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Ukraine at the Crossroads: Between the EU DCFTA & Customs Union

Olga Shumylo-Tapiola

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Previous Works

– "Putin and Ukraine: The Calm Before the Storm," *Commentary*, Carnegie Europe,12 March 2012;
– "Yanukovych and the European Union: 1 to 0," *Commentary*, Carnegie Europe, 22 December 2011;
– "Checkmate for Yanukovych?" *Commentary*, Carnegie Europe, 19 October 2011;
– "Ukraine's Systemic Error," *Commentary*, Carnegie Europe, 29 July 2011;
– "Ukraine and Russia: Ever Closer Neighbors?" *Policy Outlook*, Carnegie Europe, June 2011.

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Introduction

After serious decline in the 1990s, Ukraine's economy finally started its recovery and systemic reform in early 2000. While the economy rapidly grew by 2008, its transformation remained unfinished. The agenda of the current government under President Viktor Yanukovych is being driven by the interests of a small group of people. This, together with the electoral cycle, makes the administration disinclined to implement painful and long-awaited structural reforms. The economic crisis of 2008-2009 put Ukraine's only semi-transformed economic model in question. The closed nature of Ukraine's economy and high dependence on low value-added exports are an unsustainable basis for economic growth. To return to double-digit GDP growth and put the economy on a path of sustainable development, the country has to seek external resources and become more open. However, Ukraine's bad international ranking, lack of substantial natural resources and rent-seeking economy does not make it an attractive FDI destination.

Ukraine is now at a crossroads. There are three possible roads to take. The first, and least probable, is to stay on its own and continue "business as usual," i.e. to retain a relatively closed economy controlled by a small group of businessmen, with little competition and limited economic freedom. The second, and currently most feasible, is to sign an Association Agreement (AA) with the EU that includes a Deep and Comprehensive Free Trade Agreement (DCFTA). Negotiations with the EU are now finalized: the agreement was finally initialed at the end of March 2012—not without much controversy. However, further steps, such as signing and ratification of the agreement depend solely on the Ukrainian side. The third, and most controversial, choice is to join the Customs Union with Russia, Belarus and Kazakhstan and embark on further Moscow-led integration projects.

Ukraine's choice will not only affect trade flows with its two neighbors. It will also indicate the speed and direction of structural reforms, or lack thereof. Ukraine's choice will also have an impact on

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the EU and Russia. Ukraine is a key country within the EU's Eastern Partnership initiative (EaP). It is first of all the largest country in the EaP region with a population of forty-six million. It is also the country that initially had the biggest number of supporters among the EU member states. Ukraine was the first country to be offered deep economic integration and political association with the EU. Within the Partnership, the EU invested considerable political capital on Ukraine and the EU-Ukraine AA/DCFTA will serve as a model for relations with other EaP countries.

For Russia, striving to rebuild a closely linked economic area within the post-Soviet space, Ukraine plays a key role. Without Ukraine, the post-Soviet space's second largest economy, the Customs Union and further integration projects may be unsustainable in the long term.

Over the past months, Ukraine's leadership has repeatedly confirmed the country's interest in signing and ratifying the Association Agreement with the EU. Meanwhile, Russia's invitation to join the Customs Union has been consistently, but politely declined. However, many Western and Russian observers still question the irreversibility and credibility of this decision. The membership in the Customs Union may bring cheap Russian gas that official Kyiv is in dire need of. Ukrainian officials also keep making references to the Customs Union both in public debates and private conversations with the EU officials.[1]

The decision of which path to take has yet to be taken, however. When the time comes, it will be made by president Yanukovych alone. Unfortunately for Ukraine, it will not be made based on expertise and calculations of the national interest; rather, it will be informed by factors the interests of the president and his entourage.

[1] Interviews with high level officials, Kyiv, fall 2011.

EU Offer: Integration with Long-Term Benefits

The European Union has long been an important trading partner for Ukraine, with exports and FDI from its member states increasing dramatically between 1999 and 2008. Despite the 2008-2009 financial crisis, the EU remained Ukraine's biggest trading partner with a 23.6% share of exports and a 33.8% share of imports. Ukraine exports agricultural products, energy, chemicals, iron and steel to the Union and imports machinery, transport equipment, chemicals, agricultural products and textiles and clothing from the EU.[2]

First and foremost, however, the EU is seen as a center of gravity for Ukraine, at least on the declaratory level. Since the late 1990s, every Ukrainian president has talked about the country's European choice and advocated for an EU membership perspective, based on geography, culture and historical ties. Yet, as some Ukraine scholars have suggested, Ukraine's European integration has been happening without Europeanization.[3] Standards of democracy and economic norms have strongly deviated from those of the EU. The EU in turn has neither been ready nor keen to offer a membership perspective to Ukraine.

The 2004 Orange revolution shifted the perception of Ukraine within the EU. Not in a position to offer a membership perspective, the EU suggested deeper contractual relations. The contract—later dubbed the Association Agreement (AA)—was supposed to replace the rather vague 1998 Partnership and Cooperation Agreement that, together with the provisions of the Generalized System of Preferences, defined EU-Ukraine relations. The new agreement aimed at Ukraine's political association and economic integration with the EU.

[2] Statistics from DG Trade, <http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113459.pdf>.
[3] K. Wolczuk, "Integration without Europeanisation. Ukraine and Its Policy Towards the European Union," *EUI Working Papers*, RSCAS No. 2004/15, 2004, <www.eui.eu/RSCAS/WP-Texts/04_15.pdf>; J. Langbein "Organizing Regulatory Convergence Outside the EU", Working Paper, KFG Freie Universitat Berlin, December 2011, <http://userpage.fu-berlin.de/kfgeu/kfgwp/wpseries/WorkingPaperKFG_33.pdf>.

Negotiations on the AA were launched in February 2007 with three chapters—on political, judicial and sectoral cooperation—opened immediately. Ukraine joined WTO in February 2008, allowing the launch of negotiations on a DCFTA.

After a frustrating stalemate in DCFTA negotiations in 2008-2009, the EU and Ukraine finalized the talks in October 2011. From a technical point of view, the deal is already done. Brussels and Kyiv initialed the agreement in March 2012, preventing further modifications to the terms. However, the next steps, such as signing and ratification in the European Parliament and 27 EU member states parliaments are in question.

