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## Ukrainian economy – attracted both by Russia and the European Union<sup>2</sup>

### Ukrainian economy – attracted both by Russia and the European Union (Summary)

For the past two decades independent Ukraine has been facing an orientation dilemma. She has two partners of major importance: Russia, the old ally on the one hand, and the European Union, the new partner on the other. Both partners play key role in the foreign affairs of the country, but are almost equally important for the Ukrainian economy as well. Not surprisingly Ukraine had been following a so-called 'multivectoral' foreign policy during the nineties and for the past few years as well. At moment Ukraine has to answer the initiatives of her two major partners. She is an important partner country in the EU's Eastern Partnership program aimed at attracting six post-soviet countries closer to the EU economically and politically, while she has been invited to join a Russia-centred post-soviet integration grouping as well. However, it seems to be impossible for Ukraine to take part wholly in both integration programs. The article tries to highlight the dilemma based on economic statistical data. It analyses trade and investment relations between Ukraine and the EU on the one hand, and with Russia on the other in details.

### Intruduction

For the past two decades independent Ukraine has been facing an orientation dilemma politically and in economic sense as well. She has two partners of major importance: Russia, the old ally on the one hand, and the European Union, the new partner on the other. Both partners play key role in the foreign affairs of the country, but are almost equally important for the Ukrainian economy as well. This latter fact is not so evident while the political dilemma is widely known. The article aims at analysing this double economic linkage based on statistical data while at the same time trying to point out how many difficulties this situation creates for the country.

Ukraine had been trying to follow a so-called multivectoral foreign policy during the nineties and according to many expert opinions her leaders were rather clever at doing so. The situation became more difficult after the "orange revolution" which was widely valued as slight moving towards the European Union both politically and economically being at the same time a trial to weaken ties with Russia. At moment Ukraine has to answer the initiatives of her two major partners. She is an important partner country in the EU's Eastern Partnership program aimed at attracting six

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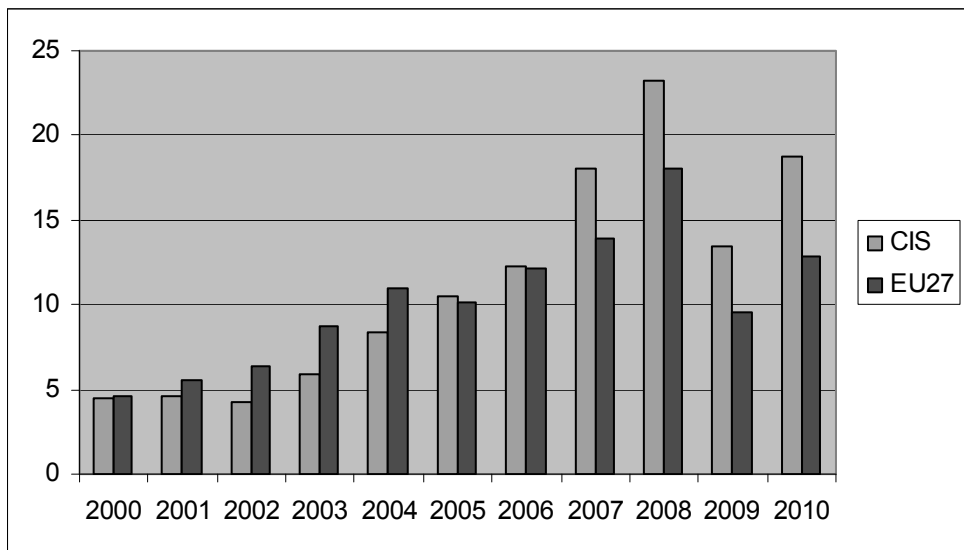
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<sup>2</sup> The article is based on the presentation given by the author in the international conference „20 years of independent Ukraine” organised by the Budapest Business School on May 4-5. Budapest.

post-soviet countries closer to the EU economically and politically<sup>3</sup>, while she has been invited to join a Russia-centred post-soviet integration grouping as well. Both initiatives include free trade idea, while at moment it seems to be impossible for Ukraine to take part wholly in both integration programs. Ukraine seems to be in a forced “either... or” situation which is to be a heavy burden for the country. Most probably this dilemma is the strongest in the Ukrainian case as compared to other Eastern Partners of the European Union. The article tries to highlight the dilemma based on economic statistical data. Besides analysing the migration side of the issue, it focuses on trade and investment relations between Ukraine and the EU on the one hand and with Russia on the other in details.

