation auctions have suffered from low transparency and vested interests. After 2014, several laws aimed at facilitating privatisation and attracting foreign investors were adopted,<sup>34</sup> but progress was limited.

### 3 IMPACT OF THE FULL-SCALE WAR

The full-scale war has had a devastating impact on the Ukrainian economy, with real GDP down by about 39% in the second quarter of 2022. The annual drop GDP is expected to be between 30% and 40% depending on how the military actions continue.

31 <https://chamber.ua/news/90-of-businesses-forecast-upbeat-financial-health-of-their-companies-at-the-end-of-2021-new-survey-by-the-american-chamber-of-commerce-in-ukraine-and-citi-ukraine/>

32 <https://eba.com.ua/en/biznes-lidery-deshho-pogirshlyly-otsinku-investklimatu-v-ukrayini-opytuvannya-eva/>

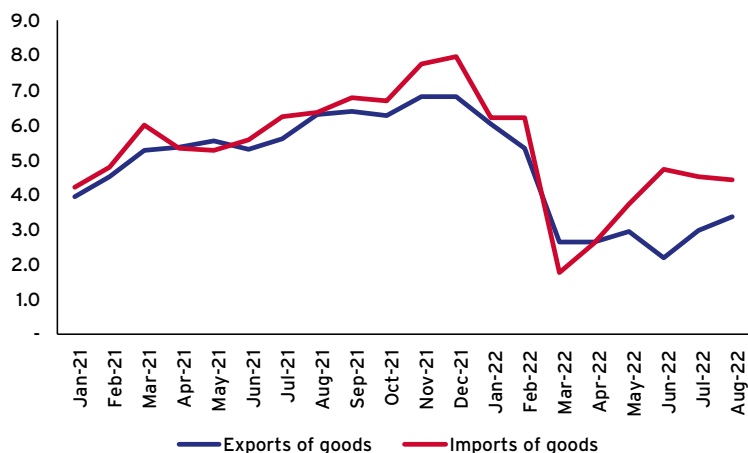
33 [https://lb.ua/economics/2017/09/14/376427\\_shcho\\_zavazhaie\\_inozemnim\\_investoram.html](https://lb.ua/economics/2017/09/14/376427_shcho_zavazhaie_inozemnim_investoram.html) (in Ukrainian).

34 <https://ces.org.ua/en/privatization-in-ukraine-high-jump-after-years-of-crawling/>



Trade has also suffered, especially exports. According to the Ministry of Economy, Ukraine's foreign trade started to revive in the second half of the summer of 2022 after the deep drop immediately after 24 February. The reduction of goods exports was most acute in June 2022 when it dropped by almost 60% in annual terms amid the ongoing blockade of Black Sea ports, logistic hurdles on land borders with the EU and disrupted production within the country. Exports started to revive in July, and in August they grew by 14% month-on-month, but remained 46% less than a year ago (Figure 21).

FIGURE 21 UKRAINE'S MONTHLY EXPORTS AND IMPORTS OF GOODS (US\$ BILLIONS)



Source: Ukrstat, Ministry of Economy.

In March 2022, imports of goods fell by over 70% year-on-year, dragged down by both disruptions of economic links and temporary administrative restrictions. Immediately after the full-scale war began, the National Bank of Ukraine introduced limitations on foreign currency purchases intended for imports of goods and services except for critical imports.<sup>35</sup>

However, already during March, the list of critical imports expanded to cover almost 90% of goods. Moreover, the Parliament introduced a temporary exemption from import duties and VAT on imports starting in April.<sup>36</sup> This resulted in a faster recovery of goods imports compared to exports, widening the trade deficit and putting pressure on foreign reserves.<sup>37</sup> Both the list of critical imports for goods and import tax exemptions were

<sup>35</sup> <https://zakon.rada.gov.ua/laws/show/153-2022-%D0%BF#Text> for the list of critical imports (in Ukrainian).

<sup>36</sup> The Parliament exempted from import duties all products, except for alcohol and tobacco, if these products are imported by business entities for free circulation in Ukraine. Moreover, businesses using certain simplified taxation scheme were exempted from paying value added tax on imports (see <https://zakon.rada.gov.ua/laws/show/2142-%D0%86%D0%A5#Text>, in Ukrainian).

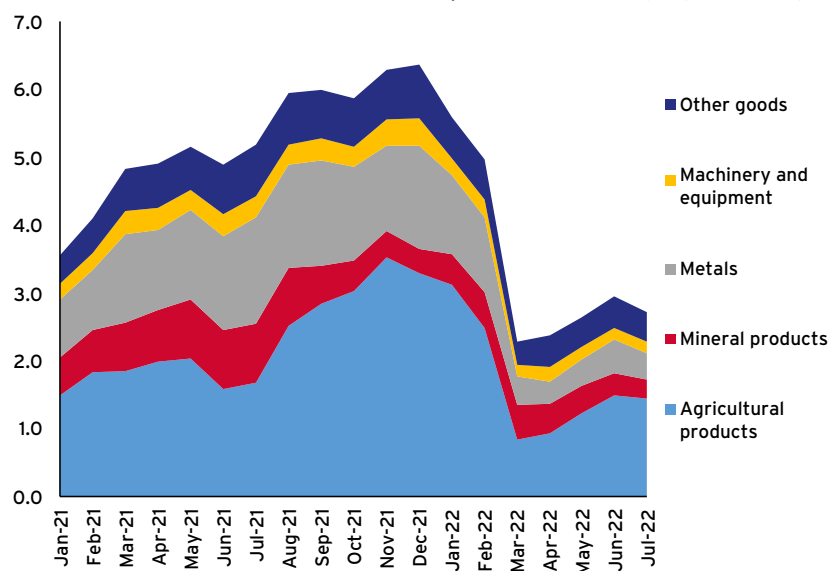
<sup>37</sup> On 21 July 2022, the NBU devalued the Ukrainian hryvnia by 25% vis-à-vis the US dollar to cope with the changed economic environment (see <https://bank.gov.ua/ua/news/all/nbu-zafiksuvav-ofitsiyinyi-kurs-grivni-do-dolara-ssha-na-novomu-rivni-ta-vjiv-nizku-dodatkovih-zahodiv-dlya-zbalansuvannya-valyutnogo-rinku-ta-pidtrimannya-stiykosti-ekonomiki-v-umovah-viyni>, in Ukrainian).