The EU has a number of reasons to be concerned about Ukraine's direction. Firstly, the EU is concerned about the state of democracy in Ukraine with a number of key opposition leaders and their allies being prosecuted, seemingly on political grounds. Without a proper response from official Kyiv (i.e. resolution of politically motivated cases against the opposition, proper constitutional reform and the conduct of free and fair elections in October 2012), the EU may have no other choice but to put the signing of the AA/DCFTA on hold. Kyiv's final decision is presently difficult to predict. Secondly, it is uncertain how Ukraine will react to Russia's offer to join the Customs Union. The EU understands that the Ukrainian leadership is now in dire need of cheaper gas, and does not know how resistant Ukraine is in reality to Russia's threats.

The conceptual framework and the scope of the DCFTA were based on the 2004 Feasibility Study compiled by a group of European and Ukrainian economists.[4] The study suggested that Ukraine's economic growth could no longer depend on high demand and high prices for metallurgical products (one of Ukraine's key exports) in world markets. A more open and transparent economy with a favorable business climate and better governance was needed to make Ukrainian industries more competitive, and ensure sustainable economic growth.

According to the study, this could not be achieved through simple free trade (i.e. further elimination of simple trade barriers), as post-WTO entry, Ukraine was entering DCFTA talks with import duties for agricultural and industrial products already lowered to 10.66% and 4.95% respectively,[5] export tariffs scheduled for gradual reduction, export quotas being eliminated on both sides, and 80-90%

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[4] CEPS, IFW & ICPS, "The Prospects of Deep Free Trade between the EU and Ukraine," 2006, <http://aei.pitt.edu/32595/1/34._Prospect_of_Deep_Free_Trade_between_the_EU_and_Ukraine.pdf>.

[5] WTO, Report of the Working Party on the Accession of Ukraine to the World Trade Organization, 25 January 2008, <www.wto.org/english/thewto_e/acc_e/a1_ukraine_e.htm>.

of the services sector committed to full liberalization.[6] Thus the new EU-Ukraine trade deal was supposed to go further, be deeper (i.e. deal with behind-the-border obstacles to trade through the adoption of the EU trade acquis), and more comprehensive, (i.e. cover trade in goods and services). This would imply the implementation of EU norms, standards and practices through institution-building.

In economic terms, such a model was not novel to the EU. Similar talks were held by the Union with Chile[7] and later on with South Korea.[8] The FTAs with these countries also envisioned the approximation of standards and norms. However, as these countries did not aspire for EU membership, both were free to choose the degree of compliance with the EU trade acquis. Approximation would mostly happen in areas that have a direct effect on trade with the EU.

The EU-Ukraine DCFTA can roughly be divided into two parts: a tariff offer and the adoption of the EU trade acquis. The former was built on Ukraine's WTO commitments, i.e. low import duties and a rather liberalized services sector. Given this, the tariff offer talks were supposed to account for about only 10% of the overall DCFTA agenda. Yet the interests of some Ukrainian industries (e.g. automobile) and the agricultural lobby turned the tariff offer talks into the main battleground between the EU and Ukraine. Several times after February 2008, the EU was close to putting negotiations on hold.[9]

Negotiations on the deep and comprehensive part were held within the following working sub-groups: trade and sustainable development; rules of origin; services; capital and establishment; intellectual property rights; geographic indications; customs and trade facilitation; public procurement; competition: anti-trust; competition: state aid; sanitary and phytosanitary standards; trade related energy issues; dispute settlement; transparency; fraud; trade defense mechanisms; and technical barriers to trade.[10]

From the very titles of these subgroups it is possible to conclude that the future DCFTA would have a rather wide coverage. However, the degree of Ukraine's compliance with the EU acquis in these areas was another difficult issue in the negotiations. Initially, the EU suggested that Ukraine as a non-candidate country had a right to

[6] Institute of Economic Research, "Costs and benefits of FTA between Ukraine and the European Union," Kyiv, 2010, <www.ier.com.ua/files/Books/Ocinka_vytrat/ocinka_vitrat_eng.pdf>.

[7] Association Agreement talks were completed in 2002, FTA entered into force in 2003.

[8] Talks on the Association Agreement including FTA were started in 2007, the AA was signed in October 2010, FTA provisionally applied from July 2011.

[9] Interview with Ewa Sinowiec, EU chief negotiator on EU-Ukraine DCFTA, *Kommersant Ukraine*, October 2010, <http://kommersant.ua/doc/1520099>.

[10] Joint report on DCFTA negotiations, 8 November 2010, <http://eeas.europa.eu/ukraine/docs/joint_progress_report4_association_en.pdf>.

choose the degree of compliance in the majority of areas. Diverging from the experience of other partners, Ukraine ended up having rather limited influence, with the EU having a clear, non-negotiable list of commitments demanded from the country. Flexibility was possible only in a few areas, for instance, environmental policy, where implementing the EU acquis is expensive and where even accession countries have had long transition periods.[11] All commitments including the scope of compliance and the timeline for the implementation together with transition periods were put in the annexes to the DCFTA part of the Association Agreement.[12]

DCFTA: potential costs and benefits

A number of solid studies were produced between 1999 and 2010 by Ukrainian and international experts on the feasibility and impact of a future EU-Ukraine DCFTA. They highlight the benefits of such an agreement for both parties. The estimates provided by the 2004 EU-funded Feasibility Study and confirmed by the 2007 Impact Assessment suggested that the DCFTA would deliver "welfare gains of the order of 4-7%," and concluded that in the long run these gains could be doubled or tripled.[13] Both studies also suggested that the reduction of capital costs would lead to further 4-5% welfare gains, and the improvement of institutions in Ukraine would increase the country's GDP "in the range of 20 to 30%." Studies conducted by leading Ukrainian think-tanks supported this by concluding that the DCFTA would stimulate real GDP growth and in the long run improve the welfare of households.[14]

According to these Ukrainian experts, the quantitative benefits would also be supported by both positive and negative qualitative changes in the short and long run. There would be no clear losers or winners as the costs of DCFTA would be shared by the state, business and consumers. At the same time, quantitative benefits were deemed more likely to be experienced in the medium and long term given 5-10 year transition periods for the implementation of certain norms and standards as well as for simple trade restrictions negotiated by the EU and Ukraine. Costs related to compliance and opening, however, would likely emerge in the short and medium term, due to reform of institutions or the creation of new ones (e.g. sanitary

[11] Interviews with Ukrainian government officials, Kyiv, September 2010.
[12] Carnegie Europe/Institute of World Politics Ukraine video conference on the EU-Ukraine DCFTA, June 2010
[13] ECORYS & CASE, "Trade and Sustainability Impact Assessment of the Free Trade Area in the Framework of the Enhanced Agreement between the EU and Ukraine," April 2007,
<http://trade.ec.europa.eu/doclib/docs/2007/june/tradoc_135055.pdf>.
[14] IER, *op. cit.* [6].

and phytosanitary standards, competition policy).

