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Stronger Together: Present and Future Challenges on Ukraine's Road to EU Integration

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Summary

Ukraine has found itself in dire straits since Russia invaded it brutally in February 2022, which has forced it into wartime mode. In the face of immense loss of human life, destroyed critical infrastructure, disrupted trade routes and seized territory, Ukraine must not only address immediate humanitarian and military needs but also plan for a more resilient future. This report examines the short-term, medium-term, and long-term challenges associated with this endeavour while emphasising the need for collaboration with international allies.

The short-term challenges naturally centre around the ongoing invasion. More than half of Ukraine's state budget for 2022 and 2023 has been directed towards financing the war effort. Due to shrinking tax revenues and limited financial resources, international partners stepped in, providing USD 68.5 billion in grants (37%) and loans (63%) since the invasion. As the conflict drags on, additional assistance is required for 2024, with the European Union drafting a facility of around EUR 50 billion for 2024-2027, primarily as concessional loan financing. While loans are standard in the European context, efforts should be made to secure more grants in view of Ukraine's strained finances.

Given the tremendous cost of rebuilding Ukraine, the costs should be covered by Russia, rather than European taxpayers. Using Russian frozen assets to finance the recovery could be considered. History shows that postwar recovery is complex, requiring trust among stakeholders, adherence to the "Build Back Better" principle, and compliance with EU standards for optimal resource allocation.

Enhanced trade cooperation is pivotal to Ukraine's economic resilience. With Black Sea ports blocked, land trade routes have gained importance. This requires improving road, rail, and port capacity, streamlining customs procedures, and aligning standards. Distortions in agriculture and the smooth transit of Ukrainian agricultural products through neighbouring countries are also crucial challenges to be overcome. While liberalising trade enhances welfare, it may initially create market inefficiencies that must be addressed transparently.

Medium-term challenges also centre around nurturing trade. Border infrastructure must be upgraded significantly to handle higher trade volumes. Progress has been made, yet problems remain, including limited border crossings, transshipment terminals, and railway connections. Capacity at Polish seaports must be boosted to accommodate increased Ukrainian exports and provide an alternative to the Romanian port of Constanța. Overcoming these challenges requires alignment between Poland and Ukraine, joint planning, and policy coordination, possibly through public-private partnerships.

Ukraine needs substantial foreign direct investment (FDI) and private capital for a full recovery. Private funds should not only cater to postwar needs; they should already help rebuild housing and infrastructure. FDI fills investment gaps, spurs exports, and modernises the economy through technology transfer. The war has shifted labour and capital across sectors, creating new investment opportunities in war and reconstruction-related sectors.

To boost investment attractiveness and mitigating risk, Ukraine's institutions must be upgraded and fiscal incentives for foreign investors – such as tax relief and investment allowances – introduced. Establishing Polish-Ukrainian economic zones for joint investment projects could be beneficial. Despite progress in institutional adjustment due to the invasion, addressing corruption, bureaucracy, judiciary issues, contract enforcement, and oligarch influence remains imperative. Learning from Poland's success in attracting foreign capital, Ukraine could adopt some of Poland's institutional approaches.

Attracting private capital on a significant scale requires a war risk insurance mechanism. This could involve international financial institutions establishing a guarantee umbrella for Ukrainian companies, engaging the private sector through reinsuring companies and insurance brokers, and creating a credible mechanism for deals that supports equal access to state and private players. Private equity (PE) and venture capital (VC) funds could bridge the investment gap, particularly for high-risk, high-growth firms. Central European countries like Poland could serve as new PE/VC jurisdictions with legislative adjustments.

Long-term challenges revolve around Ukraine's path to EU accession and integration. Applying lessons from Poland's EU journey, such as independent monetary policy, clean floating FX regimes, strong institutions, efficient public procurement, and capital markets, is crucial. Administrative decentralisation and giving the regions more power are also strategic for integration. Ukraine's integration with the EU Single Market could take different routes, including full EU membership, the European Economic Area, or the Deep and Comprehensive Free Trade Areas (DCFTA), depending on whether Kyiv fulfils the EU's recommendations and the prevailing circumstances.

Introduction

This paper was designed as a joint effort by Ukrainian and Polish economists to address the essential challenges of Ukraine's integration into the European Union and mutual economic development in light of the ongoing war. The discussion in the report concentrates on three critical perspectives: short-term, medium-term, and long-term challenges.

The first chapter assesses the short-term challenges. From this perspective, we consider Ukraine's current financial needs, trade strategy, and ongoing reconstruction critical areas for discussion. Since the beginning of the full-scale Russian invasion in February 2022, Ukraine has received massive financial help. Yet it might not be enough to cover essential spending in the future. Besides, it is vital to understand the proportion of grants and loans to project the Ukrainian budget position. The liberalisation of trade between Ukraine and the EU has already caused numerous controversies. We attempt to understand what should be done to facilitate the mutually beneficial international exchange of goods and services. Finally, we analyse the ongoing reconstruction and offer advice to support further developments.

In the second chapter, we consider the medium-term challenges. The international mobility of goods, capital, and labour between Ukraine and the EU has deteriorated sharply due to the poor border infrastructure, which represents some central areas for action. Besides, Ukraine's postwar recovery (and economic development in general) would require a substantial volume of capital. Facilitating foreign capital inflows and activating domestic capital should satisfy the need for financing, at least to some extent. The rest of the second chapter therefore discusses what should be done to attract productive investment to Ukraine. In particular, we assess the state of affairs in Ukraine, the opportunities arising from new sectoral angles, and the investment policy adopted in Poland, with an emphasis on fiscal incentives for investment and investment vehicles.

Finally, the third chapter addresses the long-term challenges. The first part of the chapter analyses Poland's experience in designing an independent monetary policy, developing more vital local institutions, public procurement and anti-corruption mechanisms, and capital markets design to formulate

advice for Ukrainian policymakers. The second part of the chapter provides an in-depth analysis of the potential scenarios for Ukraine-EU integration and their main implications. Navigating the process of Ukraine-EU integration will not be an easy task. The chapter therefore seeks to increase mutual understanding of both the challenges and the potential solutions.

1. Short-term challenges

This chapter addresses the short-term challenges associated with Ukrainian-EU cooperation. The first section presents an overview of Ukraine's financial and humanitarian needs in light of the ongoing Russian invasion. The second section discusses the issues associated with international trade liberalisation between Ukraine and the EU. Finally, the third part addresses the continuing reconstruction process in Ukraine.

1.1. Ukraine's financial, military and humanitarian needs

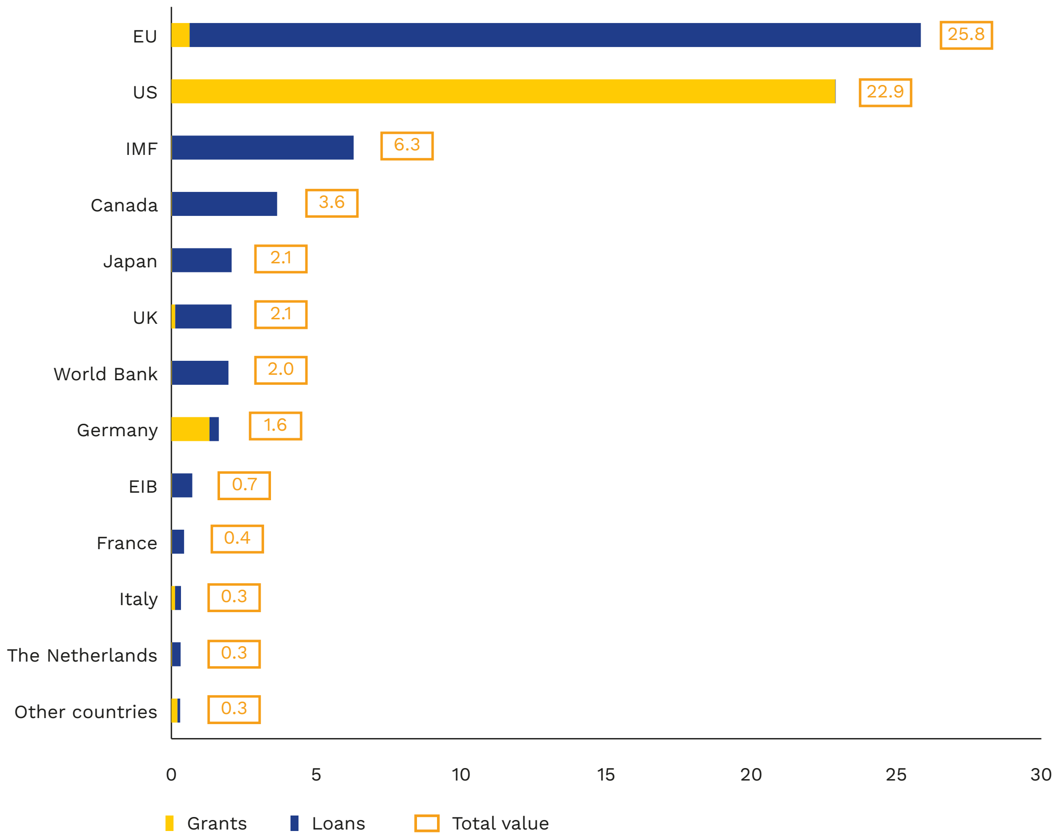
1.1.1. Financial needs

Since the beginning of the Russian full-scale invasion, Ukraine has faced unprecedented budgetary challenges. More than half of the state budget in 2022 and 2023 has been dedicated to financing the fight against the invasion. While this is covered by taxes and government bonds, Ukraine still needs to finance vital social payments and other spending – this is done using grants and loans from Ukraine's partners.

Ukraine has received more than USD 68.5 billion in foreign financing in grants and loans since February 24, 2022. Just 37% of the financing has been disbursed in the form of grants. Most of the grant financing has come from the United States, while other contributors mostly opted for loan financing (Figure 1).

In 2022, Ukraine's state budget deficit and debt repayment needs amounted to USD 55.6 billion, while foreign financing amounted to USD 31.1 billion, which left a gap of USD 24.5 billion. The gap was partly covered by monetary financing (which is highly discouraged in normal situations), which amounted to USD 12.5 billion that year (Figure 2).