lifted in July.<sup>38</sup> Moreover, the hryvnia was devalued by 25% and the central bank key rate increased to 25%. So far, capital controls remain in place and the hryvnia exchange rate essentially fixed (see the chapter in this book by Ralph De Haas and Alexander Pivovarsky on the financial sector for more details).

As noted in the introduction, the EU has become Ukraine's largest trade partner, accounting for over 70% of goods exports compared to 40% in 2021. In imports, the share of the EU is about 50% as many imported goods are just transited to Ukraine through the EU.

In terms of product composition, trade has not dropped uniformly across products (Figures 22 and 23). Exports of metals and iron ores suffered the most as these are bulk products that used to be shipped through seaports, which are currently blocked, and two large steel mills were destroyed in Mariupol. In imports, a major structural change was the increase in purchases of mineral products, particularly petroleum-processed products, after Ukrainian production and storage facilities were destroyed.

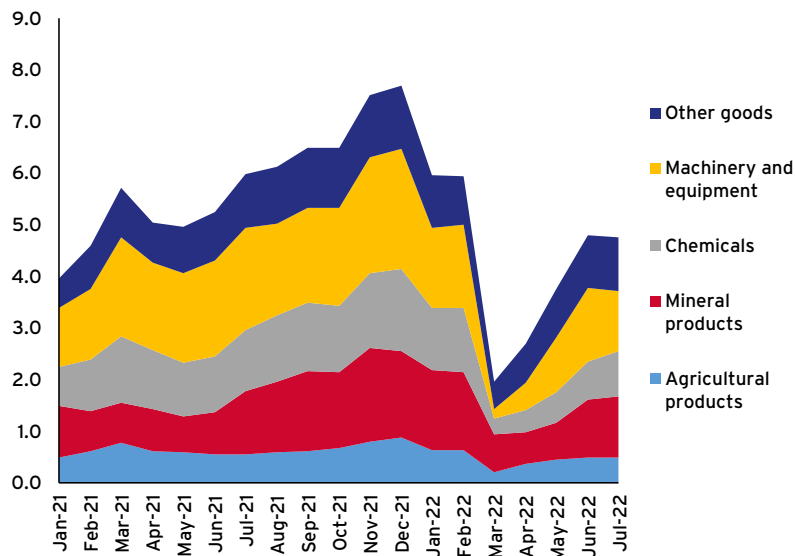
FIGURE 22 UKRAINE'S MONTHLY GOODS EXPORTS, 2021-JULY 2022 (US\$ BILLIONS)



Source: National Bank of Ukraine, trade in goods according to the balance of payments methodology.

38 The list of critical imports for services and works has remained in force, although also quite broad. The list applies towards cross-border service imports. There are also different NBU regulations limiting payments in hryvnia abroad.

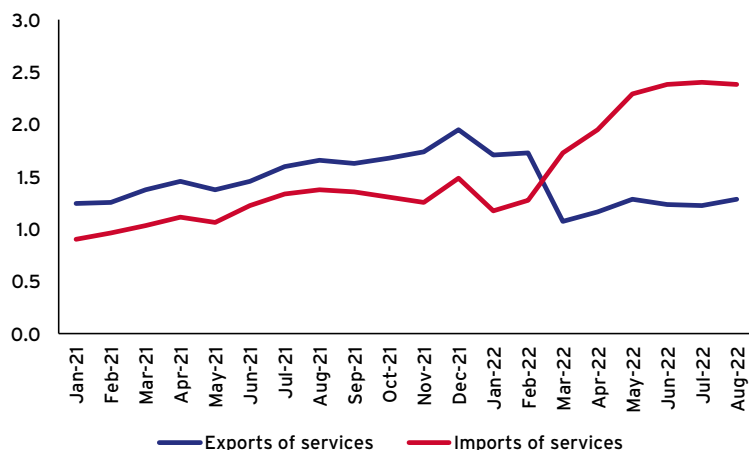
FIGURE 23 UKRAINE'S MONTHLY GOODS IMPORTS, 2021-JULY 2022 (US\$ BILLIONS)



Source: National Bank of Ukraine, trade in goods according to the balance of payments methodology.