Table 1. Costs and benefits of the EU-Ukraine DCFTA

	Benefits	Costs
State	• Political neutrality of the project, more predictable course of country's development • Improved trade with the EU • More FDI, modernization • Higher business activity, increased tax revenues	• Costs of compliance with EU acquis for the state • Possible closing down of business in some sectors and job losses resulting in social discontent • Competition for FDI, costs of modernization that may be higher than available investments
Business	• Better access to the richest market of 500 million consumers • Better domestic business climate for all, more transparency • More competitive Ukrainian goods on international market in long run • Opening of new business opportunities, such as EU public procurement	• Costs of compliance with EU standards for business (individual and shared with the state) • Costs for rent-seekers and those who benefit through corruption and red tape • Possible closing down of some business (depending on the sector) • Higher costs of compliance for the state and business in the short run • Higher costs of compliance for business (depending on the sector) • Higher competition within Ukrainian public procurement due to participation of EU companies
Consumers	• Better quality and more diversified products and services	• Possible higher prices for goods and services in short term • Increase in gap between wages of skilled and unskilled labor, possible job losses and declining incomes

Source: Author's analysis based on IER (2006, 2010) and ICPS (2006) studies.

The table above provides a general overview of the benefits and costs for the Ukrainian state, businesses and consumers. Ukrainian experts argue that overall the DCFTA will have a positive impact on the economy, and that benefits will outweigh the costs. Aside from more general costs and benefits, there will be sector and industry specific implications. In the absence of the final publicly available text of the DCFTA (and the closed nature of the talks), such implications were simulated by the Ukrainian experts. Given the limited format of this publication, only one cost and benefit analysis is provided below. It concerns the introduction of the EU acquis in one key aspect of the business environment: company law.

Table 2. Costs and benefits of the implementation of Company law

	Costs	Benefits
State	• High administrative costs for creation of the publicly open national registration system for companies, specialized court for intellectual property matters. Competitive disadvantage from lower disclosure requirements in foreign competitors' home countries. High costs of legal cooperation in some international aspects of bankruptcy.	• More effective allocation of capital and FDI growth. Access to the lower cost of capital and more liquid financial instruments. Enhanced efficiency from competition. Increased integration to the European social and economic system. • Greater confidence of investors in the stable framework on the Ukrainian market.
Business	• Competitive disadvantage from information disclosure. High costs of introduction of International Accounting Standards (IAS), International Financial Reporting Standards (IRFS) and their permanent use. • High costs of statutory audit and all the due diligence checks. Bargaining disadvantage from the disclosure to suppliers and customers.	• Lower average cost of capital. Access to more liquid markets. Avoided litigation alleging inadequate informative disclosure. Bargaining advantage from customers' and suppliers' informative disclosure. Higher level of property rights protection due to international cooperation.
Consumers	• Lower average cost of capital. Access to more liquid markets. Avoided litigation alleging inadequate informative disclosure. Bargaining advantage from customers' and suppliers' informative disclosure. Higher level of property rights protection due to international cooperation.	• The consumer protection provided by informative disclosure

Source: IER impact assessment (2007)

Ukrainian debate on the DCFTA

A recent study by a group of Ukraine scholars noted that Ukrainian negotiators tend to be open to committing the country to relatively substantial compliance with EU norms and standards.[15] The study analyzed the implementation of the EU-Ukraine Action Plan (2004-2008) and the EU-Ukraine Association Agenda (2009 – ongoing). According to EU negotiators, such conclusions can be extended to negotiations on the EU-Ukraine DCFTA.[16]

This can be explained by the overall support for European integration declared by top political levels of both the Yanukovych and Yushchenko administrations. In 2006, Ukraine's leadership welcomed the idea of deeper economic and political relations with the EU. The ratification of Ukraine's WTO accession protocol, widely seen as a first step towards closer ties with the EU, was supported by 411 MPs of the 450 in the Ukrainian parliament. The current government's 2010-2014 reform program billed the EU-Ukraine DCFTA as a strategic goal for Ukraine.[17] The president's draft law on the principles of internal and external policy defined the goal of obtaining EU membership perspective and the implementation of DCFTA commitments as a foreign policy principle.[18] Lastly, Ukraine's parliament adopted a resolution on the rapid completion of DCFTA talks with the EU during the extraordinary session "On the state and prospects of development of economic relations between Ukraine, the EU (FTA) and the Customs Union" held in May 2011.

Many in Ukraine's political elite see the AA/DCFTA as a symbol of Ukraine's proximity to the EU rather than as a set of legally binding commitments and specific measures of adaptation.[19] Yet, the agreement is not seen as enough, with an EU membership perspective remaining the ultimate goal. Some politicians would like to see the completion of the talks during their tenure, as they believe it would win them additional votes. This is especially important for the Party of the Regions (the current ruling party), as it has often been perceived as a pro-Russian and sometimes anti-liberal actor in Ukraine's politics.

When it comes to the implementation of Ukraine's European commitments, the current leadership in Kyiv surprisingly sees the

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[15] J. Wolczuk and K. Langbein, "Convergence without membership? The Impact of the European Union in the Neighborhood: Evidence from Ukraine," *Journal of European Public Policy*, September 2011.
[16] Interview with EU negotiators, September 2011.
[17] Government reform program 2010-2014.
[18] Law on the principles of internal and external policy, 2010.
[19] Discussions with representatives of Ukrainian MPs, big business in both Kyiv and the regions of Ukraine.

DCFTA as an *a la carte* exercise.[20] Having a record of poor implementation of international commitments, due to the presence of many business interests inside the parliament and strong links between the administration and big business, Ukraine has all pre-requisites to perform badly with the implementation of DCFTA commitments. In addition, the country has very low institutional capacity that may impede implementation, according to experts.[21]

The elites, the local business and the public at large remain widely unfamiliar with the real content of the DCFTA. The EU is associated with prosperity and freedoms (including economic freedoms), and overall public support for EU integration remains at 50-60%[22] (and is affected more by domestic developments than EU actions). The public at large does not have detailed information about the DCFTA. On the one hand, this can be attributed to the closed nature of the negotiations with the draft agreement being confidential. On the other, the public is unlikely to get interested in the details of economic integration, feeling little trust in any government activities and being worried about their own short-term survival rather than strategic projects.[23]

The media does not put much effort into analyzing the possible impact of DCFTA; aside from a few exceptions, it is full of myths about the future agreement with the EU.[24] For instance, the EU is believed to be planning a drastic expansion to Ukrainian markets and therefore needs the DCFTA more than Ukraine. Some predict that Ukraine will be flooded by cheap and not necessarily safe imports from the EU. Ukrainian industries tend to argue that they will suffer significantly to the extent of closure and job losses for large numbers of employees. Some believe that Ukraine will not be able to protect itself from unfair competition (unfair meaning higher quality products), whereas others predict a significant negative impact on Ukraine-Russia trade and economic bilateral relations.