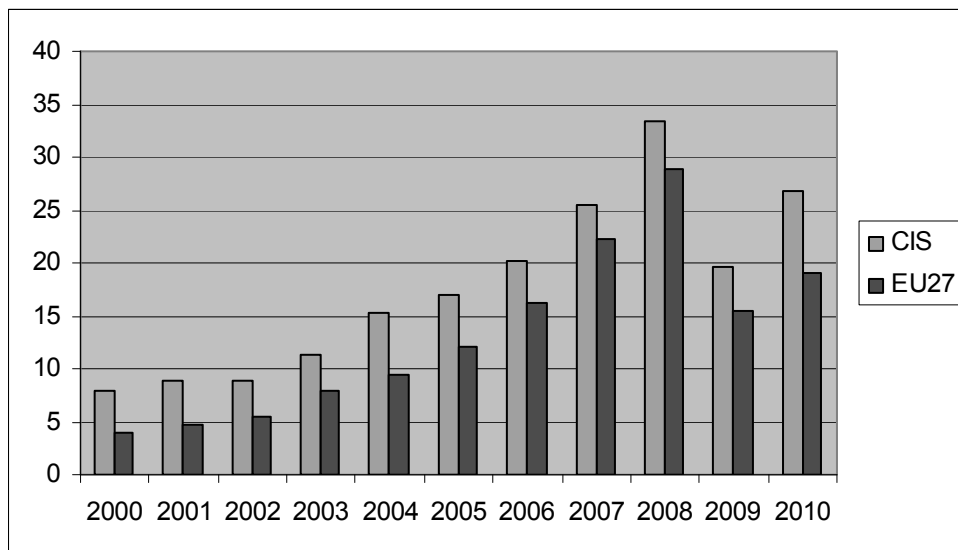
## 1. Foreign trade - balanced turnover

Foreign trade is the most evident field of the so-called double attachment of the Ukrainian economy. Figures for indicating the shares of the EU and Russia both in exports and imports have been equally high and very close to each other for the past decade.



*Ukrainian exports to the CIS countries and the EU27 (billion dollar),  
2000-2010  
Diagram1.*

<sup>3</sup> Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine



*Ukrainian imports from the CIS and the EU27 (billion dollar),  
2000-2010  
Diagram 2.*

Although one may think that after the orange revolution the post-Soviet or Russian factor of the Ukrainian foreign trade turnover had been declining for the benefit of trade with the European Union, the picture is not so simple. Generally it is true that politics and foreign affairs have a great influence on economic decisions, but the Ukrainian case is very specific. On the one hand one may see deepening economic ties, including strong trade relations with EU member states, but on the other strengthening ones with Russia as well. This latter phenomenon highlights two Ukrainian characteristics with impacts on the direction of trade flows. The first one is the special oligarchic structure of the Ukrainian economy. The second one is the deep industrial structural interweaving of the Ukrainian and Russian economies in close relationship with the oligarchic-type economy. But the situation is even more complex: sometimes Ukrainian oligarchs closely tied to their Russian partners are interested in more intensified trade relations with the European Union! Contrary to the first years of the 2000ies, due to all these complex and other industry-specific reasons, Ukrainian exports to the CIS space have been higher than supplies to the European Union since 2005. On import side supplies from the CIS partners have exceeded those from the EU during the whole analysed period. But since the difference is not big we may conclude that Ukraine has two major foreign trade partner groupings: the CIS countries and the EU.