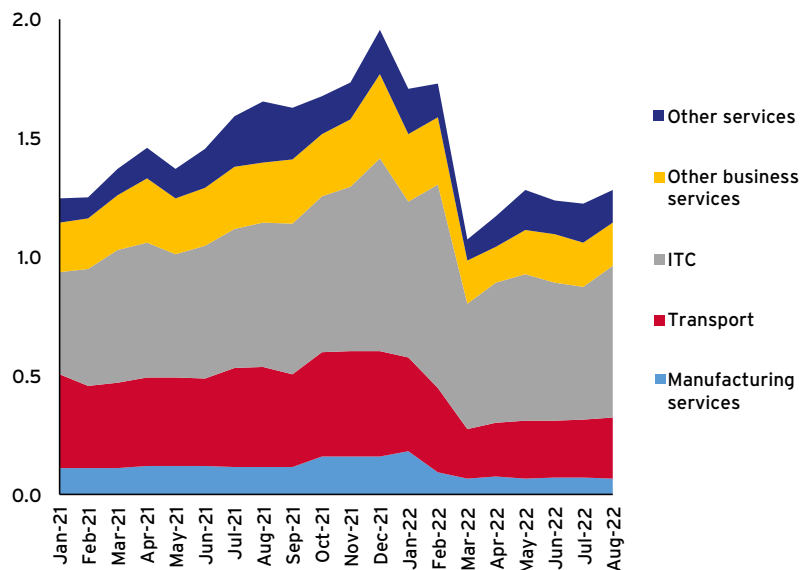
The response of Ukraine's service exports to the full-scale war was similar to that of goods exports, although not as dramatic. In March 2022, service exports dropped by 22% (Figure 24), disrupting the upward trend of post-COVID recovery. In the first eight months of 2022, the drop was only 6%, but it is likely to deepen as the base effect shows up. The expansion of IT service exports (Figure 25) is unlikely to compensate for other losses. At the same time, service imports grew by 73% compared to the first eight months of 2021, driven by external migration and the resulting expansion in travel expenses (Figure 26).

FIGURE 24 UKRAINE'S MONTHLY TRADE IN SERVICES, 2021-JULY 2022 (US\$ BILLIONS)



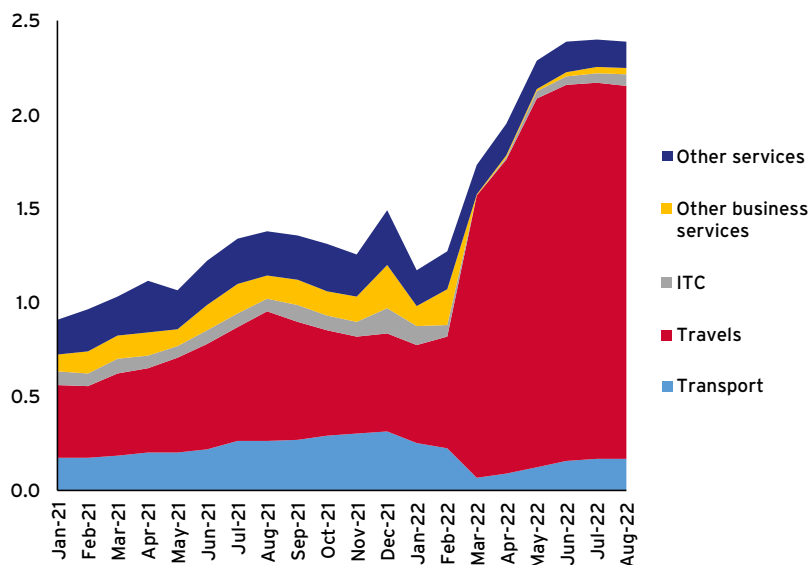
Source: National Bank of Ukraine.

FIGURE 25 UKRAINE'S MONTHLY EXPORTS OF SERVICES, 2021-JULY 2022 (US\$ BILLIONS)



Source: National Bank of Ukraine.

FIGURE 26 UKRAINE'S MONTHLY IMPORTS OF SERVICES, 2021-JULY 2022 (US\$ BILLIONS)



Source: National Bank of Ukraine.

Ukraine is making efforts to foster production and exports, supporting the relocation of companies and extending government credit programmes. The Export Credit Agency is expected to provide some export financing in 2022, though the institution is still in the process of being established.

While levying a massive toll on Ukraine, the full-scale war has also intensified some international processes, especially concerning the EU. On 23 June 2022, Ukraine was granted EU candidate status, a decision that was unthinkable in January 2022.

Several countries, including the EU and the United Kingdom, opened their markets to Ukraine for a year. In particular, the EU has abolished not only the remaining (quite low) import duties but also tariff rate quotas on agricultural products covering about 10–15% of Ukraine's exports to the EU and safeguard measures on metals.

Some positive developments have already occurred in logistics. The 'grain deal'<sup>39</sup> between Ukraine and Russia, arbitrated by Turkey and the United Nations, allowed a partial lifting of the Black Sea ports blockade by Russia and the resumption of grain exports from Ukraine.

In May 2022, the European Commission released an action plan for EU-Ukraine Solidarity Lanes to facilitate Ukraine's agricultural export and bilateral trade with the EU.<sup>40</sup> To address the immediate supply needs of railways, the plan proposes to:

- Urgently mobilise the available necessary equipment, rolling stock, vehicles, barges and vessels on the EU market.
- Make available the required rail slots between transshipment centres and EU ports.
- Prioritise Ukrainian agricultural export shipments towards freight corridors with the best available capacity.
- Identify the critical transshipment/gauge changing centres at and beyond EU-Ukraine borders to optimise volumes.
- Facilitate lending and selling and stepping up manufacture of mobile grain loaders to relevant transshipment locations.
- Investigate whether additional top-level guarantees for freight carriers are needed and cooperate with international financial institutions to provide them (we have already mentioned small World Bank programmes that do this for other countries, but the sums needed for Ukraine to cover full-scale war tail risk are much larger than in any existing programme; more details on this in the chapter on business environment ).
- Establish a matchmaking platform to facilitate exchanges between logistics chain actors to optimize cargo flows and identify a dedicated Solidarity Lanes contact point for problem notification.

39 <https://ukragroconsult.com/news/opublikovano-tekst-zernovoyi-ugody-pidpysanoi-sogodni-v-stambuli/> (in Ukrainian).

40 [https://transport.ec.europa.eu/news/european-commission-establish-solidarity-lanes-help-ukraine-export-agricultural-goods-2022-05-12\\_en](https://transport.ec.europa.eu/news/european-commission-establish-solidarity-lanes-help-ukraine-export-agricultural-goods-2022-05-12_en)

In July 2022, Ukraine and the EU signed a one-year agreement on road transportation to ease the impact of the port blockade.<sup>41</sup> The agreement cancels road permit requirements, a long-standing point of contention between Ukraine and several member states. Moreover, the mutual recognition of driver's licenses has been established.