Figure 1. Disbursed foreign financing of Ukraine's state budget since February 24, 2022, as of November 29, 2023 (in USD billion)

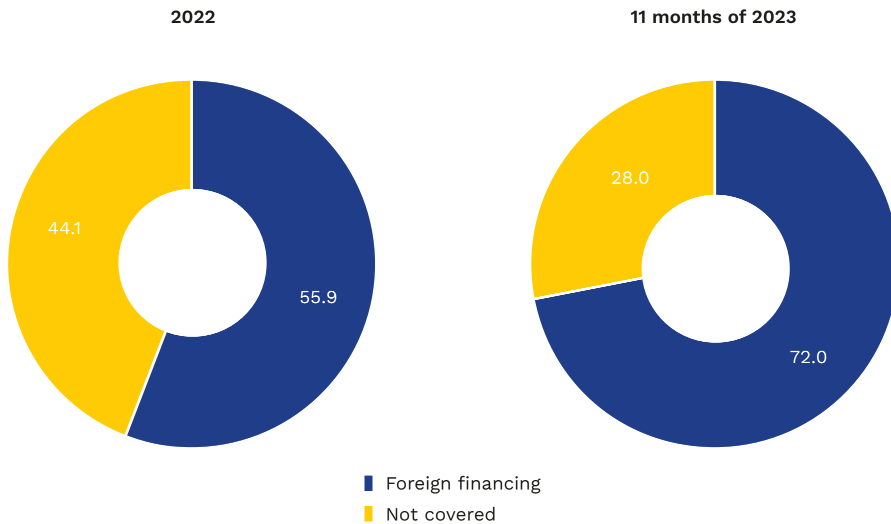


Source: prepared by CES based on data from the Ministry of Finance of Ukraine.

According to Ukrainian officials, all of the country's needs in 2023 will be covered without monetary financing (i.e. debt monetisation). In the first half of 2023, Ukraine received USD 23.7 billion worth of foreign funding; the state budget deficit and debt repayment needs amounted to USD 27.1 billion. Ukraine is set to receive a total of USD 42 billion in foreign financing in 2023. The EU and its member states (Team Europe) have provided EUR 40.4 billion in total, including EUR 18 billion in macrofinancial assistance for 2023 (www1).

On March 22, 2022, the National Bank of Ukraine (NBU) and the National Bank of Poland signed a swap line. According to the agreement, the NBU can receive up to USD 1 billion from Poland in exchange for hryvnia (www2). As of July 2023, the NBU had not used the swap line. It was prolonged to April 2024 (www3) and can be described as an "airbag" for the NBU, to be used in the case of a catastrophic international reverse contraction.

Figure 2. Coverage of the budget deficit and debt repayment needs with foreign financing in 2022 and in first 11 months of 2023 (in %)



Source: prepared by CES based on data from the Ministry of Finance of Ukraine and the National Bank of Ukraine.

According to the latest assessment by the NBU, Ukraine's foreign financing needs will reach USD 37 billion in 2024 (www4). This is slightly less than the USD 38.5 billion written into the IMF programme under the baseline scenario. Apart from the pledged IMF financing, which will amount to USD 5.4 billion in 2024, no other commitments have been confirmed so far, although the EU is working on a longer-term support proposal (IMF, 2023).

Ukraine could receive up to EUR 50 billion worth of mostly loan financing with favourable terms over the 2024-2027 period from the Facility to support Ukraine proposed by the European Commission (www5). The proposed Facility will also include conditions that must be met by Ukraine. They will consist of specific criteria for reforms that should both support Ukraine on its path to EU membership and secure European investments. This proposal needs to be approved by the European Parliament and the European Council.

In times of war, securing substantial financial assistance through grants is key to preventing a surge in debt obligations. Ideally, Ukraine needs more grants and fewer loans. The latter should be long-term, with favourable terms. An excellent example of these kinds of concessional loans is the funding from the EU. These loans are issued for 35 years, with a grace period until 2033. In addition, the interest on them is covered by EU member states

until 2027. If needed, Ukraine can prolong the subsidised interest rate on debt repayment beyond 2027 (Regulation, 2022). The proposed EUR 50 billion Ukraine Facility follows the same pattern.

1.1.2. Military needs

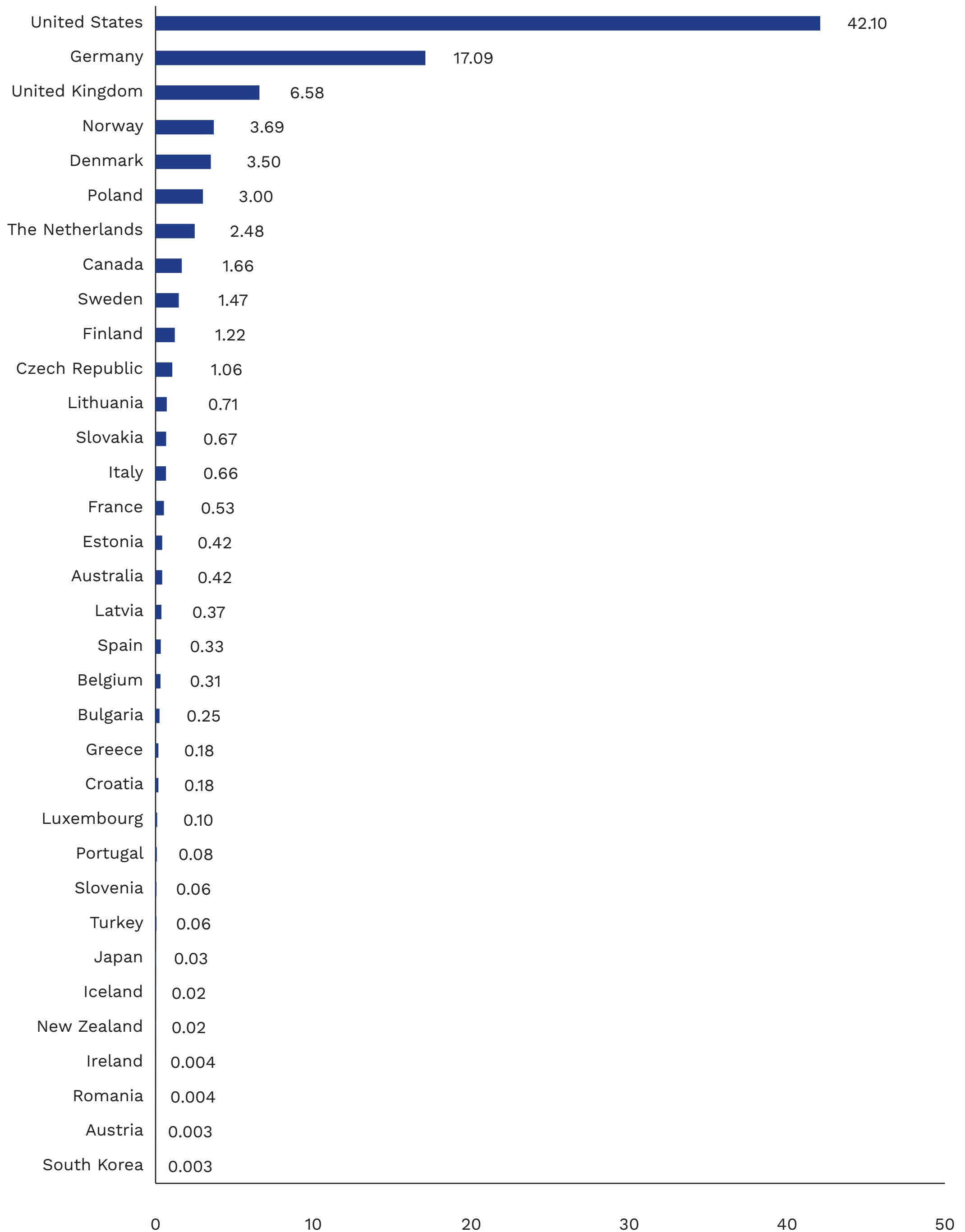
Based on the most recent data available (see Figure 3a), the US has been the most generous donor of military support for Ukraine so far. It has provided over six times more military funding than Germany, which ranks second. US support (approximately EUR 89 billion) accounts for slightly over half of total funding (as of the 31st of July 2023). However, the aggregate EU aid is almost equal to that from the US, though differences between member states' donations are substantial. Central European member states – including, in descending order, Estonia, Latvia, Lithuania, Poland and Slovakia – are the leaders when it comes to aid (including military assistance) to Ukraine as a percentage of GDP (Figure 3b). Polish support amounts to an estimated 0.7% of Poland's GDP. Supplies of military equipment have been of great importance (www6).

Among other types of weapons and military equipment, 1 Patriot air defence battery and munitions, 8 NASAM systems, 20 Avenger air defence systems, HAWK air defence systems and munitions, laser-guided rocket systems, 9 anti-drone gun trucks and ammunition, and 10 anti-drone laser-guided rocket systems were provided to Ukraine to support air defence (www7). The supply of air defence systems was intensified in light of massive Russian attacks on Ukrainian energy infrastructure in the autumn of 2022 (www8). Although there are no reliable estimates, it is difficult to overestimate the economic benefits of the air defence systems for Ukraine.

To sum up, we wish to emphasise the crucial importance of further military support for Ukraine, in particular:

- Continued support of the Ukrainian counteroffensive, including an increase in ammunition deliveries and the replenishment of vehicle losses.
- Support for Ukraine's air defence, with more MIM-104 Patriots, IRIS-Ts, and so on, and accelerated F-16 deliveries, which are crucial for continuing defend Ukraine against the Russians.
- The provision of long-range weapons, including ATACMS missiles, to decrease Russia's ability to threaten Ukraine.

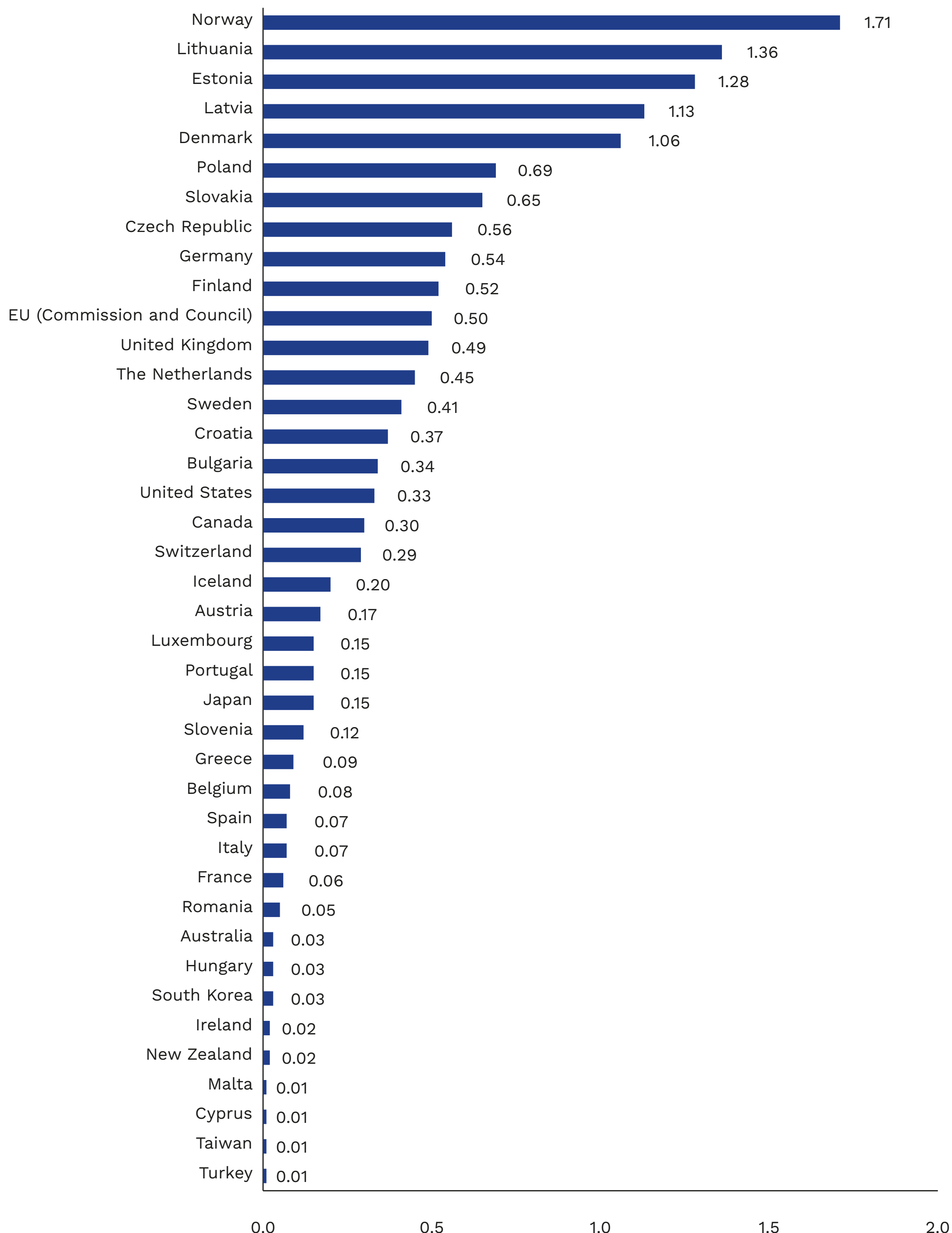
Figure 3a. Government military support to Ukraine, EUR billion (Commitments January 24, 2022, to July 31, 2023)