Naturally, post-Soviet trade for Ukraine is not equal to Russia-related turnover, however, major part of it falls on Russia. Russia's share has shown an increasing tendency for the past years. Also one should notice that the post-Soviet trade is

deeply influenced by Russian initiatives at least as regards Ukraine's other main post-Soviet trade partners like Belarus or Kazakhstan. From this point of view we may also state that Ukrainian trade is double-focused: one major focus falls onto the European Union, while the other focus is on the post-Soviet economic space dominated by Russia.

*Table 1.*

*Russia's role in Ukrainian foreign trade with CIS countries (billion dollar), 2003-2010*

	2003	2004	2005	2006	2007	2008	2009	2010
<b>EXPORTS</b>								
CIS	6.0	8.6	10.7	12.7	18.7	23.8	13.5	18.7
Russia	4.3	5.9	7.5	8.6	12.7	15.7	8.5	13.4
other CIS	1.7	2.7	3.2	4.1	6.0	8.1	5.0	5.3
<i>Russian share in CIS-related exports</i>	<b>71.7</b>	<b>68.6</b>	<b>70.1</b>	<b>67.7</b>	<b>67.9</b>	<b>66.0</b>	<b>63.0</b>	<b>71.7</b>
<b>IMPORTS</b>								
CIS	11.5	14.9	17.0	20.2	25.6	33.4	19.7	26.7
Russia	8.6	11.8	12.8	13.8	16.8	19.4	13.2	22.2
other CIS countries	2.9	3.1	4.2	6.4	8.8	14.0	6.5	4.5
<i>Russian share in CIS-related imports</i>	<b>74.8</b>	<b>79.2</b>	<b>75.3</b>	<b>68.3</b>	<b>65.6</b>	<b>58.1</b>	<b>67.0</b>	<b>83.1</b>

*Source: State Statistics Service of Ukraine*

Russia's role is even more underlined when making structural analysis. Ukrainian exports to Russia are more diversified and advanced than exports to EU markets that are dominated by steel and iron products (28.2 per cent in 2010) and fuels and mining products (27.4 percent in 2010).<sup>4</sup> Similarly to exports to the EU, iron and steel products have a high share (22.7 per cent in 2008) in Ukrainian supplies to Russian markets. Agricultural and food products play a rather significant role in exports both to the EU and Russia. Their share totalled to 16,4 per cent of total Ukrainian exports to the EU27 in 2010 while constituted 12 per cent in supplies to Russia (figure for 2008).<sup>5</sup> However, machinery supplies indicate the most important difference between the two markets. While their share is only about 10 per cent regarding exports onto EU markets they constituted approximately 38 per cent in exports to Russia in 2008.

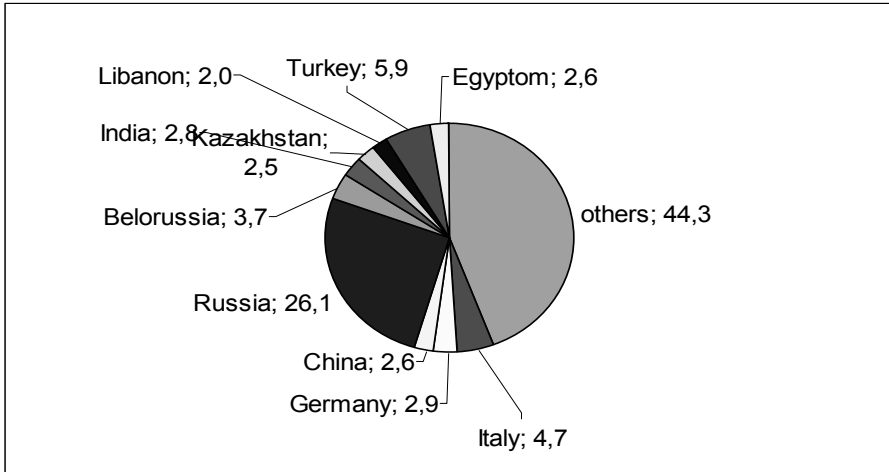
There are some CIS countries that fall out of the major Russian plans aimed at integrating post-Soviet states, but at the same time are among important trading partners of Ukraine, like Moldova, Azerbaijan, Turkmenistan or Uzbekistan.