## 4 Reconstruction

### 4.1 Baseline assumptions

The accelerated economic recovery of Ukraine is to be based on a strong recovery of foreign trade and the FDI boom, as domestic resources cannot be sufficient to fund the country's needs.

The baseline assumption for Ukraine's massive reconstruction is the de-occupation of Ukraine's territory, achievement of long-lasting peace and, thus, the resolution of major security concerns. Importantly, some security issues will remain even after reaching long-lasting peace as long as an imperialistic Russian regime is in power. Moreover, there will be a need to demine vast territories on land and water.

Full access to Ukraine's seaports is another baseline assumption needed for a successful resumption of goods trade.<sup>42</sup>

On a positive note, Ukraine's governmental institutions at both the national and local levels have remained functional in all government-controlled territories, allowing policy implementation. Moreover, the full-scale war, as discussed above, has opened up new opportunities. Specifically, Ukraine's EU candidacy streamlines the reform path, makes the policy changes more predictable and familiar for many international players, and – if security concerns are resolved at least to some extent – makes the country much more attractive for investment.

Although the baseline for the reconstruction discussed in this book is the period after the full-scale war, many recommendations can be implemented while military actions are still ongoing. Ukraine cannot wait until the war ends to start reconstruction, as the country needs a functioning economy during the full-scale war. It is impossible to rely only on international assistance to meet Ukraine's needs. The summer of 2022 showed wide gaps between promises of international aid and the actual delivery of these promises. While extensive external support remains crucial, the best way to ensure Ukraine is economically resilient in the short to medium run is the immediate support of reforms and reconstruction.

41 [https://transport.ec.europa.eu/news/supporting-ukrainian-exports-and-improving-connections-eu-eu-strengthens-cooperation-ukraine-and-2022-06-29\\_en](https://transport.ec.europa.eu/news/supporting-ukrainian-exports-and-improving-connections-eu-eu-strengthens-cooperation-ukraine-and-2022-06-29_en)

42 The assumption regarding the de-occupation of Ukraine's territories means that Ukraine can access and use all its seaports, including ports in Crimea and the Azov Sea. However, the ports in Odesa, Mykolaiv and Kherson regions are key to recovering Ukraine's sea trade.

## 4.2 Available technologies, resources and policies

The aim of trade and investment policies is to allow accelerated economic recovery.

To achieve this, Ukraine's trade policy should be export-oriented, with a focus on participation in global (European) value chains, development of diversified exports with higher value-added and limited exposure to security threats (like ITC or business services) or new niches developed due to the war. This means ensuring deep integration in the EU market, even before becoming a member of the Union, and the opening of other markets. In investments, the business climate is key.

Ukraine is well-positioned to succeed in reforming trade and investment policies aimed at boosting economic recovery.

The Association Agreement with the EU, coupled with Ukraine's recent candidate status, provides a strong boost for reforms. The recommendations embedded into the European Commission's opinion regarding Ukraine's candidacy status include issues essential for attracting FDI, in particular concerning the continuation of judicial reform and the strengthening of anti-corruption institutions. The Ukrainian government has already announced that it is taking these recommendations seriously and aiming to demonstrate substantial progress as early as 2022. The successful implementation of these reforms would mean the resolution of concerns related to property rights and the rule of law in general.

The government has also intensified legal convergence with the EU norms embedded in the Association Agreement that have not yet been adopted. It is expected that by the end of 2022, most legal commitments will be implemented, thereby making up for previous delays and surpassing the schedule. However, some time will be needed for the European Commission to verify this alignment.

Ukraine has already started a new campaign to attract FDI. In September 2022, President Zelensky launched<sup>43</sup> the 'Advantage Ukraine' initiative focused on attracting future investment by advertising the country's investment climate and sectoral opportunities.<sup>44</sup> The online platform offers potential investors information support and direct communication with responsible public officials.

43 [www.businesswire.com/news/home/20220905005440/en/President-H.E.-Volodymyr-Zelenskyy-rings-bell-at-NYSE-to-signify-Ukraine-is-open-for-business](https://www.businesswire.com/news/home/20220905005440/en/President-H.E.-Volodymyr-Zelenskyy-rings-bell-at-NYSE-to-signify-Ukraine-is-open-for-business)

44 <https://advantageukraine.com/>

### 4.3 Organisational structure

The organisational structure for trade and investment policy reforms should be aligned with both the institutional framework for the country's general recovery efforts and the existing institutions responsible for the development and implementation of these policies. It is advisable to rely on existing structures to reduce administrative costs, ensure policy continuity and preserve institutional memory, unless these institutions are tainted by corruption scandals or new institutions are required to meet international commitments.

The Ministry of Economy is expected to be a central state authority responsible for these changes. However, there are several other important state stakeholders. In particular, the changes in trade and investment policies need to be aligned with the EU integration efforts, which this requires a strong role for the Vice-Prime Minister on European and Euro-Atlantic Integration as well as the Government Office coordinating European and Euro-Atlantic Integration.

There are also several other government institutions responsible for trade and investment policy implementation. For example, UkraineInvest is the governmental advisory body helping to bring FDI into the country. The Entrepreneurship and Export Promotion Office aims to support SME development and export promotion. There are also specialised institutions like the State Service on Food Safety and Consumer Protection, which is responsible for a wide range of tasks related to both agricultural and most manufacturing product safety, and the State Service on Medicine and Drug Controls, which deals with medicine safety issues. These institutions are likely to be beneficiaries of specialised projects related to reconstruction and the EU integration efforts.

For trade and investment, the role of public-private partnerships and private money must be dominant.