Note: Countries that did not provide any aid have been omitted.

Source: prepared by CES based on data from Kiel Institute for the World Economy, Ukraine Support Tracker.

Figure 3b. Total bilateral commitments to Ukraine: % of GDP (Commitments January 24, 2022, to July 31, 2023)



Note: Countries that did not provide any aid have been omitted.

Source: prepared by CES based on data from Kiel Institute for the World Economy, Ukraine Support Tracker.

1.1.3. Humanitarian needs

Humanitarian aid is also an essential part of the support for Ukraine. According to the Kiel Institute for the World Economy, humanitarian commitments (assistance supporting the civilian population, mainly food, medicines and other relief items) to Ukraine exceed EUR 16.3 billion as of July 31, 2023, with the US the largest contributor (the equivalent of EUR 3.5 billion).

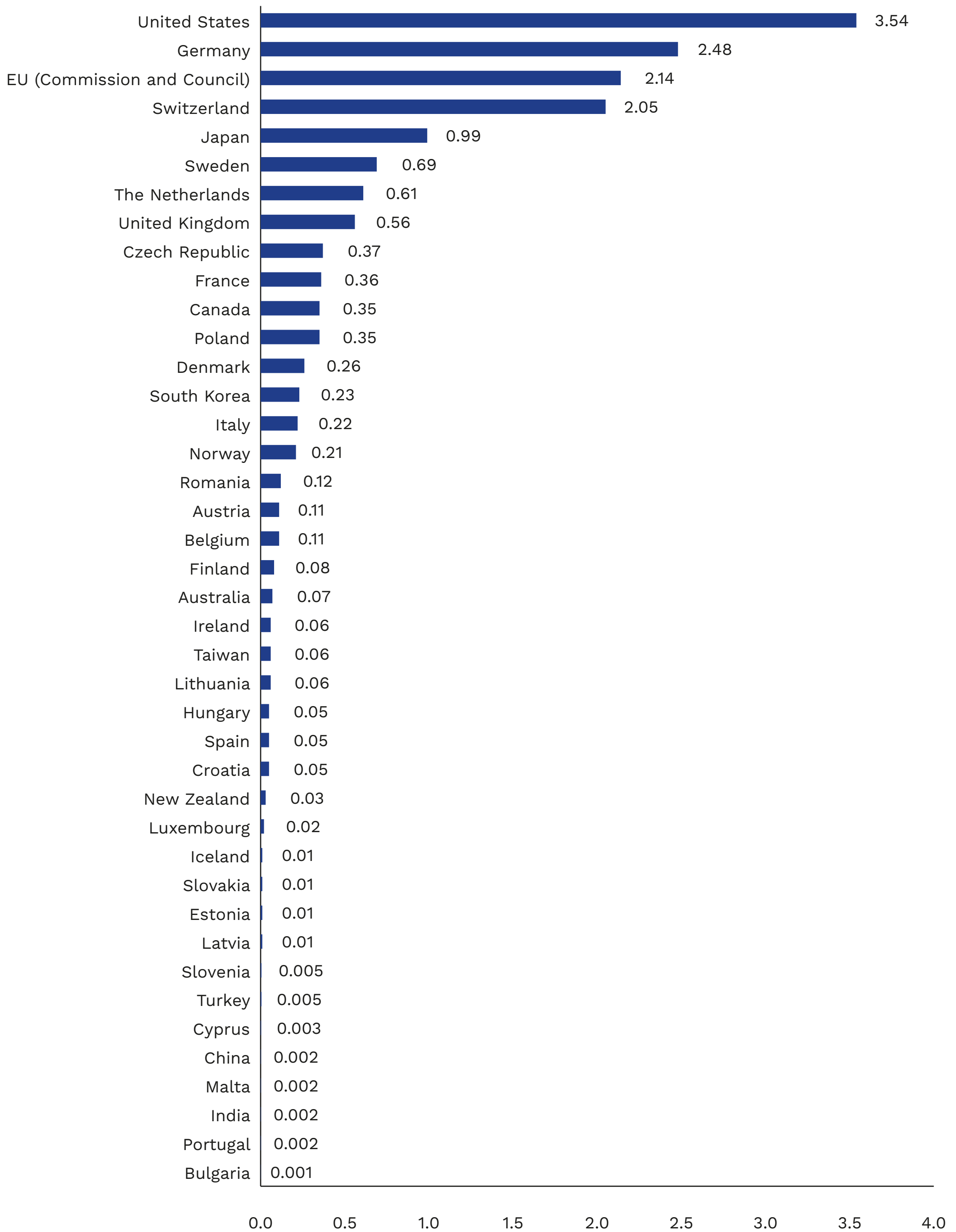
Ukraine's future humanitarian needs are also extensive. Given the Russians' ruthlessness track record, Ukraine should be prepared for all kinds of humanitarian tragedies, including chemical, biological, and radiation attacks. A prominent example is the Russians' destruction of the Kakhovka Dam, which caused flooding and significant damage downstream of the Dnipro River. According to rough estimates by Ukrainian Environment Minister Ruslan Strilets, the environmental cost of the tragedy exceeds EUR 50 million (www9).

There is also a need to support Ukraine's emergency services, which are often the target of Russian attacks. Their ability to respond swiftly and effectively depends on access to well-maintained equipment and vehicles. Ensuring uninterrupted supply lines for these essential resources not only enhances their operational efficiency but also boosts their morale and confidence. Moreover, when emergency services are attacked, the impact extends far beyond the immediate incidents, as civilians' safety and wellbeing are jeopardised.

In terms of scope, demining is Ukraine's most significant humanitarian challenge. As the war continues – and more territories become affected by active fighting – the country's demining needs increase. Given the cost of demining Ukrainian territory – an estimated USD 37 billion (www10) – there is a clear need to improve the country's demining capabilities. One way is for Ukraine to liberalise the demining sector and clear the path for more private actors, both foreign and domestic, to be involved in the process.

It is worth remembering the support received by the Ukrainian refugees who fled the country to escape the war. This help was not only state-driven, but a show of solidarity by society on a large scale. For example, according to a survey conducted by the PEI, 77% of adult Poles got involved in helping refugees from Ukraine during the first three months after the Russian invasion and spent about PLN 10 billion in private funds on this purpose (Polish Economic Institute, 2022b). During the first months of the war, neighbouring countries were the most important source of assistance. Poland, Czechia, Slovakia, and Romania hosted 50% of the refugees who fled the invasion. By June 2023, this had fallen to 38%, with higher shares in wealthier countries.

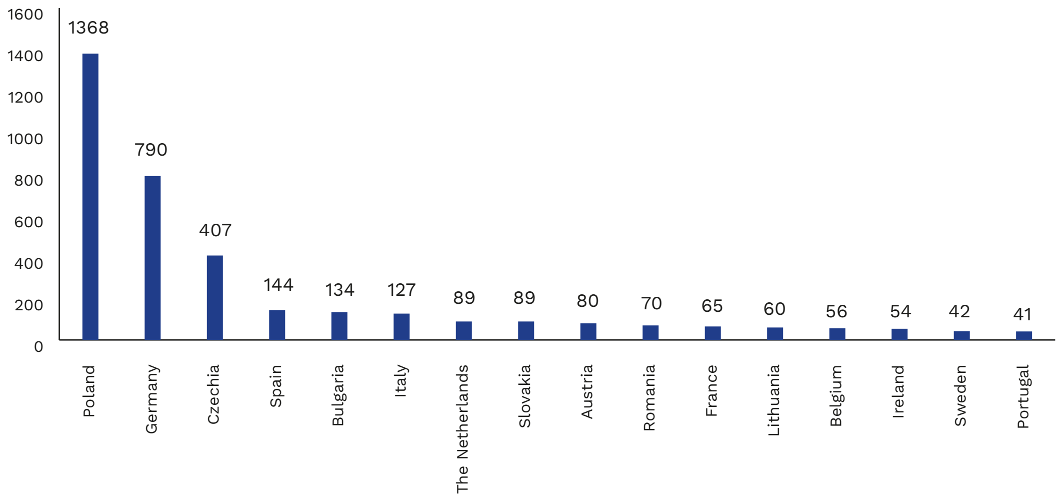
Figure 4. Government humanitarian support for Ukraine, EUR billion (Commitments January 24, 2022, to July 31, 2023)



Note: Countries that did not provide any aid have been omitted.

Source: prepared by CES based on data from Kiel Institute for the World Economy, Ukraine Support Tracker.

Figure 5. Number of refugees from Ukraine by the end of September 2023 (thousands)



Source: prepared by PEI based on data from Eurostat, Beneficiaries of temporary protection at the end of the month by citizenship, age and sex – monthly data (Eurostat, 2023).

1.2. Trade challenges

1.2.1. Intermodality and the increase in capacity

Short-term challenges in infrastructure involve increasing the capacity of intermodal transport terminals at the Polish-Ukrainian border. In the short term, the focus should be on improving the capacity of railway lines and roads, or renovating ones that existed earlier. There is also a need to invest in logistics centres and storage (grain silos on the border). The capacity of border customs and sanitary controls needs to be increased, as well as the infrastructure allowing goods to be transferred between trains travelling on different track gauges. This short-term solution could be replaced by single European gauge train routes in the long run. Funds allocated to the European Solidarity Lanes project should continue to be used to increase the infrastructure's capacity. Public-private partnerships are a viable formula for these kinds of projects.

