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Enlargement Prospects and Economic Transformations: The Future of Ukraine

Inna Melnykovska, Central European University

The economic battlefield is a critical front in Russia's war against Ukraine. Russian military attacks have targeted Ukrainian critical infrastructure and have aimed to exhaust its economy. As a result of war damages and losses, Ukraine's real GDP decreased by 30 percent in 2022. This year, the economic situation appears to have stabilised as the World Bank projects GDP to grow by 0.5 percent in 2023, but uncertainty persists. According to the National Statistics Service, Ukraine produced 61 percent of its pre-war industrial output in absolute terms in 2023. The war changed the structure of Ukraine's economy by making it shift from traditional industries such as heavy metallurgy, mining and chemistry to more modern economic sectors including IT, high-tech machinery and electronics. The economic significance of the agricultural sector also increased, amounting to about 50 percent of Ukrainian exports of goods in 2022. For its part, the EU regime of zero duties and quotas has helped to reorient Ukrainian trade flows to the European Union (EU) market.

To remain resilient, Ukraine relies on foreign financial aid provided by Western donors, including EU member states. By announcing a new 50 billion euro multi-year support package within the framework of the Ukraine Facility, which is to be delivered up until 2027, the EU has doubled its total financial commitments and signalled its lasting support to Ukraine. Moreover, EU candidate status, granted to Ukraine in June 2022, and the opening of official accession negotiations with the EU, which announced by the member states at the EU Summit in December 2023, would offer the prospect of further integration into the single market and facilitate comprehensive governance reforms in compliance with the Copenhagen criteria.

While Ukraine's future accession to the EU seems to be an inevitability, the path towards it is still long – for both Ukraine and the EU. On the one hand, the EU accession process would mean an immense reform effort on the part of the Ukrainian Government, bureaucracy and civil society aimed at transforming Ukraine's economy, consolidating democracy and strengthening the rule of law. On the other hand, the next EU enlargement round from 27 to 36 member states should potentially be combined with internal reforms in order to keep the EU functional – as the recent Report of the Franco-German working expert group Sailing on High Seas: Reforming and Enlarging the EU for the 21st Century has recommended. The scope and sequencing of the EU's internal reforms are still being debated, however.

How should Ukraine's economy be encouraged and supported, especially in accomplishing compliance reforms, while simultaneously addressing its wartime needs? What can be done to avoid the trap of delayed accession due to the need for internal reforms in the EU? These are the key questions for the EU agenda. Ukraine's integration into the EU will write a new chapter in the history of European integration as the next accession round will need to go far beyond conventional candidate's compliance with the EU's rules and standards and intertwine with the processes of Ukraine's wartime resilience and post-war reconstruction, in addition to EU internal reforms.

The combination of EU internal reforms and enlargement could undermine the EU's credibility in Ukraine and slow down its reform process. In fact, even in the context of the ongoing war, Ukraine was able to fulfil the reform requirements of the seven EU recommendations regarding candidacy, six of which are related to improving the functioning of Ukraine's economy. According to the fifth assessment round of the Independent Consortium of Ukrainian analytical centres, the average score for meeting the recommendations is slightly higher than eight out of ten.[1] Even if the date for Ukraine's accession is determined by the war's end, the current window of opportunity for the reform process in Ukraine should not be missed. Ukraine might accede to the EU in stages, which is why joining the EU market should be the initial stage of EU accession.

This paper recommends four actions that will strengthen the transformative power of EU accession in supporting Ukraine's economic recovery and modernisation.

The EU accession process should be fine-tuned to address the post-war needs of Ukraine's economy and promote its technological modernisation

Despite the losses and damages that Russia's war continues to inflict on Ukraine's economy and infrastructure, Ukrainian companies have demonstrated remarkable corporate resilience. In the territories that have been less affected by hostilities and occupation, companies began recovering their operations just a few weeks after the February 2022 invasion and continue to work despite Russia's ongoing attacks on Ukraine's power grid and massive disruptions to the power supply. Adapting to the war context, many companies in Ukraine have already started to upgrade their production or are speeding up the implementation of their existing plans to introduce technological innovations. These often rely on energy-saving and alternative energy-based technology, both of which are developed in the EU. These efforts have been supported primarily by grants from local budgets as this funding is easier to apply for than international grants and credits.

The EU's reconstruction efforts in coordination with the EU member states and other Western donors should further promote this technological transfer to the sectors of the Ukrainian economy where it is most needed, in particular in the energy and agricultural sectors. The EU must look for effective forms and channels for technological transfer and upskilling, which could include special grants or low-interest loans for business projects with a component of technological upgrading, in particular within the framework of the EU's common energy strategy and environmental policy that could become an integral part of Ukraine's reconstruction plans and economic transformation through the EU accession process.