The role of international donors should be focused on the following:

- Technical and financial assistance to ensure full alignment with the EU norms and practices for economic integration with the EU, including the realisation of opportunities embedded in the Association Agreement and other EU-Ukraine agreements.
- The participation of international donors in the capitalisation of Ukraine's Export Credit Agency (ECA) to upscale its activities and promote exports through financial means.
- A multi-donor fund to cover non-economic risks for foreign investors.



As for the latter, the World Bank Multilateral Investment Guarantee Agency (MIGA), jointly with the Ministry of Economy, announced a pilot project<sup>45</sup> to provide guarantees to foreign investors, but the initial scale (\$30 million) is likely to be insufficient for Ukraine's needs and will require upscaling (the chapter on the Yegor Grygorenko and Monika Schnitzer business environment by the has more discussion on war risk insurance).

Public-private partnerships are expected in infrastructure projects (see more in the chapter on energy by Tatyana Deryugina and co-authors and the chapter on infrastructure by Volodymyr Bilotkach and Marc Ivaldi).

The EU's role needs to be much more intense than during the period of the Association Agreement implementation prior to the full-scale war. The previous experience showed several drawbacks of implementation, including the insufficient allocation of European Commission resources to checking Ukraine's draft legal acts quickly, delays with recognition of progress and no formal progress evaluations, which also delays integration. These issues should be resolved to ensure efficiency.

The expected time horizon for the EU integration preparations is approximately five years, and it should be the same for trade and investment policy changes. However, the changes will be done in parallel and front-loaded in many cases. For instance, the legal changes associated with the Association Agreement implementation are expected to be adopted in 2022 or early 2023, but the institutional development will take more time.

#### 4.4 Estimates of the cost

There are several types of costs associated with trade and investment integration.

First are public costs linked with legal harmonisation and the capacity development of involved institutions, especially quality infrastructure. Given that Ukraine has already progressed in aligning with the EU norms and practices related to trade integration, additional investments are expected to be quite modest (under \$1 billion).

Second, there are costs imposed on producers to implement new norms. Before the full-scale war, many Ukrainian businesses, especially export-oriented ones, had already absorbed these costs. However, the process of legal alignment has not been completed, meaning that further investments in implementing changed norms are needed. The full-scale war destruction has further aggravated the financial constraints of businesses, and thus state/international support for alignment with these norms would be beneficial. It is hard to provide an exact budget, but we can use some international comparisons for benchmarking. For instance, the EU programme for the Competitiveness of Enterprises

45 [www.me.gov.ua/News/Detail?lang=en-GB&id=1885d3ee-e1fd-47bd-b44e-ec3cd42dd456&title=TheMinistryOfEconomyOfUkraineHasAgreedWithMigaToLaunchAMechanismForInsuranceOfInvestmentsDuringTheWar](https://www.me.gov.ua/News/Detail?lang=en-GB&id=1885d3ee-e1fd-47bd-b44e-ec3cd42dd456&title=TheMinistryOfEconomyOfUkraineHasAgreedWithMigaToLaunchAMechanismForInsuranceOfInvestmentsDuringTheWar)

and Small and Medium-Sized Enterprises (COSME) has a budget of €2.3 billion for all member states and several other countries for seven years (2014–2020). Thus, we can expect up to \$1 billion to be sufficient to cover the adjustment costs of Ukrainian businesses.

Third, infrastructure costs (e.g. motorways, railroads, border crossing points, multimodal transport hubs, electricity grids, high-speed internet) are needed for the successful functioning of the economy, including trade and investment. These costs are discussed in other chapters of this book, but they essentially serve as preconditions for the success of trade and investment policies.

The Polish experience provides another benchmark for our cost estimates. According to Golinowska (2019), in the pre-accession period, Poland received three types of funding:

- Polish Hungary Assistance for Restructuring their Economies (PHARE): €0.4 billion per annum aimed at infrastructure (roads, sewage plants etc.), private sector development, environmental protection, public administration reform, social protection and employment, health care.
- Special Accession Program for Agriculture and Rural Development (SAPARD): €0.17 billion per annum, aimed at the modernisation of the agriculture and food industry and infrastructure of rural areas.
- Instrument for Structural Policies for Pre-Accession (ISPA): €0.6 billion in 1990–2003, aimed at big infrastructure, environmental protection and transport network projects at the local level.

Since gaining membership in 2004, Poland has received in total €164 billion in EU support,<sup>46</sup> which has mostly been spent on various infrastructure and environmental projects.

Fourth, there are the costs associated with risk insurance, including the functioning of a fund for covering non-economic risks for foreign investors and the support of the ECA. If we assume a target of \$250 billion of FDI attracted within ten years, an average investment project duration of five years and 8–10% risk coverage, the funding needs for foreign investors could be about \$10–12.5 billion. Depending on the security situation and project needs, the required funding could be much higher. As for the ECA, its current statutory capital is about 2 billion hryvnia (\$54 million). Given the pre-full-scale war exports at over \$80 billion, the available capital is hardly sufficient and should be gradually expanded to at least \$0.5 billion. In sum, that would mean \$10.5–13.0 billion for both FDI and export insurance.

46 <https://pie.net.pl/en/15-years-in-the-eu-poland-received-a-total-of-eur-164-in-support/>

There are also other needs – for example, for organizing information campaigns and investment roadshows and the support of export networking (participation in trade fairs and trade missions, etc.). However, these costs are expected to be small compared to all other needs, in the millions rather than billions of dollars.

Thus, there are several types of costs and ‘price lists’. While the investments required for trade and investment policy per se are quite moderate, insurance coverage and infrastructure costs can be extremely high. Unlike Poland, Ukraine should not only achieve certain cohesion with other EU member states but also reconstruct and modernise after the full-scale war.