1.2.2. Customs, TBTs procedures facilitation

Streamlining customs procedures will help make the movement of goods as smooth as possible. This should include further harmonising Ukrainian

customs procedures with EU ones. Progress on Technical Barriers to Trade (TBTs) was made in 2014-2019, but in the years before the war, it stalled a little in areas such as customs reforms and transport infrastructure (Rabinovych, 2022). However, after the war began, reforms accelerated again, with Ukraine joining the European common transit system in October 2022. Extending the temporary full liberalisation of trade until 2024 (Proposal for a Regulation, 2023) by lifting the Tariff Rate Quotas applied by the EU should help Ukraine in its wartime effort to stabilise the economy. However, the big issue is tackling tax evasion and corruption.

Some other scenarios concerning the streamlining of procedures at the border can be studied; for example, the possibility of applying elements of the Windsor framework to the EU-Ukraine border customs procedures. The Windsor framework agreed by the EU and the UK on February 27, 2023 seeks to improve the trading rules for Northern Ireland. It introduces a green lane for goods that will stay in Northern Ireland and a red lane system for goods that will reach the EU. A similar arrangement could involve creating green and red lines for certain Ukrainian goods, such as Authorised Economic Operators (AEOs). The Association Agreement introduced AEOs, which might help smooth operations, provided that trust is established. This is also a way to reduce the risk of corrupt export schemes aimed at avoiding taxes decreasing the Ukrainian state's revenue. Transparency when awarding trusted trader status and EU institutions' involvement in the process could help ease tensions regarding just competition on the European food market.

Further liberalisation might be connected to harmonisation of standards and the mutual recognition of certificates. The Agreement on Conformity Assessment and Acceptance of Industrial Products is being assessed and will be negotiated. The EU is preparing a complex analysis of Ukraine's legal and institutional readiness for product safety, standards, and control of the manufacturing of industrial products. It is one of the points in the Priority Action Plan 2023-2024 (European Commission, 2022).

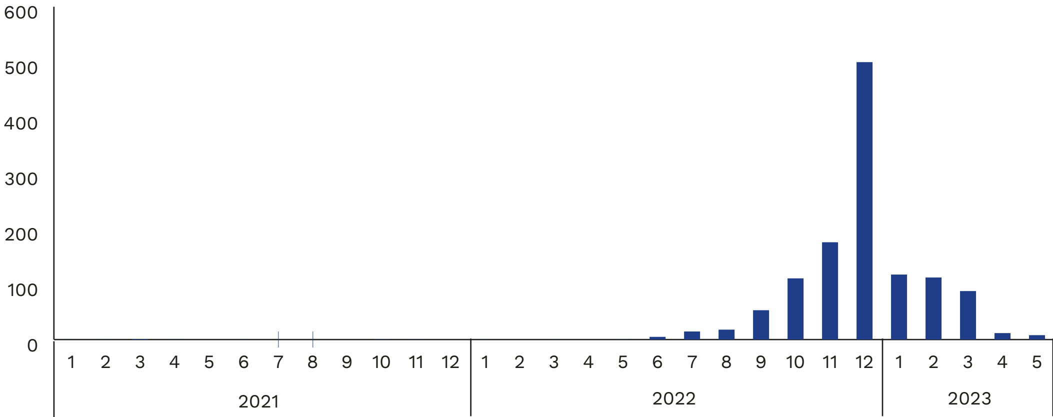
1.2.3. Trade distortion. The case of the agricultural sector

Trade negotiations are often fraught with controversy regarding the agricultural and food industries. Given the circumstances, but also Ukraine's export structure, where agricultural products accounted for over a third of exports in 2021 (41%) and more than half in 2022 (www11), it is not surprising that the tariff lines that remain in the EU-Ukraine DCFTA are mainly agricultural products. In a way typical of the support or protection offered by governments, they usually remain "reactive", in the sense that lobbying is more likely to be successful when the sector is in distress, whether due to international competitive pressure, labour-saving technological change, or declining

demand (Gaisford, 2007, 177-178). In addition, the nexus of specific time- and context-related circumstances matters, too. To name just a few: a need for a profound and sudden transformation of trade patterns brought about by the blockade of the most efficient trade routes, growing competitive pressure on new markets due to cheaper supplies, and the limited number of viable alternatives. They could therefore affect trade relations significantly in the short term, which requires a highly constructive approach to political decision making, with a mutual understanding of the social and economic rationale behind each other's positions.

This seems to be especially true in the recent case of excessive Ukrainian crop imports to Poland (and other neighbouring countries, particularly with regard to wheat and meslin, as well as maize (as depicted in Figures 6 and 7). Additionally, remarkably high growth rates were detected in fresh or chilled cuts and edible offal of *Gallus domesticus*, milk and cream, butter, animal fats and oils and their fractions, rape seeds, and apple juice.

Figure 6. Polish imports of wheat and meslin (HS 100199) from Ukraine in 2021-2023 (thousands of tonnes, monthly data)

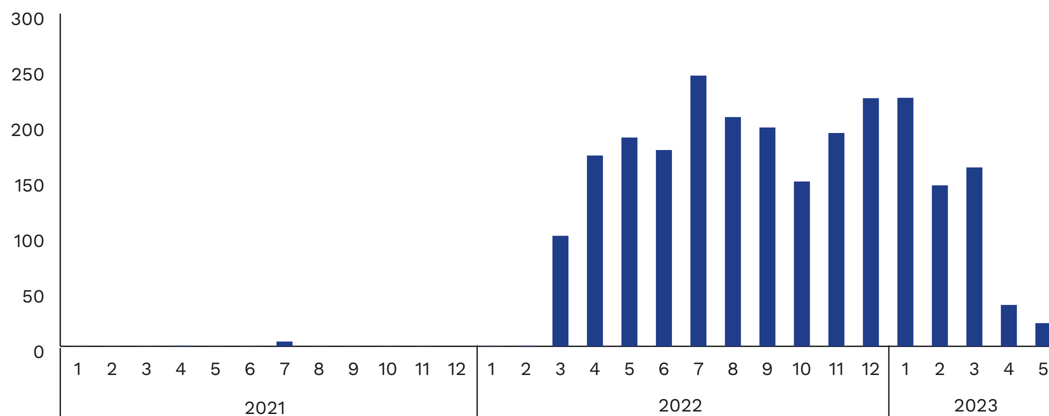


Source: prepared by PEI based on data from (www12).

The limited capabilities of less efficient – and therefore more expensive – road and railway transport routes used to redirect Ukrainian exports towards Poland's and other European countries' ports (including ones in Lithuania, Latvia, Estonia, Germany, Italy, and Slovenia) has made it difficult to match the scale of Ukraine's Black Sea ports. The existing infrastructure is incapable of transferring the expected quantity of grain due to bottlenecks, primarily the need to alter the rail gauge, the limited number of railway cars intended for the expeditious loading and unloading of grain, and European

ports' capacity. These issues can only be partially resolved in the short run; medium- and long-term infrastructural investments to expand the Solidarity Lanes and guarantees are still needed.

Figure 7. Polish imports of maize (HS 100590) from Ukraine in 2021-2023 (thousands of tonnes, monthly data)



Source: prepared by PEI based on data from (www12).

However, these are difficult in the short run and must include the potential long-term economic consequences. Preventing goods in transit from affecting the markets they travel through is a difficult objective. As shown above, the exponential rise in imports of wheat or maize (over 36000% and 31000% between 2021 and 2022) resulted in social unrest, as the full silos limited Polish farmers' chances of selling their produce. Farmers in the five countries that border Ukraine have repeatedly complained about the glut of produce that affects domestic prices and pushes them towards bankruptcy (www13). While it is economically rational to use one's competitive advantage and sell one's products on the closest market possible, Ukrainian grain exports may have been exploited by illegal schemes, including Russian criminals who avoid paying taxes to the Ukrainian state (Puiulet, Loginova, Shedrofsky, 2023).

The need to use alternative export routes after Russia withdrew from the grains deal and the destruction of port infrastructure, coupled with the economic struggle of farmers in neighbouring countries, made the situation escalate and cast a shadow over trade relations. The embargo on Ukrainian crops was lifted on September 15, 2023 by the European Commission but strongly contested by the Polish, Slovak, Hungarian, Croatian, and Bulgarian authorities, three of which introduced individual trade embargoes. Ukraine filed an official complaint against Hungary, Poland, and Slovakia to the World

Trade Organisation for allegedly discriminatory practices, but suspended it afterward. The tensions must be alleviated in a constructed way, through support schemes for Ukrainian and EU farmers, compensation for increased transit costs, and a proper transit formula that distinguishes between grain imports within a certain limit and transit to extra-EU markets.

Against this backdrop, the grain deal between Romania and Ukraine (as of October 2023) may serve as a future reference point on how to resolve tensions caused by embargo disagreements. After undergoing broad consultations by both parties, the Emergency Ordinance seeks to protect Romanian farmers against excessive imports of Ukrainian crops through marketing agreements issued by the Romanian Ministry of Agriculture. The only possible exception is a license for domestic producers who prove that they need to replenish their own stocks, with certified quality and sanitary, veterinary, and food safety checks by Romanian authorities (National Sanitary Veterinary and Food Safety Authority, ANSVSA). Moreover, the final list of licensed products may be re-negotiated and readjusted upon request and in coordination with the Romanian agri-food sector. Meanwhile, the Romanian authorities were working to boost the transport of Ukrainian grain through their Danube River ports (from 2 million to 4 million tonnes per month) and getting around 60-70% of Ukrainian grain exports as transit.

1.3. Ukraine’s ongoing reconstruction

While there have been some positive developments regarding financing for Ukraine’s budget, the postwar reconstruction is still up in the air. The World Bank estimates the rebuilding costs at USD 411 billion (www14). This will grow as the war continues, with new damage and losses every day. Other estimates point to even higher reconstruction costs – from USD 600 billion (Kyiv School of Economics) to USD 1 trillion, according to Danel Bilak (former chief investment advisor to the prime minister of Ukraine) (WiseEuropa, 2022). There is still no clear plan when it comes to financing this recovery, though talk of using Russian foreign assets has intensified. Russian frozen assets should be one of the instruments used to fund the reconstruction. Russians, rather than European taxpayers, should bear the costs of the invasion. The Russian assets will be instrumental when it comes to garnering sufficient funds for Ukraine’s reconstruction.