These myths are supported and spread further by a small number of proponents of Ukraine joining the Moscow-led Customs Union through their media resources. These are a small group of oligarchs and the Communists. The interest to divert Ukraine from the EU differs in case of each group. The former would prefer to see Ukraine as part of the grey zone or at least the Customs Union. Transparency that could be brought by the EU would have negative

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[20] Interviews with Ukrainian diplomats and foreign ministry officials, EU diplomats in Kyiv.

[21] ICPS, “Capacity Assessment of the Government to Organize Implementation of the EU-Ukraine Association Agreement,” Kyiv, 2010, <www.icps.com.ua/files/articles/57/50/SIDA_2010_ENG.pdf>.

[22] Razumkov Centre, 2004-2010

[23] Razumkov Centre, Poll “Do you Support the Activity of the Government of Ukraine?” (recurrent, 2000-2011), <http://razumkov.org.ua/eng/poll.php?poll_id=75>.

[24] Newspaper 2000, <www.gazeta.net.ua>.

effect on their business. Despite being small in number, these people are rather influential, their impact on the Ukrainian president should not be underestimated. The logic of the Communists is simply ideological. However, they have little power to change Ukraine's EU course. Coupled with lack of information from the government, these myths inform public opinion. However, they are unlikely to change the overall positive attitude towards the EU.

Discussions with aides to major economic players[25] over the last four years reveal that the majority of so-called oligarchs (or tycoons as they prefer to call themselves) are in favor of the DCFTA. They see it predominantly in terms of better market access and increased FDI for the modernization of their companies. Supporting the DCFTA in public is fashionable as it also positions the oligarchs, many of whom are also members of the Ukrainian parliament, as open-minded and pro-Western. The companies of a number of oligarchs, especially in metallurgy, have already started modernizing their production plants, making them compliant with European and international norms. This means that their future costs of compliance will not be too high.

A few business interest groups may still pose a threat to the DCFTA's implementation. These are largely those who already opposed Ukraine's WTO commitments (e.g. the automobile industry, agriculture) and who attempted to influence the DCFTA talks.[26] Their main arguments are "the need to protect domestic producers and to stop cheap and unrestricted EU exports from overflowing Ukrainian markets."[27]

In addition, there is a possibility that the interests of current Cabinet Ministers will clash with Ukraine's commitments under the DCFTA. The current Cabinet includes a large number of millionaires[28] whose businesses enjoy access to state resources through public procurement schemes and state aid.[29] While publicly supportive of the DCFTA during the negotiation phase, some of these politicians may find it difficult to allow reform of their agencies to improve transparency. Some oligarchs who, due to close links with the current administration, managed to gain individual control over certain sectors of the Ukrainian economy (e.g. chemicals, gas, aviation) may also try to oppose reform.

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[25] Author's interviews in 2007-2011.
[26] Author's interviews with EU officials, 2011.
[27] Gorshenin Institute, Roundtable "Ukraine-Russia Relations after the Completion of DCFTA Talks with the EU" June 2011.
[28] Gorshenin Institute, Roundtable "FTA with the EU or Customs Union with Russia—What is More Preferable for Ukraine" April 2011.
[29] *Ukrainska Pravda*, "Milioneri Forbes: oligarkhi, ministri, deputati ta sin Yanukovitcha" [Forbes Millionaires: Oligarchs, Ministers, Deputies and Yanukovych's Son], <www.epravda.com.ua/publications/2012/04/5/320733/>.

According to the results of a series of consultations, held between 2007 and 2010, by the Ukrainian Ministry of Economy, Ukrainian independent think tanks, and the European Business Association, Ukrainian businesses in the regions do not see the DCFTA as a major threat.[30] Still, they have their concerns.

Many of these businesses are still trying to adjust to Ukraine's membership in the WTO. Their initial reaction towards DCFTA was rather protectionist. One of the most visible examples is Ukraine's commitment to adopt EU rules on geographic indicators. This was strongly opposed by Ukrainian wine producers, due to the EU's "take-it or leave-it" position.[31] However, the attitude improved slightly due to EU attempts to shift the debate from losses to new possibilities for Ukrainian businesses.[32]

Businesses in Dnipropetrovsk and Donetsk, as well as Lviv and Uzhhorod (east and west of Ukraine respectively) are concerned with the costs that may occur due to adoption of EU standards. There is a strong belief that the DCFTA will not have a negative impact on big Ukrainian producers and exporters, whereas small and medium enterprises may have problems due to competition from EU exports.[33] While businesses are also concerned with the competitiveness of their products, they see the DCFTA as a possibility to gain better access to investment and quality human resources. This, according to some businessmen, would significantly outweigh existing protectionism and subsidies that many of the interviewed saw as ineffective.[34]

Businesses in Northern Ukraine, i.e. Poltava and Kharkiv, are concerned about the existing unstable legislation and the lack of funds for SMEs to adapt to EU norms. Given that a large share of the region's output is in heavy industry exporting to Russia, some entrepreneurs have expressed concerns over the implications for trade with Russia.[35] Businesses in Odessa, in Southern Ukraine, share this concern and suggest a more gradual approach to integration with the EU, i.e. after understanding the implications of

[30] ICPS Newsletter, No.16 (408), 19 May 2008; ICPS Newsletter, No.7 (399), 3 March 2008.
[31] Products with a specific geographical origin that possess particular attributes linked to that place. Ukrainian companies use product names to produce local products that bear little resemblance to the originals patented in the EU. Champagne is one obvious example. Under the DCFTA, Ukraine will have to rebrand such products.
[32] According to EU officials, Ukrainian wine producers have already started visiting French wineries to study wine production according to EU norms. EU negotiators also conducted meetings with Ukrainian wine producers during 2010-2011 to explain the potential of DCFTA.
[33] In the Ukrainian regions, people still tend to buy products from small shops supplied by small producers.
[34] ICPS Newsletter, No. 7 (399), 3 March 2008.
[35] ICPS Newsletter No.16 (408), 19 May 2008.