## 5 Historical comparisons

This chapter focuses on trade and direct foreign investment, so it is beyond our scope to go deeply into historical analogies for reconstruction such as the Marshall Plan; this topic is taken up elsewhere in this book. But it is worth including a short discussion of the environment for trade and investment, particularly in the context of a post-war nation, which is the appropriate context given the baseline assumptions of this book. In particular, we assume that Ukraine regains access to its former shipping routes in the Black Sea. There are numerous historical examples of countries whose development was derailed after losing shipping access (for instance, Bolivia, which lost its coast to Chile during a conflict in the last part of the 19th century). There are also examples of countries that suffered immense physical damage during wartime and yet, thanks to a legacy of institutions and human capital, were able to rebuild successfully (for example, West Germany and Japan after World War II), relying very much on an open trading regime.

However, it is important to understand that in most of the historical examples, the resumption of full trade liberalisation took place gradually, with Japan and Germany (and indeed all of Western Europe) retaining a complex regime of exchange controls for a decade or more after World War II. These exchange controls typically had an array of different rates corresponding to different types of imports and exports and, in effect, amounted to a system of tariffs and subsidies. In other cases, there were only one or two exchange rates, but they were kept at significantly overvalued levels using severe capital controls as, say, Argentina does today. During the full-scale war, Ukraine has begun to institute such controls, as already noted, but if anything, too slowly, given the overriding imperative of winning the war while protecting society. But after the full-scale war, EU agreements will make implementing any such controls difficult. We have detailed at length all the steps Ukraine is taking to gain rapid trade integration with the EU, and implementing capital controls, and especially a goods-specific menu of exchange controls as in post-war Europe, is effectively off the table. This raises the question of how to ramp up trade after the war without running large trade deficits that put unsustainable pressure on the currency. We would highlight this as especially important for Ukraine, which has suffered World War II levels of destruction, but in its trade regime is jumping several decades ahead of what European countries achieved under the Marshall Plan.

We are not questioning the imperative of the transition to ever freer trade, especially with Europe, but simply emphasising that the unique relationship with Europe creates special issues. There is some precedent in the other countries of the former Soviet Union that joined the EU, but of course, they did not suffer the devastating destruction of invasion. The nearest analogy for Ukraine is perhaps Estonia, which during the 1990s chose a much faster pace of liberalisation than did, say, Latvia (which maintained tariffs up to 75% on a third of agricultural goods even as late as 1999) or Lithuania. It is interesting to note that Estonia ended its early-1990s hyperinflation by adopting a currency board that started in June 1992 and ended with its adoption of the euro in January 2011. Currency boards often fail (typically because they are not sufficiently backed), and one should not assume that the Estonian example can be adopted in a much larger economy. But this does seem like an important example to study in the post-war transition, given that Estonia chose extremely rapid trade and investment liberalisation, a course Ukraine has effectively already decided on.<sup>47</sup>

A less optimistic analogy is Bosnia-Herzegovina, which was also devastated by full-scale war in the 1990s and continues to suffer significant tensions, as does the region as a whole – again, a possible parallel if the Russian aggression continues at a low boil even after peace. Ukraine had much more time to develop institutionally before its descent into all-out war compared to Bosnia, where the Dayton accords took place in the 1990s. Bosnia conformed only very slowly to WTO agreements, despite a number of regional free trade agreements, with the WTO being vastly less ambitious than the EU, particularly in service trade. The slow pace of reform in Bosnia, and corresponding very slow growth, would seem an example to avoid.

There is much more to be said, of course, but again discussions of historical context are much better done in a broader context of overall post-war economic policy.

## 6 SENSITIVITY ANALYSIS

The main assumption of this book is that long-lasting peace will be established, and thus, Ukraine – and the international community – will be able to channel most resources into reconstruction rather than security and defence. However, other scenarios are also regrettably plausible. The prolongation of active military actions for another year or more, a second attack on Kyiv, or an unstable ceasefire like the Minsk agreements that appeared to be a pause before the escalation of Russian aggression would require adjustments of trade and investment policies, likely delaying many changes. Still, while Ukraine remains an independent state, its orientation to the EU market and commitment to integrating into the EU will stay strong. Thus, the country will move along the policy lines stipulated in the chapter, while the war developments will regulate the speed but not the direction.

47 For a discussion of the Estonian experience, see Feldmann (2003).

## 7 CONCLUSION

The full-scale war has significantly impacted Ukraine's foreign trade and FDI inflows. However, it has also triggered geopolitical changes that will frame the country's future, including its future trade and investment policy. In June 2022, Ukraine was awarded EU candidate status. This important milestone in the country's status within Europe will govern its reform path for the years to come. Given the significant transformational power of the preparations for EU accession, we expect reconstruction and modernisation to be realised within this dominant political objective.

However, a rapid post-war economic recovery will be possible only if based on solid exports and significant foreign capital inflows. This means the country will have to complete fundamental reforms related to the rule of law and to property rights protection. These are preconditions for the EU accession talks and key to attracting foreign investment. In parallel, Ukraine will continue sectoral reforms allowing economic integration with the EU even before the country becomes an EU member state.

It is expected that the role of public-private partnerships and private money will dominate the post-war recovery. International donors' primary role in trade and investments is technical and financial assistance in reforms aiming at EU integration and the funding of (new) insurance schemes for exporters and investors. The costs of foreign technical assistance should be relatively modest (a few billion dollars), but the cost of insuring operational risk against a future resumption is obviously going to be highly dependent on the nature of the peace.

## APPENDIX: OVERVIEW OF KEY TRADE AND INVESTMENT POLICY REFORMS IN 2014-2021

Below we list a range of areas where Ukraine is moving to conform its legislation and institutions with the EU. As one can see, this is a very large project involving enormous expert resources at a time when human capital is scarce. Nevertheless, Ukraine is making steady progress.