1.3.1. Current progress

Reconstruction is underway in many regions and sectors. So far, there is no single source of information tracking all the progress, but attempts are being made (more on that below). At the end of April 2023, the government

announced the start of a comprehensive reconstruction, with six pilot projects: settlements in the Kyiv (Borodyanka, Moschun), Sumy (Trostyanets), Kharkiv (Tsyrkuny), Kherson (Posad-Pokorvsk) and Chernihiv (Yagodne) oblasts. The projects include housing, healthcare, education, culture, and administrative services (www15).

To finance these efforts, the government established the Recovery Fund. The money came from the frozen assets of Russian banks (UAH 17 billion) and half of the UAH 72 billion in the NBU's profits in 2022 (www16). On May 15, the inter-agency working party considered the first 377 projects to be financed from the Recovery Fund (www16). At the end of May, the government rerouted UAH 588 million in subsidies for seven oblasts to 26 reconstruction projects in healthcare, education, culture, and administrative service (www17). In June, the government allocated UAH 6.6 billion to more than 150 reconstruction projects in eight oblasts and UAH 4.4 billion for subsidies for local budgets for the reconstruction of social infrastructure, culture, housing, and utilities (www18).

After being de-occupied rapidly, and with a labour market stronger than the national average, Kyiv Oblast was one of the first where the reconstruction began on a large scale. It was reported that a year after de-occupation, 11,000 facilities in the oblast had been rebuilt, out of the 27,000 that had been destroyed or damaged (www19).

Fundraising platform UNITED24 started the reconstruction of multi-storey buildings in Kyiv Oblast. The memorandum between the Ministry of Reconstruction, the Kyiv Oblast Administration, and the United Nations Development Programme (UNDP) included 18 facilities and a budget of UAH 800 million (www20). In May 2023, the reconstruction of three buildings began. All the construction works follow the BBB (build back better) principle, especially when it comes to thermal efficiency. In Irpin, the reconstruction of private housing has begun.

Other efforts have been linked to emergencies. For example, the Agency of Reconstruction intended to build a water path of 87 km to secure the water supply disrupted after the destruction of the Kakhovka hydroelectric power plant (HPP) (www21). The next priority would be physical defence around energy infrastructure facilities to protect them from the missile strikes that did a lot of damage in 2022.

1.3.2. Institutional capacity

The reconstruction process has been made a national priority, reflected in several institutional changes. The Ministry of Infrastructure and the Ministry

of Regional Policy were merged to create the Ministry of Reconstruction, led by Deputy Prime Minister for Restoration of Ukraine Oleksandr Kubrakov. Also, the government established a committee dedicated to reconstruction headed by the minister. At eight other ministries and in twelve oblast administrations, the post of reconstruction deputy was introduced (www22). The Recovery Fund (a dedicated budget programme) was transferred from the Ministry of Finance to the Ministry of Reconstruction.

In February, the Ukrainian road construction agency and the Agency of Infrastructure projects were transformed into the Agency for Restoration and Infrastructure Development. According to World Bank executives, the Agency could become a key partner for international financial organisations. In 2023, the main focus areas will be the reconstruction of energy infrastructure, roads and bridges, housing, and social infrastructure in 11 frontline and de-occupied oblasts.

The Agency's head, Mustafa Nayyem, mentioned an audit of ongoing projects and institutional capacity building among the priorities. Also, he suggested establishing an implementation office which would streamline projects.[1] It currently takes 5-12 months to undergo all the procedures. With thousands of projects, it will take years, unless all the procedures are simplified and streamlined.[2] The EBRD, EIB, and WB have promised to assist the Agency with this.

There have also been developments on the demand side. In May, the Ministry of Digital Transformation launched the e-Reconstruction electronic platform where a person can apply for reimbursement for damaged housing. After that, the option of filing requests via administrative service centres, social security offices, and notaries was introduced (some detailed regulations are needed here, though). Later, the government allowed constructors and building material suppliers to join the system. Epicenter, the largest DIY retailer in Ukraine, seized this opportunity immediately.

The tool mentioned above is essential since about 18,500 multi-storey houses and 142,000 private houses were destroyed or partially damaged. For starters, the government allocated UAH 4.4 billion for these purposes. A person can receive up to UAH 200,000. By the beginning of July, about 20,000 requests had been filed, mostly from the Kyiv, Kharkiv, and Mykolaiv oblasts. The first payments have already been made.

To track both damage and reconstruction, several information tools were created. The Registry of Destroyed and Damaged Property has been tracking damaged assets since August 2022. In May 2023, the government launched

[1] Open sources.
[2] Open sources.

a platform called DREAM (Digital Restoration Ecosystem for Accountable Management) (www23). The goal is to track every stage of each reconstruction project, from filing damage claims to financing, procurements, and construction. It is already public but as a beta version. Currently, the database contains more than 2200 projects, more than 500 of them active, but most projects still lack all the relevant information (www24).

Transparency is crucial for the money to be spent as effectively as possible. Transparency and anti-corruption efforts are critical for increasing financial aid to Ukraine, the G7 countries' ambassadors to Ukraine stressed during several meetings with the Ukrainian authorities. To address the reporting requirements, the Ministry of Reconstruction and the US Government Accountability Office (GAO) have started developing reporting mechanisms. The government has also obliged the Recovery Fund to publish monthly reports about revenues and spending. Later, similar requirements regarding progress when it comes to implementing reconstruction plans were introduced for ministries. Now, they must report on this to the Ministry of Reintegration every month.

1.3.3. Donor participation

In January, the EU expressed its willingness to lead the reconstruction process in Ukraine. Later that month, a dedicated platform started operating. The Western NIS Enterprise Fund (WNISEF) financed by USAID announced it would attract 135 USD million for critical needs and economic recovery in Ukraine and Moldova (www25). The World Bank provided USD 50 million for the reconstruction of transport infrastructure; half this amount is going to the Agency of Reconstruction and Infrastructure Development to repair bridges (www26). Ukraine has signed a memorandum on reconstruction with the Energy Community. Nordic Environment Finance Corporation (NEFCO) and European funds are carrying out three reconstruction projects related to infrastructure and housing. The projects include 30 communities. The budget for the first programme is EUR 50 million. The European Investment Bank (EIB) has started the selection process for reconstruction projects (www27).

Individual countries have expressed their interest, too. Poland wants to be the first to help Ukraine with the reconstruction. The Netherlands will participate in reconstruction programmes. France is ready to give EUR 2 billion; some of this amount will be assigned to reconstruction. The Japan International Cooperation Agency (JICA) has reestablished its activities in Ukraine, focusing on reconstruction, focusing on energy, housing, and demining. First, it disbursed a grant of almost USD 160 million for urgent programmes. Later, Japan spent another USD 470 million on energy reconstruction, demining, agriculture, and other needs (www28).

Some plans are comprehensive in scope, while others focus on particular sectors, especially social ones. For example, the German government has provided EUR 5 million for the reconstruction of 12 schools (www29). It has also launched a platform to coordinate the efforts of German companies willing to participate in the reconstruction. Latvia has promised to participate in the reconstruction of the Chernihiv oblast (www30). The UN Children's Fund announced plans to spend EUR 4.8 million to reconstruct Lyceum No. 3 in Irpin (www31). UNDP and UNOPS will participate in rebuilding more than 100 schools in 14 oblasts (www32). One of the two projects is financed by UNDP. It envisages the repair of 50 schools in 10 oblasts and will cost EUR 14 million. UNOPS is funding the other, which costs EUR 20 million for 54 schools.

The remaining sectors include energy, transport infrastructure, and housing. The IFC has rerouted USD 50 million, previously allocated for energy efficiency projects in Ukraine, to housing reconstruction. The EU was set to allocate EUR 50 million for temporary bridges (www33).

As of April 2023, more than 300 communities have signed approximately 1500 partnership contracts with donors from almost 60 countries (www34).

Additional plans were announced during the Ukraine Recovery Conference held in London in late June. For example, the UNDP announced the establishment of a five-year USD 300 million fund to reconstruct communities. US Secretary of State Anthony Blinken pledged to provide USD 1.3 billion. Of this, USD 520 million would go to the energy sector and USD 657 million to transport infrastructure. The EIB has announced a USD 840 million package in 2023. The UK has promised to provide GBP 64 million for energy reconstruction. Citigroup was going to spend GBP 26 billion on rebuilding bridges (www35).

1.3.4. Summary of the ongoing reconstruction

The main aspects of the ongoing reconstruction in Ukraine are:

1. Requirements for transparency, reporting, and anti-corruption. Donors want to be sure that the reconstruction money will not be stolen; moreover, the effective absorption of funds requires the absence of corruption. The G7 countries' ambassadors explicitly stated that anti-corruption efforts are crucial for expanding foreign aid. To address the reporting requirements, the Ministry of Reconstruction and the US GAO have started developing reporting mechanisms.
2. Project requirements (such as accessibility, energy efficiency, security, etc.). The common understanding is that reconstruction should follow the BBB (Build Back Better) principle. For example, the Ministry of

Reconstruction has promised that all the reconstructed social and administrative buildings will be accessible.

3. Decentralisation. Just 20% of all the reconstruction funds will go through the Agency of Reconstruction (for large national projects or in urgent cases). Otherwise, all the efforts will be local.
4. Who (which foreign partners, both public and private) is willing to participate, what are their sectoral preferences, and what are their conditions? Many international organisations and individual countries have expressed their willingness to participate in reconstructing destroyed or damaged assets. The organisations are the World Bank, IFC, UNICEF, UNDP, UNOPS, NEFCO, EIB, and EBRD. The countries include France, Germany, Japan, Latvia, Poland, the UK, and the US. In total, about 60 countries are assisting Ukraine with the reconstruction. The sectoral priorities are utilities, energy, education, and healthcare.

2. Medium-term challenges

This chapter analyses the key medium-term challenges for Ukraine's integration with the EU. The first section assesses the consequences of the current state of Ukrainian infrastructure for cross-border cooperation. The second addresses the potential for domestic and foreign investment in Ukraine, concentrating on the Ukrainian authorities' policies to facilitate productive investment. The third is devoted to the fiscal incentives for foreign direct investment (FDI). The final section addresses the potential investment vehicles for Ukraine.

2.1. The border between Ukraine and Poland: Infrastructural Challenges in Economic Cooperation

The Ukrainian-Polish border has become the most important border for EU economic, military, and humanitarian support for Ukraine during the war. The infrastructure serving the Ukrainian-Polish border has proven ill-prepared to handle the substantial flow of goods since the Russian invasion and blockade of Black See trade routes. The borders with Ukraine's other neighbours are even less suitable for significant flows of goods and people. The underdevelopment of border infrastructure can be attributed to historical underinvestment, limited land-based trade, and a lack of emphasis on developing cross-border infrastructure because Ukraine's trade model centred on its Black Sea ports. Therefore, the land border between Poland and Ukraine requires significant investment and changes to meet evolving economic needs.