WTO membership.[36]

Ukrainian bureaucracy remains a very influential interest group, and could become potentially active in jeopardizing DCFTA implementation. Negative reactions are likely since a more effective and transparent system introduced through DCFTA implementation will reduce the powers of the bureaucracy and limit opportunities for rent-seeking. The degree of resistance will depend on the scale of reform within each government agency. Resistance may be higher in areas where there are state and business monopolies and consequently high levels of rent-seeking (e.g. standardization system, chemicals, aviation, etc.).

The EU and Ukraine completed negotiations last year. The text was initialed in March—meaning its provisions cannot be subject to later re-negotiation. However, the signing and ratification are under threat. Both sides try to remain optimistic that the agreement could be signed by the end of this year or early next year. However, there is very little reason for optimism. As the Swedish Foreign Minister, Carl Bildt recently confirmed at an event organized by the European Policy Center in Brussels: “if Ukraine does not deliver, the EU will not move with the signing of the Agreement”.[37]

Even if the signature and ratification go well, the EU will have to remain engaged in the implementation process. Bilateral agreements are traditionally not taken seriously by the Ukrainian state and non-state actors.[38] Problems with the ratification of the DCFTA part on the Ukrainian side are unlikely to occur. However, the above-mentioned interest groups may try to push for decisions deviating from Ukraine’s commitments at a later stage. Thus, the implementation and application of the EU acquis will depend directly upon the Union’s ability to hold the country accountable and provide incentives in a number of overly protective sectors.

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[36] ICPS Newsletter, No. 22(414), 30 June 2008.
[37] *Kommersant Ukraine*, Kievu dali vramya dozret” [Kyiv Given Time to Mature], 29 February 2012, <http://kommersant.ua/doc/1882999>.
[38] J. Wolczuk and K. Langbein, *op. cit.* [15].

Russia's Offer to Ukraine

Russia-Ukrainian relations

Since the collapse of the Soviet Union, Ukraine-Russia relations have been sensitive. Moscow has consistently viewed Ukraine as an important part of its integration projects. Russia has not wanted to accept Ukraine's independence and questioned her sovereign statehood.[39] At the same time, all presidents of independent Ukraine have resisted returning to Moscow's orbit. Various Russian offers to Kyiv have looked unappealing, and even contrary to the interests of the Ukrainian economic elite.

Despite being important markets for each other, Ukraine and Russia have not succeeded in forging stronger institutional economic and trade ties. The two countries have survived two serious "gas wars" (2006 and 2009) and a number of smaller-scale trade wars. Kyiv has wanted to continue enjoying cheaper Russian gas and access to her markets, but has remained unwilling to go further than simple bilateral or multilateral free trade agreements with Moscow. Russia has resisted the creation of such free trade zones with Ukraine and has continuously applied restrictions to the import of Ukrainian goods. There were even attempts to stop Ukraine joining the WTO. In the months before Ukraine's accession, Russia employed all possible means from threatening to close her markets to Ukraine, to calling for synchronized WTO accession, to employing the Kyrgyz government to block Ukraine's accession talks.[40]

In 2009-2010, relations between the two countries became more neutral; Russia even looked as having lost interest in Ukraine. Moscow was preparing to launch the Customs Union with Belarus and Kazakhstan, while Ukraine was negotiating the DCFTA with the EU. The two countries had to deal with the consequences of the

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[39] For instance, Vladimir Putin's statements cited in J. Marson, "Putin to West: Hands off Ukraine," 25 May 2009 <www.time.com/time/world/article/0,8599,1900838,00.html>.

[40] Valeryi Piatnytsky, Ukraine's chief negotiator with WTO in interview with Zerkalo Nedeli, "Kyrgyzstan ne puskae Ukrainu v SOT z politychnyh mirkuvan" [Kyrgyzstan does not allow Ukraine into WTO for political reasons], <http://dt.ua/POLITICS/pyatnitskiy_kirgizstan_ne_puskae_ukrayinu_v_sot_z_politichnih_mirkuvan-51417.html>.

global economic crisis, diverting their attention from bilateral relations. Moreover, Ukraine and Russia had signed a new gas contract that was supposed to make Russian gas more expensive and Ukraine less dependent on it in the medium term.

However, Yanukovych's election in 2010 brought back Russia's hopes for integration, as Moscow saw a potential ally in power in Kyiv. The new president's first few months underpinned Russian expectations, with Ukraine extending the agreement allowing the basing of Russia's Black Sea Fleet in Crimea for a further 25 years in exchange for cheaper gas. However, the honeymoon did not last long. Officially Kyiv insisted on the finalization of DCFTA negotiations with the EU while resisting Moscow's invitation to join the Customs Union.

Although not seen as a threat initially, the DCFTA became of serious concern to Russia as negotiations proceeded towards a close. Over the past months, there has been a series of negative statements and even threats from both president Medvedev and premier Putin aimed at stopping the finalization of DCFTA talks.[41] Membership in the Customs Union has been insistently offered as an alternative that would bring immediate benefits to Ukraine, significantly outweighing the EU offer.

Russia is not convinced about the Ukrainian elite's willingness to engage in a deal with the EU that would result in more transparency and therefore reduce the opportunities for rent-seeking. Russians appear to believe that if Ukraine is offered a "better deal," she may in the end join the Customs Union. As a result, promises of cheaper gas prices—Russia's trump card—coupled with threats and small trade wars, are used to pull Ukraine away from her European choice. This, however, has not yet borne fruit; president Yanukovych has made a counter-offer of a "3+1" cooperation formula (i.e a simple FTA between Ukraine and the members of the Customs Union).

The Customs Union: preliminary conclusions

The Customs Union was launched in January 2010 with the introduction of a common tariff scheme between Russia, Belarus, and Kazakhstan. This was followed in July 2010 by the entry into force of a common Customs Code. The Customs Union covers trade in goods, leaving aside trade in services and the free movement of

[41] "Putin: Ukraina prodast Evrope 2 litra moloka, a Tamozhenniy soyuz dast ey $9 mlrd v god" [Putin: Ukraine will sell Europe Two Liters of Milk, the Customs Union would Bring her $9 Billion a Year], *Zerkalo Nedeli*, 6 October 2011, <http://news.zn.ua/POLITICS/putin_ukraina_prodast_evrope_2_litra_moloka,_a_tamozhennyy_soyuz_dast_ey__9_mlrd_v_god_-89118.html>.