1 See the assessment results of Ukraine's candidate check at: https://www.eurointegration.com.ua/eng/articles/2023/09/27/7170234/. Due to the Venice Commission's delayed conclusion regarding the "anti-oligarch" law and the scope of the recommendation that is too comprehensive to be implemented in a matter of months, the experts suspended the evaluation of the "anti-oligarch" recommendation and called on the European Commission to clarify this criterion.

The EU accession process should advance Ukraine's sectoral approximation with the EU, considering the structural changes in Ukraine's war-torn economy

It is true that not all Ukrainian companies have done equally well in times of war. Ukraine's textile industry and IT sector continued to work with little disruption, thanks to the low energy intensity and flexibility of their production processes. Ukrainian agriculture was rescued by the UN Black Sea Grain Initiative, which managed until July 2023 to open a safe maritime humanitarian corridor for Ukrainian grain and foodstuffs exports, but which suffers from the trade restrictions introduced by several EU member states (such as Poland). In contrast, Ukraine's energy and metal industries, mainly consisting of large enterprises located in south-eastern regions, have experienced major damage and losses to production output and exports. Ukrainian large enterprises, able to draw more heavily on available resources, have generally demonstrated better survival and adaptation capacities, while small and micro-businesses typically suffered most or took longer to adapt their activities.

Ukraine's accession process will build upon economic sectoral and trade approximation achieved within the framework of the EU-Ukraine Association Agreement (AA) and the Deep and Comprehensive Free Trade Agreement (DCFTA), but will need to be adjusted to the new composition of Ukraine's economy and encourage its decarbonisation and digitalisation in line with the goals of the European Green Deal. The moment of recovery could be used by the EU to stimulate the development of green metallurgy and green fertilisers in Ukraine as well as to enhance its production capacities and supply of green energy, green hydrogen and critical raw materials to Europe, such as lithium.

Sectoral approximation should go hand in hand with substantial progress in the implementation of anti-corruption reforms and improvement of corporate governance. Anti-corruption measures and tools should involve civil society and engage ordinary citizens (through the mechanisms of consultations and public audits). Strengthening open government practices in EU recovery and accession as well as support for further decentralisation will increase the transparency and accountability of reform efforts and distribute the benefits of recovery processes among Ukrainian society.

Furthermore, small and micro-businesses, especially those concentrating their activities on social entrepreneurship and ecological innovation, should be supported with special grants and programmes or though cooperation with private initiatives and social venture funds.[2]

The EU accession process should support Ukrainian companies in their compliance with the integration requirements of the EU market and encourage business-to-business cooperation

Ukrainian companies have been integrating into the EU common market as part of the institutional framework of the AA and DCFTA. In some sectors (e.g. agriculture, telecommunications, electricity generation and energy exports), their integration even went beyond the existing institutional framework thanks to business-to-business cooperation, and since last year due to trade restrictions being lifted by the EU. Furthermore, Ukrainian companies see integration into European and global value chains as a way to sustain resilience during the ongoing conflict and to develop their business after the war. However, they are restricted by non-tariff barriers, limited logistical capacities and the "wait-and-see" strategies of their international partners.

2 Ukrainian local authorities support SMEs with a preferential interest rate of five, seven or nine percent, whenever commercial loans have much higher rates. There are also several private initiatives to support SMEs. The Franco-Ukrainian network CCI organises yearly Business Women Awards and has established a special fund to compensate for the war-related losses of small French businesses operating in Ukraine. Meanwhile, the Ukrainian Social Venture Fund gathers resources to promote the development of Ukrainian social entrepreneurship (https://www.usv.fund/en/about). These private initiatives have limited resources, however.

The EU accession process, likely to be a key part of Ukraine's reconstruction, could open many important doors. However, the EU's conditions of entry are aimed at making the economies of prospective members more open to companies from EU member states, which in previous waves of EU enlargement sometimes placed additional burdens on domestic business in newly admitted countries. In fact, Ukrainian experts point to the additional costs for Ukrainian carriers that compliance with EU safety standards will result in, or limitations of state support for business losses during the war due to EU criteria concerning stricter control of the provision of state aid to economic entities in Ukraine.