At the same time, despite the war, much has been done to improve and speed up the border crossing. There is also a need to solve bureaucratic issues that might delay investments and new initiatives. High-quality communication between Polish and Ukrainian railways companies is needed to maximise the existing lines' efficiency and increase the infrastructure's quality and capacity. Cargo rail communication is smoother than in the case of passenger transport. Long-forgotten railway lines have been reopened and the opening of border crossings that were taking years to build has been accelerated. To improve road freight and passenger transport, it will be necessary to expand border crossings and the accompanying infrastructure, and

to build new border crossings (road and rail). The condition for Ukraine's economic reconstruction and success is the modernisation of its transport infrastructure and expanding the logistics corridor into the EU. The railway tracks in Poland are 1435 mm wide, while those in Ukraine are 1520 mm wide. There is an immediate need to expand transshipment terminals along the Ukrainian border. The efficient functioning of one existing Broad Gauge Metallurgy Line (LHS) in Poland is also advantageous, but it requires new terminals. In addition, Ukraine should revitalise and expand its existing European gauge network.

New connections are needed to transfer the goods needed to win the war, for Ukraine's economic integration with the EU, and the transformation and development of the Ukrainian economy. The current infrastructure fails to meet the demands of trade flows, resulting in congestion, delays, and higher costs. Insufficient capacity and outdated facilities hamper the smooth movement of goods, impacting business certainty and economic efficiency. Connectivity gaps persist along the Ukrainian-Polish border, inhibiting seamless transport operations. Inconsistent rail gauge and rolling stock standards, inadequate road networks, and insufficient logistical integration impede trade facilitation and prevent economic cooperation from reaching its full potential.

Given the vital role of cross-border infrastructure, there is a need to prioritise investment in upgrading and expanding transport networks. Increasing the export capacity of Polish seaports offers an opportunity to redirect the transport of Ukrainian goods (in particular, grain) through Poland (instead of Romania). The Polish seaports and the railway lines connecting the ports with Ukraine would require expansion and huge investments, which would require EU financing.

Efforts should be made to rebuild the Ukrainian railway network in line with European standards. The European Commission's commitment to developing connections with Ukraine through the Connecting Europe Facility provides an opportunity to secure funding for transnational infrastructure projects. Including Ukraine in these projects could increase cohesion between current EU member states; for example, by building railway connections between Poland and Romania. Embracing multimodal transport solutions would enhance trade connectivity and reduce reliance on congested road transport. Expanding TEN-T connections by the shortest route from Ukraine to Polish ports via Lublin would be beneficial; this was not included in the TEN-T update proposal presented by the European Commission in July 2022.

Figure 8. European Commission's proposal to include Ukraine in TEN-T rail transport corridors

Source: European Commission, Map Finder Chart for European Transport Corridors, https://transport.ec.europa.eu/system/files/2022-07/Revised%20corridors%20to%20include%20Ukraine%20and%20Moldova.pdf [accessed: 28.11.2023].

Encouraging public-private partnerships and attracting private investment could facilitate the implementation of ambitious infrastructure projects, bolstering economic cooperation, and fostering sustainable growth. Ukraine and Poland should align their national strategies to prioritise cross-border infrastructure development. Enhanced collaboration, joint planning, and policy coordination will strengthen connectivity, streamline border procedures, and optimise resource allocation. Collaborative infrastructure projects and the harmonisation of regulations will promote regional connectivity, benefiting trade relations between Ukraine and Poland. Infrastructural investments may

also have a positive impact on energy trade. The low capacity of the Poland-Ukraine interconnectors presents a significant challenge for gas transmission to Ukraine. With an annual capacity of just 1.9 billion cubic metres, there is a clear need for improvement. However, cooperation involving Poland, Slovakia, and Ukraine has the potential to bolster gas supply security in the region, contributing to regional development and stability. This enhanced infrastructure opens up opportunities for gas cooperation between Warsaw and Kyiv, enabling Poland to use Ukraine's surplus storage capacities. This collaboration could be mutually beneficial since Ukraine's storage capacities currently exceed its annual gas consumption.

Polish-Ukrainian cooperation in the electro-energy sector also involves infrastructure investments. Since May, the power connection between Rzeszów and the Khmelnytskyi Nuclear Power Plant became operational, aiming to enable Poland to import electricity from Ukrainian nuclear power plants. However, the Ukrainians have limited energy availability due to the war and intensified missile attacks. In the summer of 2023, the electricity lines were mostly used for emergency energy support for Ukraine. The progress in interconnections shows that, in the future, Ukrainian nuclear power plants could serve as a stable, low-emission, and cost-effective supplementary source of electricity for EU countries.

The current infrastructural challenges at the Ukrainian-Polish border underscore the need for comprehensive solutions to enhance economic cooperation. By addressing capacity limitations, improving connectivity, and promoting cross-border collaboration, Ukraine and Poland could achieve their full potential in trade relations, foster economic growth, and strengthen their position on the European market. But even the best law will not overcome the limitations of poor infrastructure at border crossings and insufficient staffing in customs, sanitary, veterinary, and phytosanitary offices. For example, Ukraine's adoption of the EU Customs Code is an essential legislative challenge that could help increase trade.

2.2. Investments

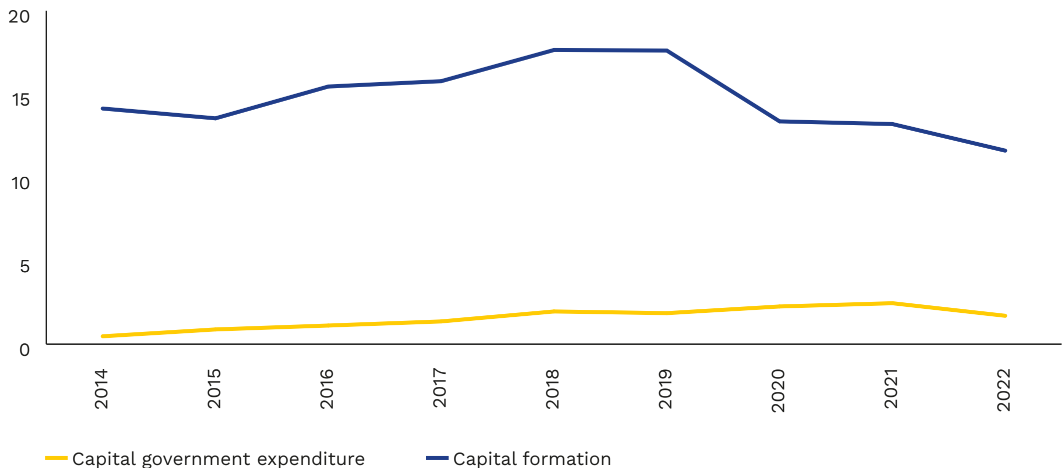
To fully recover and ensure sustainable, long-term economic growth, Ukraine will need to attract private investment. Private funds should become one of the primary sources of funding for Ukraine's reconstruction.

With every missile strike on Ukraine, it is becoming increasingly apparent that public funds fall short of covering the staggering USD 411 billion it will need, according to estimates by the World Bank (WB, 2022). While the prospect of Russian reparations or assets looms as a distant possibility, and grants and loans only cover the country's current needs, the reconstruction

requires immediate action. With budgetary constraints limiting large-scale reconstruction efforts, private entities could already be engaged in rebuilding destroyed housing, infrastructure, and businesses.

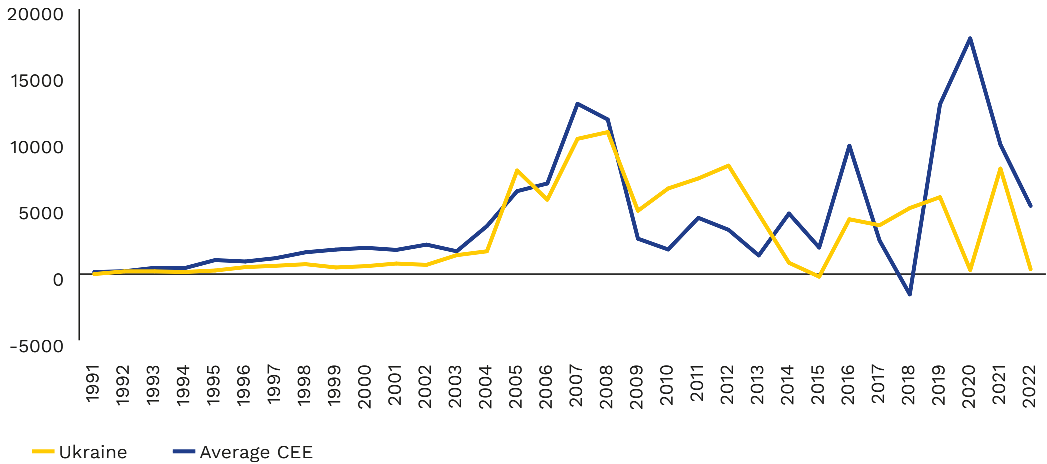
Private foreign investment in the reconstruction will create links between private businesses in Ukraine and abroad. Networking at both the company and individual levels will spur exports, fostering investment, integration with global markets, and sustainable economic growth in the future. As Figure 9 demonstrates, gross fixed capital formation as a percentage GDP has been declining in Ukraine since 2005, pointing to insufficient domestic investment. Considering the modest share of public capital expenditure, the possibility of the Ukrainian government undertaking an active interventionist policy to increase the stock of capital is rather doubtful. It would be natural to expect foreign capital to compensate for the inadequate domestic saving; nevertheless, Ukraine has been attracting, on average, a smaller amount of foreign investment than other countries in Central and Eastern Europe (see Figure 10) in absolute terms despite being a substantially bigger economy. To summarise, facilitating domestic and cross-border investment in Ukraine is a key condition for the economic recovery.

Figure 9. Capital government expenditure and gross fixed capital formation in Ukraine as a proportion of GDP (in %) in 2014-2022



Source: prepared by CES based on Ministry of Finance of Ukraine government expenditure and national output statistics; World Bank, Gross fixed capital formation (% of GDP).

Figure 10. Foreign direct investment, net inflows (BoP, current USD million) in Ukraine compared to countries in the East-Central Europe (according to the OECD classification) average in 1991-2022



Source: prepared by CES based on World Bank, FDI, net inflows (BoP, current USD).

2.2.1. New sectoral angles

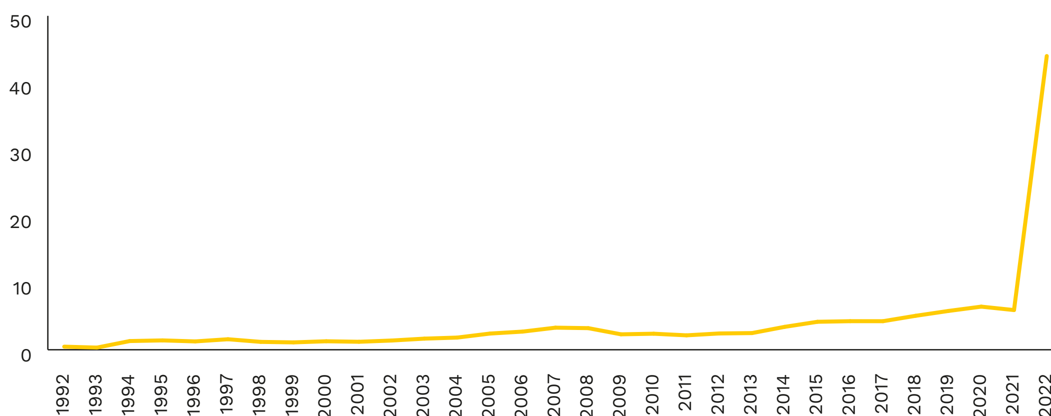
The war has drastically worsened Ukraine's investment climate and added several new angles that were not present in Ukraine's prewar investment attraction narrative, as discussed below.