capital and persons. It is envisioned that import duties received under it will be consolidated into one account, "with Russia receiving 87.97% of the proceeds, while Kazakhstan and Belarus would receive 7.33% and 4.70%, respectively."[42] Member countries have subsequently created a commission for the union, whose voting power is divided 57%, 21.5%, and 21.5% among Russia, Belarus and Kazakhstan, respectively.[43]

Russia claims that it wants to create a single market with 160 million consumers and unified technical and sanitary standards, integrated transport, pipelines and electricity grid infrastructure. However, on closer examination, the project appears political with rather uncertain economic benefits. In reality, the Customs Union will primarily serve Russia's interests in strengthening her global economic position.[44] As a side effect, it is also believed to stop flows of cheap goods from China through Central Asia.[45]

Despite the tensions existing within the Customs Union, it was rather easy to convince Belarus and Kazakhstan to join. The first is isolated from the West after events in the aftermath of the December 2010 presidential elections. The Belarusian economy is highly dependent on Russian loans as neither the IMF nor the EU is willing to engage with the current regime. For Kazakhstan, the invitation had a symbolic meaning of good relations with its neighbor. In economic and trade terms, the country is EU-oriented and did not have much incentive to join.

It is too early to make conclusions about the costs and benefits of the Customs Union for Russia, Belarus and Kazakhstan, as well as for their neighbors. However, many scholars already question the durability of the project given previous experiences of integration in the post-Soviet space (e.g. a CIS-wide FTA signed in 1994 and never implemented or the Eurasian Economic Community [EurAsEC]). There are a limited number of general studies on the benefits and costs of Ukraine's possible membership in the Customs Union, as well as a few studies on the rather negative impact of the Customs Union membership for Belarus and Kazakhstan.[46]

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[42] IER/German Advisory Group, "Trade policy in Ukraine: Strategic Aspects and Next Steps to be Taken," Kyiv/Berlin, April 2010, <www.beratergruppe-ukraine.de/download/Beraterpapiere/2010/PP_02_2010_new_Format_eng.pdf?PHPSESSID=3096a07cc1c2adc7fe951423032e6841>.

[43] O. Shumylo-Tapiola, "Ukraine and Russia: Ever Closer Neighbors?" 8 June 2011, <http://carnegieendowment.org/files/ukraine_russia_2.pdf>.

[44] D. Trenin, *Post Imperium*, Moscow, Carnegie Endowment for International Peace, 2011.

[45] Oxford Analytica, "Customs Union Offers Marginal Benefits to Central Asia," 28 July 2011.

[46] P Kalra and S. Varadzhakov, "The Customs Union between Russia, Kazakhstan and Belarus First Steps towards the Revival of the Silk Road," <http://cambridge-centralasia.academia.edu/PrajaktiKalra/Papers/472081/The_Customs_Union_between_Russia_Kazakhstan_and_Belarus_First_Steps_towards_the_Revival_of_the_Silk

Moreover, some experts believe there is little potential for real economic integration between Russia and other CIS countries, as they lack the prerequisites for it, such as "a high level of manufacturing and concomitant diversification of export and import operations."[47]

The overall atmosphere within the Customs Union reflects the levels of trust and lack of a spirit of partnership. Tensions between Moscow and Minsk over oil export duties at the beginning of 2011 were one of the first signals of Russia's unwillingness to be flexible with its partners.[48] On the one hand, Belarus and Kazakhstan feel pressured to open up to Russian scrutiny (e.g. their customs services). On the other, they have already started complaining about unfair treatment of their goods by Russian customs authorities.[49]

Since there are no solid publically available studies on the subject, it is difficult to conclude whether Belarus' and Kazakhstan's concerns have real grounds. They believe that Moscow will be the only winner, given that the Union was built on 92% of Russian custom tariffs. They are concerned over being used as a playground for the production of raw materials for the benefit of Russian business. There is an expectation that the creation of the Customs Union will attract more FDI. If this to happen, investment flows are more likely to come to Russia and perhaps Kazakhstan. Belarus will remain a difficult destination, given problems with democracy, affecting the country's reputation.

Minsk and Astana expect losses in budget revenues, the rise of domestic prices, and higher inflation. Recently, Belarus expressed her concerns with the increase in the volume of smuggled goods through the intra-union borders.[50] Kazakh businesses and later on members of parliament have voiced concerns over the possible rise of consumer prices and inflation, with some linking the recent 12% inflation with the membership in the Customs Union. There have been public protests against Kazakhstan's membership in the Customs Union with a number of public figures from different groupings asking the president to stop the integration process.[51]

_Road>; M. Yilmaz and K. Moldashev, "The Possible Effect of the Customs Union on Belarus, Khazakhstan and Russian on Development of Kazakhstan Economy," <http://horizonresearch.kz/index.php/ru/analytics-ru/regional-integrations-ru/75-cu-effects>; I. Tochitskaya, E. Aksen "Joining the Customs Union with CIS Countries: The Belarusian Case," <http://eaksen.narod.ru/publications/toch-aks.pdf>.

[47] Trenin, *op. cit.* [44].

[48] See RIA Novosti, "Ukraine's New Leadership Eyes Customs Union with Russia—Paper," 17 February 2010, <http://en.rian.ru/exsoviet/20100217/157913841.html>.

[49] *Belaruskaja Delovaja Gazeta*, 27 August 2011, <http://bdg.by/news/politics/11891.html>.

[50] *Ibid*.

[51] Deutsche Welle, "Protesti protiv Tamozhennogo soyuza v Kazakhstane: slishkom rano ili slishkom pozdno? [Protests against Customs Union in Kazakhstan: Too Soon or Too Late?], 1 April 2010, <http://www.dw-world.de/dw/article/0,,5421638,00.html>;

Yet, the three partner countries have already invited Kyrgyzstan, Tajikistan, Uzbekistan and Ukraine to join the Customs Union. Also, Russian Prime Minister Vladimir Putin announced the creation of a Eurasian Economic Union followed by a Eurasian Union to cover cooperation far beyond trade towards the four freedoms (movement of goods, services, capital and people) and a political union within the next few years.[52]

WTO membership may be a factor influencing developments within the Customs Union. If Kyrgyzstan, a current member of the WTO, decides to join the project, she will set a precedent and give Russia additional arguments for pressure on other invitees, such as Ukraine. Russia's recently-approved membership in the WTO will lead to the revision of customs duties within the Union. This may create additional problems for its members as WTO accession talks by Moscow and Astana were not synchronized, and Minsk cannot proceed with its own. However, it is too early to make definite conclusions about the impact of Russia's WTO membership.

Customs Union and Ukraine: what's on offer?