<sup>4</sup> Eurostat database

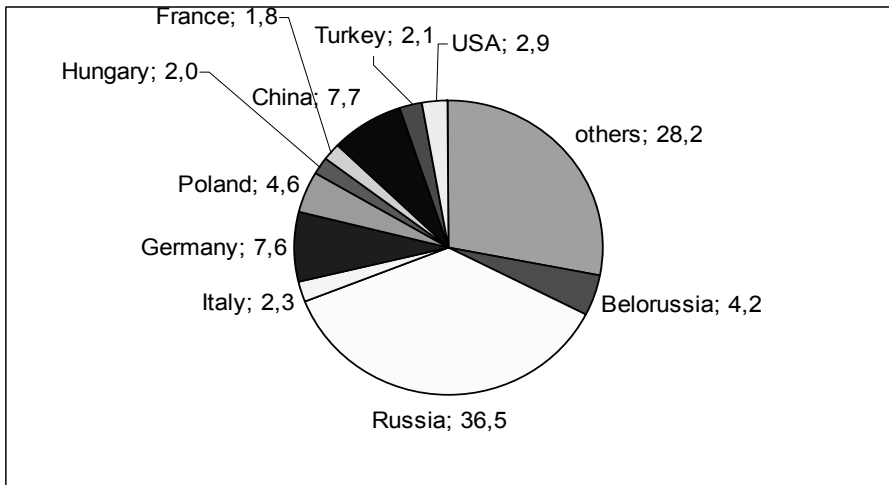
<sup>5</sup> Unfortunately there are no statistical figures on commodity structure available for exports to Russia for years later than 2008.

Moldova is big market for Ukrainian export products, while the other three countries have major significance in Ukrainian attempts to diversify energy imports.

Also we should not forget that beside the two basic country groupings, the EU and the CIS, foreign trade turnover of the independent Ukraine has always been having a third pillar: the block of countries on other continents like China, the USA or the Eurasian-located Turkey.



*10 main country destinations for Ukrainian exports, 2010 (%)  
Diagram 3.*



*10 main country sources for Ukrainian imports, 2010 (%)  
Diagram 4.*

In a country to country comparison Russia's role is outstanding, five times higher than any other single trading partner of Ukraine. What does it mean for the Ukrainian economy? First, trade barriers initiated on Russian part cause serious consequences for the whole economy since Russia is the main market for a wide range of Ukrainian products. One should not forget that Russia has been very active in introducing protecting measures against Ukrainian producers for the past few years, often motivated by political considerations. Second, Russia is of high importance on import side as well due to its well-known outstanding significance in Ukrainian energy supplies. Notwithstanding the enormous efforts to weaken Russian dominance, Ukraine is still highly dependant on Russia in her energy sector. This dependence, up till now being rather symmetric, will become more asymmetric in the future due to the launch of the Nord Stream pipeline, a new route for Russian gas to Europe and some other possible new Russian infrastructural projects.

The role of the European Union is also of high importance. Major modernisation inputs come from the EU which is crucial for the structurally and, in several industrial cases, technologically undeveloped Ukrainian economy. On the other hand the EU as a market also greatly matters since major Ukrainian branches (metallurgy, energy, agriculture etc.) are deeply interested in EU markets.