### Technical barriers to trade (TBT)

This is a fast-moving area, covering an extremely broad spectrum of issues, some quite technical. By aiming to conclude the Agreement on Conformity Assessment and Acceptance (ACAA) of industrial products with the EU, Ukraine greatly facilitates future trade integration. The ACAA is a special case of a mutual recognition agreement of conformity assessment (MRAs) offered by the EU to its partners.

Unlike the usual MRAs, the ACAA is based on aligning the partner country's legislative system and quality infrastructure<sup>48</sup> with those of the EU. On the one hand, it means that the preparation for the ACAA is much more cumbersome than for the usual MRA. On the other hand, this alignment provides an additional guarantee of the high reliability of the conformity assessment procedures, thus opening the door for MRAs with a wider array of countries.

Below we give a quick overview of past progress and ongoing change:

First, Ukraine has progressed significantly in aligning its legislation with EU norms. The country has already harmonised its framework TBT legislation, i.e. general requirements regarding technical regulation, metrology, accreditation, conformity assessment and market surveillance. Moreover, Ukraine has also passed scores of new technical regulations using the EU directives as a basis. The process is well underway. For instance, 25 out of 27 technical regulations envisaged in the DCFTA have been adopted and implemented.<sup>49</sup> The precondition for the conclusion of an ACAA is that Ukraine's technical regulations are identical to the currently applied EU directives. Prior to the full-scale war, the EU had been conducting an expert assessment mission in preparation for forthcoming ACAA talks; this is now scheduled to resume.

Alongside alignment with the EU directives, the government had to cancel other legal norms, such as sanitary and labour safety norms, that contained additional mandatory requirements regarding product characteristics, production methods and processes, and hence duplicated technical regulations. For example, a long-lasting cumbersome heritage of the Soviet Union, the mandatory product certification, has now been cancelled. Important progress has also been achieved towards institutional alignment, in some respects a more difficult and fundamental step. Since 2016, the State Service on Food Safety and Consumer Protection (SPSA) has been established as the key responsible authority in the sphere of non-food products market surveillance.

### **Sanitary and phytosanitary (SPS) measures**

The SPS reform has been extremely comprehensive, involving having Ukraine align with over 250 SPS EU norms.<sup>50</sup> By the beginning of 2022, Ukraine had adopted legislation covering about two-thirds of these commitments, as estimated by the state monitoring platform Pulse of the Agreement.<sup>51</sup>

<sup>48</sup> See footnote 7.

<sup>49</sup> The full list as of April 2022 is at [www.me.gov.ua/Documents/Download?id=84de50b5-ca95-4913-9d1b-20f4ad74bfaf](http://www.me.gov.ua/Documents/Download?id=84de50b5-ca95-4913-9d1b-20f4ad74bfaf) (in Ukrainian).

<sup>50</sup> [www.kmu.gov.ua/ua/npas/248928183](http://www.kmu.gov.ua/ua/npas/248928183) (in Ukrainian).

<sup>51</sup> <https://pulse.kmu.gov.ua/ua/direction/sanitarni-ta-fitosanitarni-zahody> (in Ukrainian).

The most important change concerned the introduction of the principles of the Hazard Analysis and Critical Control Points (HACCP) methodology aimed at reducing food risks for consumers by controlling the key potential hazards.<sup>52</sup> The key legislation was adopted in 2014,<sup>53</sup> and the HACCP has been mandatory for all entities since September 2019.

New laws were adopted on food safety and quality,<sup>54</sup> food safety control,<sup>55</sup> veterinary medicine,<sup>56</sup> information for consumers<sup>57</sup>, and so on. New institutions and procedures have been introduced to ensure compliance with these new laws. In particular, before 2016, the policy implementation functions were dispersed among several public agencies, including the State Veterinary and Phytosanitary Service, the State Inspection for Consumer Protection, and the State Sanitary and Epidemiological Service. In 2016, the State Service on Food Safety and Consumer Protection of Ukraine took over all of their functions.<sup>58</sup>

In 2020, Ukraine and the EU mutually recognised the equivalence of safety systems certification for grain seeds.<sup>59</sup> This decision reduces trade costs, providing benefits similar to those generated by the ACAA for manufacturing products. Currently, Ukraine's aim is to get the same equivalence recognition for most agricultural products even before the EU accession.

## Customs

Customs-related reforms have progressed slowly but steadily. Before the full-scale war, Ukraine managed to implement multiple steps contributing to the reduction in costs and time spent on documentary compliance in cross-border trade. These include:<sup>60</sup>

- The introduction of online administrative services for exporters and importers, increasing efficiency and reducing corruption risks.
- The launch of authorised economic operators (AEO), the mechanism allowing to simplify customs formalities for traders that meet integrity criteria.
- The introduction of an electronic 'single window' at customs<sup>61</sup> that allows all required documents to be submitted and processed in a single place.

52 [www.fda.gov/food/guidance-regulation-food-and-dietary-supplements/hazard-analysis-critical-control-point-haccp](http://www.fda.gov/food/guidance-regulation-food-and-dietary-supplements/hazard-analysis-critical-control-point-haccp)

53 <http://zakon2.rada.gov.ua/laws/show/1602-18> (in Ukrainian).

54 <https://zakon.rada.gov.ua/laws/show/771/97-%D0%B2%D1%80#Text> (in Ukrainian).

55 <https://zakon.rada.gov.ua/laws/show/2042-19> (in Ukrainian).

56 <https://zakon.rada.gov.ua/laws/show/1206-20> (in Ukrainian).

57 <https://zakon.rada.gov.ua/laws/show/2639-19#Text> (in Ukrainian).