It has long been suggested that for both economic and political reasons, any Russian project will not succeed without Kyiv. From the economic side, Ukraine is a valuable asset with her 46 million consumers, industries, and agriculture as well as energy transit capacities. Ukraine is also Russia's third largest trading partner, after Germany and China. From the political (and often emotional) point of view, Russia believes that if Ukraine, the largest country within the EU's Eastern Partnership initiative, decides to shift sides and join the Customs Union, this may push other EaP countries to re-consider their direction.

Yet, the Ukrainian leadership has remained firm on its position regarding the Customs Union. Yanukovych has declined all invitations by the Russian leadership and has instead insisted on the "3+1" formula of simple free trade between Ukraine and the Customs Union**.** A European choice remains the main declared direction for the country.

From a technical and economic point of view, the main barriers to Ukraine's membership in the Customs Union are the country's WTO membership and a clause in the Constitution that prohibits the country from surrendering decision-making powers to

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Deutsche Welle, "Tamozhennii soyuz zabespokoil teper i politikov v Kazakhstane" [Customs Union now a Worry for Politicians in Kazakhstan], 3 March 2010, <www.dw-world.de/dw/article/0,,5315170,00.html>.

[52] V. Putin article in *Izvestia* on 4 October 2011, <http://premier.gov.ru/eng/events/news/16622/>.

any supra-national authority. If Ukraine wished to join the Customs Union, amending the Constitution could prove easy. According to recent practice, the Constitution may be simply amended, or at least reinterpreted, by the Constitutional Court and not necessarily through the parliament or a public referendum.[53] However, WTO membership and the implications from the breach of commitments by Ukraine are rather unbeatable impediments to Customs Union membership at the moment.[54]

Russia has an emotional fear of losing Ukraine, and is pushed to use various “sticks and carrots” to pressure Kyiv. According to estimates put forward by Moscow, direct per annum gains for Ukraine from the Customs Union would come to 6.5-9 billion US dollars. Russia is ready to provide cheaper gas to Ukraine and to compensate possible losses in case of WTO members’ claims.[55] The immediate benefits outlined by Putin would come from the elimination of export duties on oil (US$ 3 bn. per annum) and on oil products (US$ 4.6 bn. per annum), lowering of gas prices to the level of Russian domestic prices, the elimination of safeguard measures existing in bilateral trade, leading to the increase of Ukrainian exports to Russia (up to US$ 670 m. per annum).

Customs Union membership with Russian estimated benefits for Ukraine of almost 9 billion US dollars annually is also contrasted with the IMF Stand-by Arrangement, through which Ukraine will borrow approximately 10 billion USD over 15 years.[56] The Customs Union should also help Ukraine become the breadbasket of the region, and later on of the European Union and the rest of the world. The country’s aviation sector, unless included in the Customs Union, will have to disappear due to significant pressure from EU-based competitors.[57]

Among the mildest arguments coming from Moscow is a Russian conviction that the door to EU membership is closed for

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[53] In October 2010, the Ukrainian constitutional court overturned the 2004 Constitution, bringing back the 1996 Constitution with substantial powers of the president.

[54] Author’s interviews with independent Ukrainian experts revealed that while there are no clear estimates from possible revision of the country’s WTO commitments, it is possible that many WTO members, especially those who were members of the working group on Ukraine’s accession, would claim compensation.

[55] Prime minister Putin’s suggestion quoted by Interfax, 12 April 2010, <http://www.interfax.ru/business/news.asp?id=185377>.

[56] ‘Focus, “Putin rasskazal o vygode vstuplenia Ukrainy v TS” [Putin Spoke about the Benefits of Ukraine Joining Customs Union], 6 October 2011, <http://focus.ua/politics/202767/>.

[57] “Produkti iz Ukraini na evropeiskii rinok ne pustyat, aviatsiya umret—Putin” [Ukrainian Products will not Enter the European Market, Aviation will Die—Putin], *Ekonomicheskie izvestiya*, 6 October 2011, <http://news.eizvestia.com/news_politics/full/produkty-iz-ukrainy-na-evropejskij-rynok-ne-pustyat-aviaciya-umret-%E2%80%93-putin>.

Ukraine. For instance, in his statement at the 2011 Sochi investment forum, Putin said that he could hardly imagine Ukraine's approximation with the EU.[58] In discussions with Kyiv, Moscow does not seem to rule out economic integration between the EU and the Customs Union at a later stage. The Russian leadership claims in this context that Ukraine's bargaining power would be higher if channeled through Moscow.[59]

Russia's main arguments are that Ukraine's European choice is political and emotional, while joining the Customs Union would be a pragmatic choice. At the same time, Moscow has raised a number of concerns, including that the Customs Union countries will be flooded with cheap exports from the EU once Ukraine forms a free trade area with the EU.[60] It is argued that Poland, Romania and the Baltic states would try to channel their products through Ukrainian territory, as Ukrainian tariffs are much lower than those of the Customs Union.

Despite the fact that this danger could be eliminated through rules of origin regulations, Moscow has threatened to impose stricter control on the Custom Union's border and serious restrictive measures applied to exports from Ukraine. In the Summer of 2011 members of the Customs Union raised customs duties for Ukrainian caramel, sugar, potatoes and cabbages, and introduced antidumping measures against several Ukrainian steel pipe manufacturers, some parts of the industry producing equipment for heavy machinery, and industrial nylon yarn. Albeit new to Ukraine, these restrictions have affected a number of key Ukrainian economic actors (i.e. R. Akhmetov, V. Pinchuk, I. Kolomoisky and O. Yaroslavsky).[61] Experts also suggest that Russia has managed to block the signing of a new CIS free trade agreement through the Uzbek government. This FTA is of particular interest for Ukrainian businesses and the state. The agreement on FTA within CIS was sealed at the 2011 Saint-Petersburg summit of the heads of CIS members, but the document has yet to enter into force.

In reality, Russia's promises and threats do not necessarily

[58] "Putin schitaet nerealnim vstuplenie Ukraini v ES" [Putin Considers Ukraine Joining EU to be Unrealistic], 16 September 2011, <http://economics.lb.ua/state/2011/09/16/115158_putin_schitaet_nerealnim_prisoed.html>.

[59] "Vesti, "Putin: otkaz Ukraini vctupit v Tamozhenniy soyuz nosit politico-emotsionalniy kharakter" [Putin: Ukraine's Refusal to Join the Customs Union is Emotional and Political],16 September 2011, <www.vesti.ru/doc.html?id=572358>.