Future institutional frameworks of trade both with Russia and the EU highly influence Ukrainian economic possibilities. There is a definite initiative aimed at some degree of integration on both sides towards Ukraine. In 2008 the EU launched negotiations with Ukraine on so-called *deep and comprehensive free trade* (DCFTA). There are hopes that negotiations in the framework of the EU Eastern Partnership initiative could be finalised by the end of 2011 during (and backed by) the Polish EU Presidency. DCFTA is a classical free trade agreement plus legal harmonisation in several crucial fields of the Ukrainian economy towards EU *acquis*, a formula having been elaborated by the EU originally for Ukraine. But Ukraine also has been invited, later even pressured by Russia to join the Russia-centred integration group of Russia, Kazakhstan and Belarus, a formulation that by 2010 already reached the stage of a customs union. It is not a new Russian idea to formulate an integration group of the four strongest CIS economies. The idea was first put on the agenda in 2003 when all the four countries agreed to establish a so-called Single Economic Space. However, after the orange revolution Ukraine was not so enthusiastic about the project, saying classical free trade is the maximum level of integration goals of Ukraine within this initiative since Ukraine aims at integrating to the EU. Meanwhile Ukraine joined the WTO which further complicated the Ukrainian case limiting her scope for participating in a new customs union. The problem for Ukraine is crucial. The country has been forced into an 'either ...or' decision taking situation. Russia is unsatisfied with the Ukrainian degree of participation in the integration group led by her and tried to put economic pressure on the country. On the other side the EU is thinking in one direction integration for Ukraine with the group of EU27, but without giving the country the badly desired membership perspective. Without membership promise this offer is rather one-sided since Ukraine will not be in the position to take full part in further decision-making process influencing her interests

in the future. Also, the EU seems to be unable to consider the impacts of the Russian 'offer' on Ukrainian economy.

There are no final answers to the above dilemmas at moment. However, it is probable that not only EU-Ukrainian relations and Ukrainian-Russian relationship will influence the situation but the future of EU-Russian relationship as well.

## 2. Investment flows

Investment flows constitute the other most important field to study when analysing the foreign economic ties of a country. It is evidently the EU that has invested the major part of the inward FDI up till now in Ukraine. The share of EU companies in total Ukrainian stock of FDI amounted to almost 80 percent at the beginning of 2011, while Russian proportion was at 7.6 per cent with Russian companies ranking 4th in the country list. However, due to the round-tripping phenomenon linked to FDI flows from Cyprus, real EU share is somewhat lower (72.7%), but still dominating.<sup>6</sup> On the other hand, excluding Cyprus, with a share of almost 10 per cent, Russia is also a very important investing country, ranking third after Germany and the Netherlands.

Companies from the European Union have invested mostly in producing, financial and other service sectors. Although precise Russian involvement is hard to be shown by official statistics due to the widely used non-transparent ownership structures both in Ukraine and Russia, there is a general expert assumption that Russian investments are much significant than reflected by statistics and usually aim at sectors, crucial or strategic for the Ukrainian economy as a whole usually with highest shares in Ukrainian exports. Russian presence is significant in oil industry, chemistry, aluminium industry, telecommunication, food industry, machinery, in financial services, production of constructing materials and in the iron and steel industry, the latter being responsible approximately for one third of total Ukrainian exports.<sup>7</sup>

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<sup>6</sup> Round-tripping in the Ukrainian case means that major part of foreign direct investments arriving from Cyprus according to statistics is Ukrainian capital in reality. One should not exclude the possibility that Russian investors also use this way to invest into Ukraine, however the overwhelming part of the round-tripped investments most probably is of Ukrainian origin. Brit Virgin Islands play a similar role in foreign investment flows.

<sup>7</sup> Szabó (2009)