58 <https://dpss.gov.ua/>

59 <https://craneip.com/eu-recognized-ukrainian-seed-certification/>

60 See the chapter on customs in Emerson et al. (2021).

61 [https://mof.gov.ua/uk/the\\_only\\_window\\_for\\_international\\_trade-472](https://mof.gov.ua/uk/the_only_window_for_international_trade-472) (in Ukrainian).

- Strengthened protection of intellectual property rights when moving goods across the border, in particular the establishment of IPR objects register at customs<sup>62</sup> and mechanisms to enforce IPR for goods moving across the border.

On 1 October 2022, Ukraine joined the EU Common Transit Convention and the Convention on the Simplification of Formalities in Trade in Goods. This enables easier movement of goods across the EU and other common transit countries (Norway, Iceland, Switzerland, North Macedonia, Serbia, Turkey and the UK) by applying a single customs declaration between the participating countries, mutually recognised financial guarantees and fewer controls.<sup>63</sup> The application of a common IT product (NCTS) increases customs efficiency and transparency.

Of course, because of the ongoing war destructions and the partial blockade of ports, moving products by land remains a cumbersome and costly process compared to transportation structures in neighbouring countries. However, the reorientation of Ukraine's goods trade flows towards the EU also created pressures on the European transport and logistic infrastructure.

### Public procurement

To overcome corruption risks and increase public spending efficiency, since 2016 all public procurements above a certain threshold have been conducted through the online public procurement system ProZorro<sup>64</sup>. This e-procurement system became the category winner for the public sector in the World Procurement Awards 2016.<sup>65</sup> The legislation also contains disclosure requirements for all public procurement transactions, even if the purchase was below ProZorro thresholds. The business intelligence platform associated with ProZorro offers further analytical tools to increase transparency and monitoring efficiency.

Until recently, Ukraine has been applying an equal treatment of Ukrainian and foreign companies in public procurement. In 2021, Verkhovna Rada adopted a law introducing public procurement preferences for domestic producers. However, these localisation preferences are not applied to the EU and other signatory parties of the WTO Government Procurement Agreement (GPA).<sup>66</sup>

The public procurement reforms allowed the country to join the WTO GPA in 2016, opening access to public procurement markets in 48 countries worth over \$1.7 trillion.<sup>67</sup>

62 <https://cabinet.customs.gov.ua/ipr/reg/overview> (in Ukrainian).

63 See <https://www.kmu.gov.ua/en/news/rada-asotsiatsii-ukraina-ies-1-zhovtnia-ukraina-zmozhe-priednatysia-do-mizhnarodnykh-mytnykh-konventsii> (in Ukrainian).

64 <https://zakon.rada.gov.ua/laws/show/922-19#Text> (in Ukrainian).

65 [www.procurementleaders.com/world-procurement-awards/winners](http://www.procurementleaders.com/world-procurement-awards/winners)

66 <https://zakon.rada.gov.ua/laws/show/1977-IX#Text> (in Ukrainian).

67 [/www.wto.org/english/tratop\\_e/gproc\\_e/gp\\_gpa\\_e.htm](http://www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm)



## Services

The Association Agreement envisages the provision of so-called internal market treatment by the EU for Ukrainian service providers in four areas:<sup>68</sup>

- International maritime transportation
- Postal and courier services
- Electronic communications
- Financial services

Although Ukraine has been interested in EU market integration in all four areas, the digital sector is definitely the priority, given the country's advances in IT and e-government.

A law on electronic trust services implementing the new EU regulation on electronic identification and trust services was passed in 2017.<sup>69</sup> The law develops a unified system of electronic trust services<sup>70</sup> and introduces mutual recognition of Ukrainian and foreign public key certificates and electronic signatures and seals. A new law on electronic communications introducing the EU regulatory standards into this market was adopted in 2020.<sup>71</sup> Ukraine has updated its law on e-commerce<sup>72</sup> respectively.

New intellectual property legislation in many areas is being introduced to support Ukraine's strong IT sector and other trade in intellectual property. Major changes occurred in the national intellectual property system, work of collecting societies (i.e. organizations licensing and managing copyrighted works on behalf of copyright owners), geographical indications, trademarks, patents and industrial designs, and, as mentioned above, customs enforcement.<sup>73</sup> This means major changes from Soviet-era disregard for IPRs.

Ukraine has also progressed with the adoption of EU norms in banking and insurance regulations. For instance, bank supervision was brought much closer to EU rules, including the implementation of the Basel principles on effective supervision, improved rules on capital buffers, the introduction of the new liquidity ratios, and so on. The law aiming to simplify business and attract investment by securities issuers<sup>74</sup> updated the rules for issuing securities and public offers of securities, information disclosure rules

68 See the chapter on services in Emerson et al. (2021).

69 <http://zakon3.rada.gov.ua/laws/show/2155-19> in Ukrainian).

70 Electronic trust services means an electronic service consisting of the creation, verification, validation of electronic signatures, electronic seals, electronic time stamps, electronic registered delivery, website authentication and certificates related to those services (see [www.lawinsider.com/dictionary/electronic-trust-services](http://www.lawinsider.com/dictionary/electronic-trust-services)).

71 <https://zakon.rada.gov.ua/laws/show/1089-20> in Ukrainian).

72 <https://zakon.rada.gov.ua/laws/show/675-19#Text> in Ukrainian).

73 See the chapter on IPRs in Emerson et al (2021).

74 <https://zakon.rada.gov.ua/go/2210-19>

for security issuers and regulation of professional security market participants. Ukraine has thereby implemented part of the EU Markets in Financial Instruments Directive (MiFID/MiFID II) regulations, considered the most cumbersome of the new EU financial markets regulations. This is a major undertaking, to say the least.

Progress was also achieved in reforming other service sectors, including transport.

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