[60] Aktualnie Kommentarii,"Putin—Ukraina vigraet ot vstupleniya v Tamozhenniy soyuz" [Putin: Ukraine Will Benefit from Joining the Customs Union],12 April 2011, <http://actualcomment.ru/news/22974/>.

[61] Rinat Akhmetov, Ukraine's richest man with substantial interests in the metallurgy sector; Viktor Pinchuk, the son-in-law of former president Leonid Kuchma with interests in the steel industry and the media; Igor Kolomoisky, a media, banking and oil tycoon; Oleksandr Yaroslavsky, a former banking tycoon, now with interests in the real estate and chemicals sectors.

match her capabilities or even her real will to pay for Ukraine's Customs Union membership. There is no data that would corroborate suggested welfare gains and other opportunities. Moreover, the Ukrainian government and Ukrainian non-state actors are not rushing to analyze the subject in detail. When it comes to energy prices, Ukraine may only get a short-term concession: Russia is committed to raising domestic gas prices to the levels charged for exported gas by 2012.

It is highly unlikely that the Kremlin will be able to explain to Russian consumers and businesses the need to keep the price for Ukraine below Russia's own domestic prices. Ukraine's case should not be compared to that of Belarus that recently got gas discount for giving away the remaining 50% of its gas transit system to Gazprom and for agreeing to further integration steps. In simple terms, one cannot compare the markets in the two countries with Belarus's 9.5 million and Ukraine's 46 million inhabitants. Russia's losses would be higher than it can afford.

Discussions among Russian business (except Gazprom) reveal the lack of support to the billions of US dollars promised to Kyiv by Putin.[62] Russian business may be interested in getting better access to Ukraine's rather protected market. However, it expects the Kremlin to pursue an access strategy at the lowest possible cost: the example of Belarus is informative in this case. While it is technically possible to revise the country's commitments with all interested parties within the WTO, Ukraine may get into serious trouble. Firstly, the revision may send a negative signal to foreign investors who already question Ukraine's ability to implement its commitments. Also, the final bill to all interested WTO members may surpass the 1.9 billion US dollars that Russia has pledged as compensation to Kyiv for joining the Customs Union. Lastly, some Ukrainian businesses will have to adjust to new export and import tariffs, taking time and bringing additional costs.

The public debate and the interests of Ukraine's elites

There is little public debate about the possibility of Ukraine joining the Customs Union. When it does take place, it is usually linked to and contrasted with the prospect of the DCFTA. There is general consensus among local elites that integration with the EU is a civilizational choice, while maintaining good trade relations with Moscow, Minsk and Astana is economically important for Kyiv. This was confirmed at a number of recent roundtables organized by the

[62] Interviews with Russian business representatives, April-May 2011.

Gorshenin Institute, a leading Kyiv-based think-tank, with the participation of representatives of the parliamentary majority, government, businesses and independent experts.[63]

There are only few political figures who are openly in favor of Customs Union membership, one of them Valery Muntian, special envoy of the Ukrainian government for relations with CIS countries. These individuals have limited or no influence over decision-making. Their statements about the positive impact of Customs Union's membership do not necessarily reflect the official line. However, they are often used by official Kyiv when it comes to bargaining with the EU.

There may be a bigger number of people, especially in business, who are supportive of the Customs Union. Yet they opt for silence on the issue. These are the above-mentioned oligarchs, the opponents of Ukraine's integration with the EU. They prefer to stay silent as they do not want to go against official policy. Due to the low level of awareness about both the EU and the Customs Union, the media manages only to speculate about the compatibility of the two projects and the costs of both integration initiatives for Ukraine.

One of the factors with potential influence on Ukraine's relations with the Customs Union is her high dependence on energy resources from Russia. At the moment Ukraine is pushing for the revision of the 2009 gas agreement with Moscow. However, it is clear that cheaper gas from Russia may only materialize if Ukraine joins the Customs Union and gives away its gas transit system. However, experts close to the presidential administration in Kyiv assure that trading the country's independence in trade policy in the short run and possibly economic independence in the long run is not on the agenda. So far Ukraine has opted to blackmail Moscow and threaten to take Gazprom to the Stockholm Court of Arbitration. It also did not take all contracted gas—in January 2012, Minister for fuel and energy, Yuri Boyko announced that the country would take delivery of only 27 bcm of a contracted 52 bcm for the year.[64]

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[63] Gorshenin Institute, Roundtable "FTA with the EU or Customs Union with Russia—What is More Preferable for Ukraine" April 2011; Roundtable "Ukraine-Russia Relations after the Completion of DCFTA Talks with the EU" June 2011.
[64] Kyiv Post, "Boiko: Ukraine to halve gas purchases from Russia," 11 January 2012, <www.kyivpost.com/news/business/bus_general/detail/120293/>.

Conclusions

While the costs and benefits of the EU-Ukraine DCFTA have been calculated and are publicly discussed, similar estimates are lacking concerning the Customs Union. Deeper integration with the EU will cost Ukraine—both the state and businesses—in the short run. However, it promises to have clear welfare benefits in five to ten years. It may also send a positive signal to foreign investors and create new possibilities for Ukrainian goods and services on EU markets through the improvement of norms and standards. The Ukrainian economy is supposed to become more transparent and the rules of the game for businesses are likely to improve significantly.

There is little evidence to suggest that membership in the Customs Union would bring sustainable benefits. The Russian government has presented several positive figures, but no substantial evidence. The experience of Belarus and Kazakhstan shows their bargaining power in relation to Russia to be limited. The costs of deviation from WTO commitments are likely to outweigh compensation promised by Russia. Moreover, the Ukrainian leadership and the business interests connected to it are not ready to hand decision-making power to Moscow.

Russia's offer is based on promises. Yet there is little evidence of available money in Moscow. Promises of cheaper gas are likely to remain on paper. Moreover, Ukraine's economy may be better off without cheaper gas. Georgia's experience shows that once cut from the "Russian energy needle," it becomes easier to diversify energy sources and increase energy efficiency. However, Russian threats of negative consequences are real and Ukrainian businesses are concerned about them.

The consensus in Ukraine's public and elite debate is largely in favor of the EU-Ukraine DCFTA while membership in the Customs Union does not find public support. Thus, it is difficult to see Ukraine changing course especially given forthcoming parliamentary elections in October 2012 and presidential elections in 2015.

Kyiv's choice will be made based on the economic (corporate) interests of the current leadership and a small circle of businesses around it rather than on expert calculations. So far analysis suggests that the leadership is in favor of a European direction. Even if democratic failings prevent Ukraine from signing the EU-Ukraine DCFTA in the short run, it is highly unlikely that Kyiv would consider Customs Union membership.