Compliance with EU standards is costly, especially for small and medium-sized enterprises (SMEs), which could in turn make Ukrainian business more vulnerable to the EU's existing companies. The EU's accession process should therefore be complemented by support mechanisms and toolboxes that can help Ukrainian companies to mitigate the impact of the war and achieve compliance and full integration with the EU in the relevant sectors. While the EU accession criteria should be fulfilled, the EU should take into consideration what the country needs in order to sustain and strengthen its domestic corporate resilience in times of war and post-war recovery. In other words, it should help, not hinder, Ukrainian businesses, especially SMEs, in reaping the benefits of full integration into the European single market. The EU would also need to consider and eventually tame the political and economic interests of its member states that would oppose the full opening of their markets to Ukrainian goods (as demonstrated by the recent blockade of Ukrainian grain exports to/via Hungary, Poland, Romania and Slovakia).

The EU accession process should incorporate a financial and insurance toolkit to counter security concerns and attract foreign investment to Ukraine

The current adaptation strategies of Ukrainian companies are cost intensive and the full recovery and reconstruction of Ukraine's economy will be even more so. Many Ukrainian companies will have depleted their assets and equity resources by then and will be in urgent need of cash. The EU and the governments of EU member states are providing a high level of public funds and support, but this will not be enough to meet the needs. Security concerns, as well as the old problem of corruption, might remain an obstacle to foreign direct investment. While the EU's accession criteria as regards anti-corruption and judicial reforms should not be compromised by geopolitical considerations, their full implementation will take time. In the short run, the EU must develop and offer alternative mechanisms to guarantee security of capital and property rights to private – both direct and portfolio – investors. In fact, international donors and Western governments have tried and tested instruments of risk insurance, such as the World Bank's MIGA guarantees or German federal export credit and loan guarantees, as well as investment guarantees and the BPI France Assurance Export mechanism. Adapted to the Ukrainian context, these insurance provisions could make investment in Ukraine's market and Ukrainian companies better risk-protected and thus more attractive for private investors. Furthermore, the legal jurisdiction of capital inflows and commercial interactions could be moved outside Ukraine through such mechanisms of financial integration as bonds, shares and syndicated credit deals – thereby "outsourcing" weak Ukrainian rule of law to more secure EU legal systems. Beyond their immediate role in contributing to Ukraine's reconstruction and modernisation, these mechanisms could help to unleash the transformative powers of global financial markets and promote the implementation of good corporate governance, corporate transparency and accountability, as well as social responsibility standards – and contribute to corporate modernisation in a bottom-up way.

Franco-German perspectives on the future of Ukraine

The EU accession process should not be compromised but speeded up due to geopolitical considerations. The EU's transformative powers should be unlocked in the process of Ukraine's full compliance with EU standards, which in turn will support Ukraine's economic recovery and modernisation. However, existing EU accession policies should be complemented with support mechanisms and toolboxes that could help Ukrainian companies to mitigate war damage and losses as well as enable them to comply with EU standards and integrate into the single market and EU business communities in short order.

Franco-German leadership, including business-to-business initiatives, should be a driving force in EU internal reform and consolidation of political will among EU member states, which will guarantee the credibility of EU membership prospects and thus increase the transformative effects of the EU accession process in Ukraine. The report by the Franco-German working expert group presents concrete suggestions for EU internal reforms as regards, among other things, the decision-making formula and power- and competence-sharing, which would enable the EU to remain functional after the next enlargement round. While signalling the credibility of the offer of EU membership and paving the way to make EU institutions "enlargement ready", it also re-states that there should be no compromise on the fulfilment of requirements and standards for EU membership – and thus the reform incentives for Ukraine should be enhanced.

Certainly, the EU accession process will require the full mobilisation of governmental and civil society efforts inside Ukraine to fulfil EU requirements in parallel to fighting the war. For their part, Germany and France will need to initiate concrete policies and programmes to support Ukraine's domestic efforts. The stance of Germany and France should be visionary and instrumental in this regard. Both Germany and France have aligned their strategic views towards Ukraine's EU membership prospects and consider the revival of EU enlargement in general to be imperative in the contemporary geopolitical context. France's President Emmanuel Macron initiated the establishment of a European Political Community, which aims to support Ukraine (as well as Moldova and the countries of the Western Balkans) on their path to full EU membership. Federal Chancellor Olaf Scholz initiated the establishment of the donor platform under Germany's G7 Presidency and is scheduled to host the next Ukraine Recovery Conference in Berlin in 2024. Special positions in French and German bureaucracies, such as the URC24 Task Force at the German Federal Foreign Office (headed by Jean P. Froehly) and the Special Envoy of the French President for Ukraine's relief and reconstruction (a position currently held by Pierre Heilbronn) could help to overcome bureaucratic inertia and tailor the EU's offer to the needs of Ukraine's economy.

Author
Inna Melnykovska is an Assistant Professor in Comparative Political Economy at Central European University in Vienna.

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Stiftung Genshagen
Am Schloss 1
D-14974 Genshagen
institut@stiftung-genshagen.de

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