*Table 2.*  
*Stock of foreign direct investments in Ukraine, January 2011*

	million dollar	share (%)	ranking
<b>EU27</b>	<b>35225.2</b>	<b>78.8</b>	
<i>Cyprus</i>	<i>9914.6</i>	<i>22.2</i>	<i>1.</i>
Germany	7076.2	15.8	2.
Netherlands	4807.8	10.5	3.
Austria	2658.2	5.9	5.
France	2298.8	5.1	6.
United Kingdom	2367.1	5.3	7.
Sweden	1729.9	3.9	8.
Italy	982.4	2.2	11.
Poland	935.8	2.1	12.
Hungary	723.6	1.6	14.
<i>above EU10 together</i>	<i>33494.4</i>	<i>74.6</i>	
Brit Virgin islands	1460.8	3.3	9.
Switzerland	859.4	1.9	13.
<b>Russia</b>	<b>3402.8</b>	<b>7.6</b>	<b>4.</b>
USA	1192.4	2.7	10.
Other	4298.2	5.7	
<i>All together</i>	<i>44708</i>	<i>100.0</i>	
<i>without Cyprus:</i>			
<b>EU26</b>	<b>25310.6</b>	<b>72.7</b>	
Russia	3402.8	9.8	3.
<i>All together</i>	<i>34793.4</i>	<i>100.0</i>	
Source: State Statistics Service of Ukraine			

Ukrainian outward investments have also had rather two-dimensional character during recent years. Based on official statistics it is Cyprus again that plays the most important role in these flows which is a direct proof of the above-mentioned round-tripping phenomenon dominating foreign direct investment flows into and from Ukraine. Taking Cyprus out of the investigation it is already Russia that ranks first. In this more realistic approach more than one third of total Ukrainian outward investments went to Russia based on statistics on OFDI stock, and this sum is even higher than investments regarding the whole European Union. Mutually intensive investment activities underline the extremely high degree of link-ups between the Ukrainian and Russian economies. It is especially true for the metallurgy, machinery, chemistry, energy sectors and financial services.<sup>8</sup>

<sup>8</sup> For further details see Szabó (2009).

*Table 3.*  
*Outward FDI stocks from Ukraine, January, 2011*

	million dollar	share (%)	ranking
<b>EU27</b>	<b>6523.9</b>	<b>94.9</b>	
<i>Cyprus</i>	<i>6342.5</i>	<i>92.3</i>	<i>1.</i>
Latvia	87.9	1.3	3.
Poland	49.1	0.7	4.
Germany	9.2		
Austria	4.7		
Brit Virgin Islands	25.8	0.4	6.
<b>Russia</b>	<b>194.3</b>	<b>2.8</b>	<b>2.</b>
Georgia	31.1	0.5	5.
Kazakhstan	25.2	0.4	7.
Other	70.8		
All together	<i>6871.1</i>	<i>100.0</i>	
<b><i>Without Cyprus</i></b>			
<b>EU26</b>	<b>181.4</b>	<b>34.3</b>	
<b>Russia</b>	<b>194.3</b>	<b>37.0</b>	<b>1.</b>

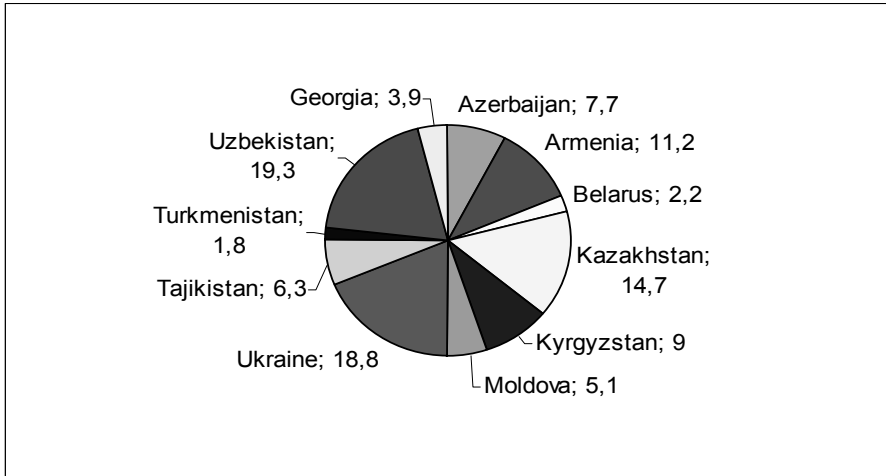
*Source: State Statistics Service of Ukraine*

### 3. Migration

Ukraine is a key country in all-European migration flows. It is almost equally important as a ‘sender’ and as a ‘receiver’. Ukraine is a significant source of migration towards the EU, mostly for Germany and the new-member neighbouring countries. Ukrainian migrants typically stay for a long period in most developed EU countries, often even for a decade, while temporal migration is also typical in the case of Hungary, Slovakia or Poland. Migrants often come from the most educated groups of the society and from among the youth which causes a serious loss for the Ukrainian economy and a danger for the society. Brain drain is a significant negative phenomenon regarding migration to the West. Beside the EU the USA, Canada and Israel represent main destinations for Ukrainian emigrants in the most developed economies.

