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## What now for EU-Ukraine relations?

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**Ukraine's decision not to sign the Association Agreement (AA) with the European Union should not have come as a surprise. Despite years of negotiations, seasoned observers of Ukrainian politics – with knowledge about the political psyche of President Yanukovich – have said it was always a bold assumption to expect the Ukrainian President to sign the Agreement when Russia was strong-arming him away from it. President Yanukovich is too weak to make an independent decision and he runs an economic policy that has enriched his own political tribe, but pushed the country to the brink of an economic collapse. In addition, the country is split on the overall orientation of the economy. A big part of President Yanukovich constituency favours closer ties with Russia – and accepts the view that there is a choice between Russia and the EU.**

The Association Agreement between the EU and Ukraine is part of the EU's Eastern Partnership to strengthen economic and political integration with Former Soviet Union (FSU) countries. For Ukraine, association with the EU would be a strategic choice for economic modernisation and growth. But Ukraine has now walked away from a deal that would considerably support its economy. The market access component in the so-called "Deep and Comprehensive Free Trade Agreement" (DCFTA), which is a part of the Association Agreement, would no doubt increase Ukraine's export to the EU and align Ukraine's economy with EU and global markets.

The expected immediate welfare gains from such a deal have been estimated at 4-7% of Gross Domestic Product (GDP) – and, in the long run, gains increase to 10-20% of GDP. Ukraine's adoption of the EU acquis – the EU's legal framework – would increase Ukraine's GDP by an additional 20-30%, not least by freeing up the country's economy from non-transparent and highly distortive economic regulations. The Association Agreement was meant to improve Ukraine's economic and political credibility. And with Ukraine's signature on the agreement, and with subsequent reforms in the pipeline, the confidence of its foreign lenders to channel new financial assistance to Ukraine would certainly increase.

For want of a nail, a kingdom was lost. President Yanukovich has now decided to put on hold the Association Agreement – and it seems difficult to imagine a scenario where the Ukrainian President would voluntarily revisit the agreement with the intention to sign it before the elections in early 2015. President Yanukovich defended his decision by pointing to "insufficient financial assistance from the EU" and that it would risk putting its trade and economic ties with Russia in limbo - particularly now that its former imperial master is deepening its Eurasian customs union. But none of these reasons make sense.

First, the Association Agreement is not about generating new economic transfers to Ukraine: it is a medium-to-long term strategy for modernization and growth. The EU cannot stamp up the resources demanded by President Yanukovich – and it cannot guarantee more funds than what already has been

envisaged under the association framework. Ukraine is no doubt in need of greater external assistance to finance its budget and current account deficits, but additional financial assistance could come from International Monetary Fund (IMF) and World Bank (WB) funds should Ukraine accept the conditions of the Association Agreement.

Second, the notion that deepened trade ties with Russia, possibly through membership in the Eurasian Customs Union, would deliver bigger gains is illusory. Membership in the Customs Union would promote trade, but the benefits would hardly be as high as suggested by the Eurasian Development Bank study, which recently estimated potential gains for Ukraine at 6-7% of GDP if it joins the customs union. Similarly, the study's projected 1.5% GDP drop, had Ukraine signed the DCFTA can only be explained through assumptions about a political response from Russia. In short, membership in the Customs Union would deepen Ukraine's dependency on arbitrary Russian gas trade and its political idiosyncrasies.

A better explanation to why President Yanukovich refused to sign the Association Agreement is that he was pressured to it by Russia and that he fears the effects of the institutional and judicial reforms demanded by the EU on that strange politico-commercial operation built around the President. But it is obvious that the President, like most others, misjudged the popular sentiment around the country's EU orientation and how his decision not to sign the Association Agreement triggered a larger reaction to the failed and unpopular policies of his administration.

It is difficult to say what will happen now. Obviously, the popular revolt against the government and the President himself will have consequences. It is a bold hypothesis today that the President can remain in office until the next election. It would not be surprising if the government agrees to new elections in early 2014. What is clear, however, is that the longer the protests go on, the bigger the political cost will be for President Yanukovich.

It is important that the EU now maintains its offer of an Association Agreement and that it does not back down on its conditions. Now is the time for increased engagement with Ukraine rather than scoring political points of what went wrong ahead of the Vilnius summit. The EU could also give clearer demonstrations that the Association Agreement will also come with support to deal with potential reactions from Russia. First, and symbolically, the EU should extend an offer to the Ukrainian government to assist and finance legal complaints in the World Trade Organisation against Russian retaliations, if the Ukrainian government wishes to go down that route. Second, it should make clear that it is not going to tolerate further Russian politicking over its gas export to Ukraine, which would affect the gas transit to countries in the EU. The European Commission is already pursuing a case against Gazprom for its contracts and structural operation of gas in those countries, transited through Ukraine. But it could do more, especially applying its competition disciplines more directly towards decisions to cut gas exports for political reasons. It is an abuse of market dominant position to impose unfair trading conditions. Third, it should put much more emphasis on how short-term credit to Ukraine would come from international organisations if it signs the Association Agreement. The Ukrainian government is in need of external finance. Appeasing Russia to get money from the Kremlin should not be an excuse for not signing the Association Agreement.