- **War-related investments.** Ukraine is likely to remain part of the European defence architecture and its frontier in future decades and military tech is the obvious candidate for investments in light of skyrocketing military spending. As the war progresses, the military sector is increasing production and the government is increasing its defence budget (see Figure 11). Local military-tech startups are getting government orders if they can present a working serial production of drones or other equipment. Based on the old post-soviet aircraft industry, tank industry, and shipbuilding, the renovated NATO-oriented production facilities might become relevant in the distant future. Given the close cooperation between the government and private sector in the defence industry, we expect the growing public spending to result in the crowding-in effect; in other words, to facilitate private investment.

  Given the number of civic casualties and soldiers wounded, there could be expectations when it comes to developing medtech, namely the prosthetics industry and the production of tourniquets and other combat

medic supplies. The “Sich” tourniquets produced in Ukraine are on par with the internationally renowned CAT, at a lower cost.

Figure 11. Military spending in Ukraine in 1992-2022 (constant 2021 USD billion)



Source: prepared by CES based on SIPRI Military Expenditure Database.

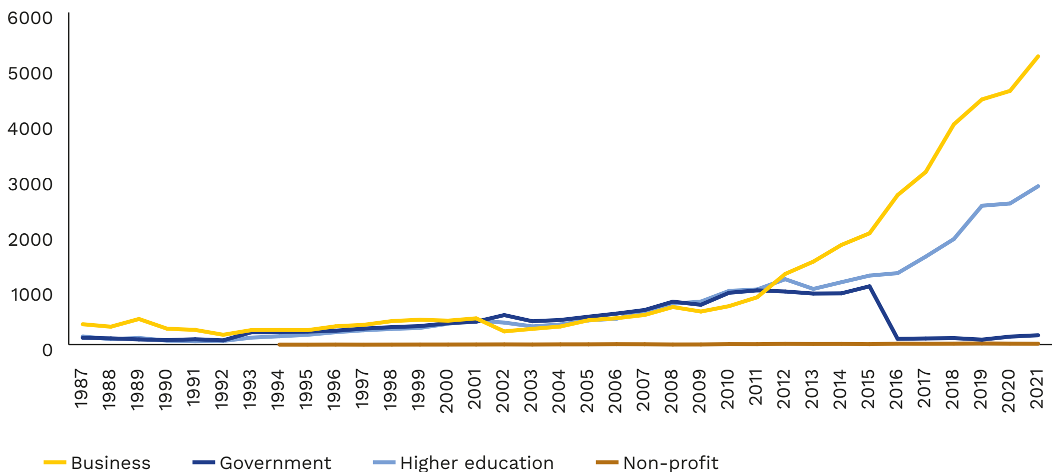
- **Reconstruction-related investments.** The new opportunities include two dimensions: private-public partnerships (PPP) when rebuilding infrastructure and housing and investment in related areas such as construction and development, logistics, and the building materials industry. So far, Serbia and Kosovo have benefited from the PPP format in their postwar development (Matviishyn, Vershyhora, 2022). This solution seems even more attractive in light of the violated sustainability of Ukrainian public finance, as discussed earlier. In other words, employing private capital in the reconstruction process seems a reasonable strategy for Ukraine. Regarding the latter point, creating economic incentives for investment in particular sectors or regions is not new; in fact, it is widely used in EU member states, such as Poland (Annex, 2023).

- **EU-related investments.** Ukraine’s new candidate status and easier access to the EU consumer market in the future would allow export-oriented investors to build on existing lower parts of value chains (developed agriculture, raw materials, energy) to get products to the EU market. Proximity to the EU border and the nearshoring trend (relocating multinationals’ production from China and other Asian countries to closer to home) could make Ukraine an attractive destination. Investments in transborder logistics facilities also seem interesting from this angle. Although economic benefits associated with EU membership are usually

analysed from future members' perspective, we must not forget the existing member states. Positive spillover (some of it associated with investment opportunities) linked with the EU enlargement of 2004 meant that not only the countries that joined that year, but also the EU-15 member states, experienced a significant increase in per capita income (Cieślik, Turgut, 2021). Research shows that the benefits for Germany exceeded 1% of GDP in 2004-2010 (Baas, Brucker, 2011), while those in the EU-15 amounted to about 0.5% of GDP in 2000-2008 (www36). It would make sense to expect similar effects after Ukraine's potential accession.

EU candidate status also forces Ukraine to comply with more environmentally sustainable standards. It will mean a focus on green energy, green metallurgy, and construction materials. Green industries, driven by European expertise and local production, might become an investment opportunity. In Poland, the scale of spending on research and development (R&D) has increased significantly since it joined the EU (see Figure 12). It is worth mentioning that the volume of R&D investment by private businesses grew the most rapidly. This provides some evidence in support of the positive spillover of integration with the EU, in the context of a sustainable and innovative economy.

Figure 12. Spending on R&D by sector in Poland in 1994-2021 (EUR million)

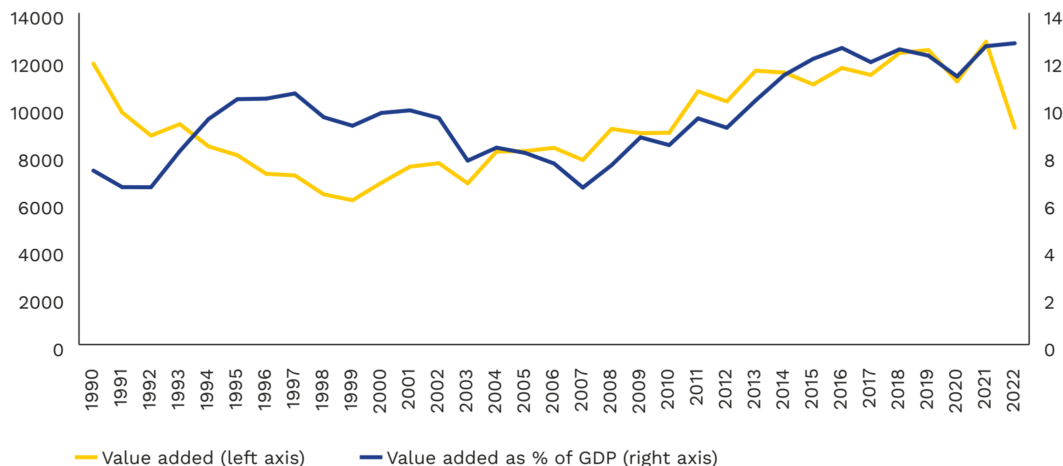


Source: prepared by CES based on Eurostat, GERD by sector.

- **Traditional investments.** Pre-war industries oriented at domestic demand, such as banking and financial services, fuel, food and beverages, and retail, have lost potential with the massive outward migration and increase in poverty caused by the war. Nevertheless, even now, Ukraine

remains a market of approximately 38 billion people (according to World Bank estimates), larger than most European countries. Traditional sectors, like agriculture (see Figure 13), electricity generation, and raw material extraction, remain the strengths of Ukraine's economy and present investment opportunities.

Figure 13. Agriculture, forestry, and fishing value added in Ukraine in 1990-2022 (constant 2015 USD million) and as a proportion of GDP (in %)



Source: prepared by CES based on World Bank, Agriculture, forestry, and fishing, value added and GDP (constant 2015 USD).

2.2.2. The preconditions for impactful private investment in Ukraine's recovery (Ogryzko, 2023)

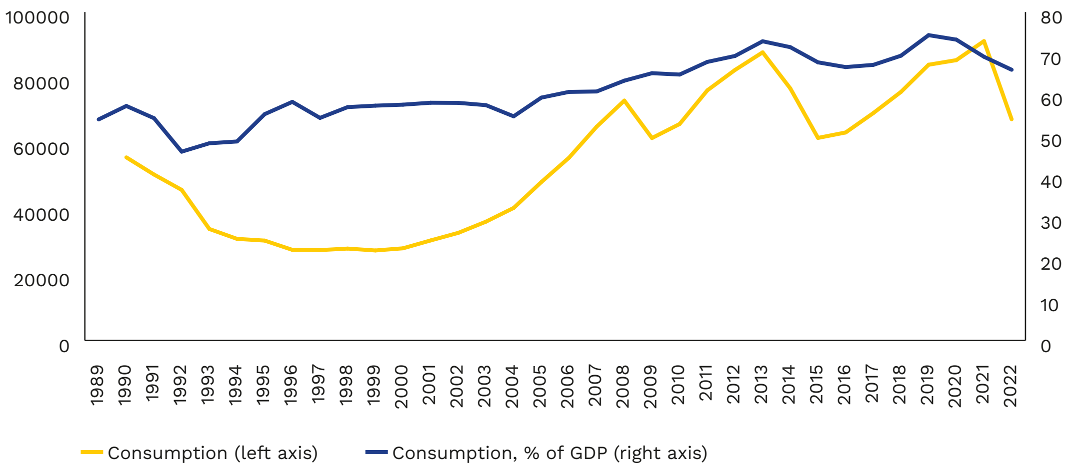
Involving investors in the reconstruction requires specific projects in targeted regions that are ready for investment, planned based on the conditions and priorities for the country's development. But the overall investment climate is no less critical, as it will facilitate private investment.

Any investment decision is based on an assessment of the ratio of return to risk. The higher the risk, the higher the expected return must be to make businesses interested. Ukraine will have to work with both parts of this equation.

When it comes to return (revenue and profits), businesses rely on domestic or external demand. The government can work with both domestic and external demand to increase investment as part of the reconstruction process.

- **Domestic demand policies.** Domestic demand in Ukraine has been weakened by emigration and poverty. The challenges caused by the war will include population decline, weakening the domestic demand and reducing the labour force. Approximately 6.3 million people have left Ukraine, a significant proportion of them of working age (www37). Consequently, spending on consumption dropped dramatically in 2022 (Figure 14). Internal displacement and companies' relocation have led to mismatches in labour force supply and demand in different regions. The challenge for the government is to implement labour and education reforms that might help solve these issues.

Figure 14. Households and NPISHs final spending on consumption (constant 2015 USD million) and as a proportion of GDP (in %) in Ukraine in 1990-2022



Source: prepared by CES based on World Bank, Households and NPISHs Final consumption expenditure (constant 2015 USD and % of GDP).