However, migration represents the third very important economic linkage between Ukraine and Russia. After the first decade of migration all over the CIS space characterised by migration flows motivated by ethnic reasons, migration shows more signs of economic features nowadays.

Russia is a major destination for Ukrainian emigrants generally and within the CIS space specifically.<sup>9</sup> In 2006 more than one third of all Ukrainians working abroad stayed in Russia. Their number totalled to 1.1 million.<sup>10</sup> The role of Ukrainian workers in the Russian economy has increased for the past few years and by now the Ukrainians represent the second major ethnic group from all the post-Soviet countries after Uzbekistan, with a share of almost 19 per cent. Migration is more and more a two-direction movement with a big number of people going to Ukraine from Russia as well.<sup>11</sup>



*Share of CIS countries in total number of migrants into Russia  
- coming from the whole CIS space (2008)*

*Diagram 5.*

## Final conclusions

Ukraine has been in an ‘in-between’ situation politically, geopolitically and economically as well. The article deals with the economic dimension: Ukrainian economy has an evident double linkage. It has two major partners: the European Union and Russia. Trade and investment flows equally underline this fact which is both a burden and an opportunity for the country. At moment it is a burden since Ukraine seems to be forced to choose the number one partner from among its basic partners: it cannot be simultaneously part of economic integration with the EU and Russia. The country is on the way to conclude a so-called *deep and comprehensive free trade agreement* with the EU, negotiations are hoped to be finished by the end of 2011. On the other hand, Russia has pressured Ukrainian participation in the

<sup>9</sup> Russia is followed by Moldova and Belarus as major CIS destinations for the Ukrainian emigrants.

<sup>10</sup> Szabó (2009)

<sup>11</sup> Simon (2011)

Russian-led customs union which is seen rather sceptically by Ukraine's European partners. Moreover, Ukrainian WTO membership makes it impossible to join a customs union which did not exist in the time of Ukrainian accession to the organisation. However, keeping out of the customs union may mean concrete economic problems for Ukraine. Trade barriers possibly built up by Russia may cause serious harms to Ukrainian business circles, while the card in the hand of Russia is still strong in the field of energy cooperation.

On the other hand, having two major partners is an advantage, since the two partners are different and the Ukrainian economy has no one-sided economic dependence.<sup>12</sup> Analysis of trade flows highlights the possibilities the two markets create for Ukrainian business. While there are sectors (metallurgy, agriculture and food industry, etc.) that export to both markets in large extent, some branches of the economy, such as machinery supply first of all to Russia.

To sum it up, Ukraine is interested in developing both economic frameworks, the one with the EU and the other one with Russia. 'Great politics' will heavily influence the future possibilities of the Ukrainian economy. However, although European integration is definitely the number one goal of the country, one must be aware of the fact that economic (and political) ties with Russia are still of high importance. They will remain crucial even in middle, and possibly, long term. It is so not only on the basis of trade statistics but paying attention to mutual investment or migration flows as well. At moment Ukraine has no other choice than following the well-known multivectoral policy, widely used by Ukrainian leaders during the nineties. But the scopes and the time for doing so are limited: some decisions have to be made in the foreseeable future. It falls into the responsibility of the European Union also that the consequences of these decisions would be manageable for the country.

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<sup>12</sup> Further more Ukrainian economy has other important partners as well like China, Turkey, India and some post-Soviet countries like Moldova or Belarus.

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