The recovery in domestic demand should be harmonised with reconstruction projects. When planning the reconstruction, the focus should be on creating an environment that people will want to come home to. This will create effective demand and allow businesses to recover. In the coming years, it is important not to introduce an ultra-tight fiscal policy, leaving a budgetary incentive in the form of generous social assistance and other budget expenditures. This will create a domestic consumer and allow businesses to develop. In addition, the physical presence of skilled workers is a necessary labour resource for businesses. It therefore makes sense to develop a policy of encouraging Ukrainians to return to the country through special programmes informing them about the opportunities within Ukraine.

- **External demand policies.** In the coming years, external demand will be shaped mainly by EU integration. Ukraine must strive for open doors for industries. The start of negotiations on the EU membership, aligning procedures with EU standards and rules, resolving problematic trade issues with neighbours, and continuing work to expand transport corridors are all components of the country's investment attractiveness as a location for export-oriented enterprises.

- **Cost-management policies and investment incentives.** These might include industrial parks with pre-made electricity and water connections, logistical infrastructure, and other facilities, as well as subsidised funding (such as the 5-7-9 programme of affordable loans for business development purposes in Ukraine) (www38) and some tax incentives, which might be relevant in areas heavily affected by the war. The incentives should be designed to compensate for market distortion caused by the war and – in the case of Ukraine – by clumsy government policies like those on grid connection, creating a level playing field rather than distorting market forces even more by serving vested interests.

2.2.3. The Polish experience with investment incentives

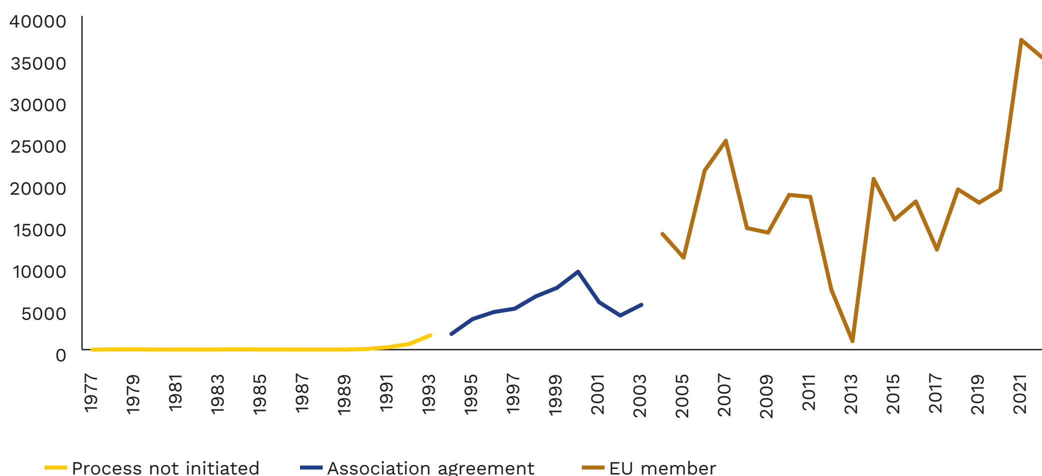
When discussing investment incentives in Poland, international capital liberalisation has contributed to domestic capital formation. As Figure 15 shows, Poland recorded modest growth in inward FDI after the Communist regime collapsed in 1989, but the rate increased significantly in 1994. EU accession further contributed to an increase in inward FDI in Poland.

Poland's experience in creating an adequate investment environment demonstrates the potential benefits of combining market-oriented and interventionist supply-side policies. The following initiatives are particularly noteworthy:

- **Industrial parks.** According to the Polish Investment & Trade Agency, there are 77 industrial and technology parks, located in all 16 of Poland's voivodeships (www39).
- **Special economic zones.** There are 14 Special Economic Zones (SEZs) in Poland. Depending on the zone, they offer companies different economic incentives, including tax exemptions, government grants, unique benefits for small and medium-sized enterprises (SMEs), and so on (www40).
- **Government grants.** Currently, government grants are provided as part of the programme for supporting investments of significant importance to the Polish economy in 2011-2030 (Annex, 2023). Its key objectives are: a long-term and sustainable increase in investment; improving the innovative potential of Polish firms; foreign expansion (developing export industries); increasing human and social capital; regionally sustainable

development (supporting regional development by utilising endemic regional resources and taking into account local features). In practice, this implies targeting enterprises operating in strategically important sectors and/or economically deprived regions. Moreover, the programme specifies the minimum number of jobs that should be created.

Figure 15. Foreign direct investment, net inflows (BoP, USD million) in Poland in 1977-2022, depending on status



Source: prepared by CES based on World Bank, Foreign direct investment, net inflows (BoP, current USD).

2.2.4. Risk mitigation policies and overcoming institutional barriers

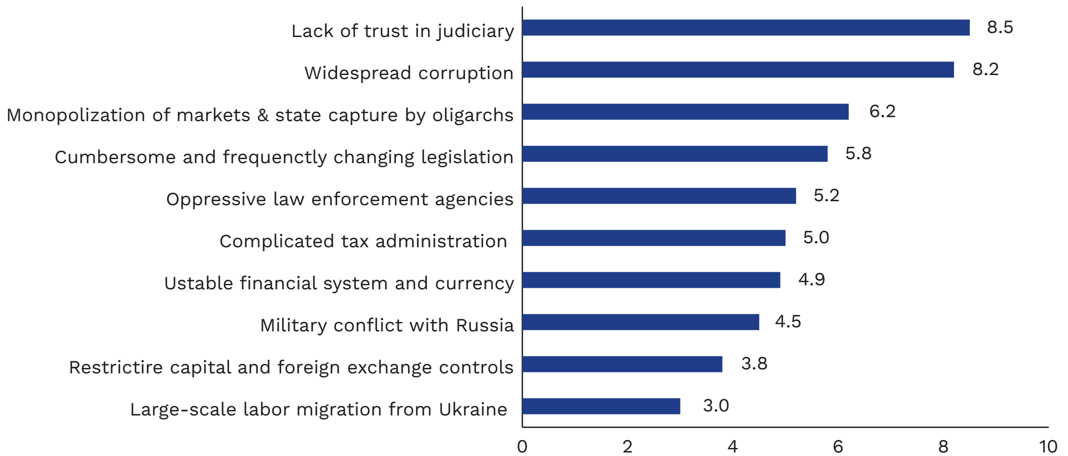
Reducing institutional barriers to investment is even more important. These include corruption, red tape, lack of trust in the judiciary, and contract enforcement problems, which increase construction and production costs and pose a risk for investors (Figure 16).

When it comes to risks, Ukraine is likely to face an even more difficult job. Before the war, risks relating to the rule of law were at the top of the list of barriers to investment (Dragon Capital et al., 2020).

Work on judicial protection and improving the rule of law in a broader sense remains equally important today. This includes the notorious raiding, non-transparent practices at inspection bodies, including the tax and customs authorities, and companies' highly problematic interaction with the judiciary. The creation of anti-corruption infrastructure, such as the Anti-Corruption Court, the NABU, or the SAPO, has become a necessary part of this process.

However, the other side of the coin are the entire judicial and law enforcement systems, which must operate in accordance with universal rules. Restoring and consolidating Ukraine's status as a strong, independent state that borders an aggressive imperialist country requires political will and rapid efforts to strengthen the rule of law at the highest level. This is also a prerequisite for Ukraine's EU accession and its geopolitical choice in the long term.

Figure 16. The main obstacles to investing in Ukrainian assets from 0 (least important) to 10 (most important)



Source: Dragon Capital, EBA, Centre for Economic Strategy (2020); Foreign Investor Survey 2020.

Ukraine has been seeking to improve the rule of law for many years and the result is far from perfect. Yet after the war, the rule of law will become an existential question. The government is actively working in every area: from transparency and reconstruction digitisation to reducing corruption risks, active negotiations on the creation of an international investment insurance programme, and negotiations on EU accession.

However, wartime challenges – operational risks including the risks of damage from warfare and/or war-related natural disasters, risks of energy supply disruptions, and other war-related risks – are likely to cloud the horizon until the war ends.

Military risks are now at the forefront. Israel's approach, where the state covers losses caused by hostile actions or its own defence forces, is not suitable for Ukraine, at least because of the large difference in country risk (Fitch's A+ credit rating for Israel versus CC for Ukraine). Guarantees from the Ukrainian

government are not enough to inspire foreign investors' confidence. Single cases of guarantees from some states (Germany) or institutions (MIGA, DFC) are difficult to scale up to the required level. Since the risk is incalculable and cannot be reinsured, private markets are not a realistic alternative, either. The only possible avenue seems to be to seek stable guarantees from reliable international partners, such as the EU and the G7 countries, through the creation of a special guarantee scheme (see the next section for details). War risk insurance might help, but only to some extent. The priority for Ukraine and the West should be to end the war as soon as possible with Ukraine's victory.

The Polish insurance scheme for Ukraine: Korporacja Ubezpieczeń Kredytów Eksportowych (KUKE, the Export Credits Insurance Corporation)

As an expression of solidarity with Ukraine, but also due to calls from Polish businesses, Polish companies have been eligible for insurance provided by KUKE as part of the Borderless Policy (Polisa Bez Granic) since June 2022. The scheme initially covered the sale of goods and services to the Ukrainian market, which are not stipulated in the payment moratorium adopted by the National Bank of Ukraine in February 2022 (the list of critical imports was lifted on July 9, 2022). Furthermore, KUKE lowered the rates under guaranteed insurance by 35% to encourage Polish exports. In 2021, KUKE provided insurance for goods and services worth PLN 1.5 billion, which amounted to 5% of the total exports to Ukraine. In contrast, since the war began, the scheme has covered exports worth PLN 2 billion, with virtually zero loss (www59), which might point to Ukrainian partners' reliability. Food (20%), plastics (15%), chemical and construction (10% each), and metals (6%) account for the largest share in KUKE-insured exports.

KUKE is also increasingly engaged in supporting Polish investment in Ukraine. In September 2023, the Polish parliament enacted the amended law on state-guaranteed insurance against political risk (including war), which enables KUKE to provide coverage for investments by Polish companies in Ukraine and ensure the repayment of 100% of the value of investment loans. The latter's objective is to encourage banks to provide financing to companies interested in entering the Ukrainian market. Before the war, the demand for these kinds of support had been negligible. On top of that, KUKE's assistance extends to finding financing for individual projects relating to Ukraine's reconstruction, such as rebuilding infrastructure. It does this by guaranteeing the repayment to financial institutions, as long as the Polish firms are involved in these types of projects and at least 30% of the content (work and the supply of components) comes from Poland.

2.2.5. A war risk insurance mechanism for Ukraine (Gorodnichenko, Stepanchuk eds., 2023)

Since 2014, when Russia annexed Crimea and started the war in Donbas, operational safety has become a crucial element of the business climate in Ukraine. The full-scale invasion in 2022 made it far more relevant to the country's entire territory. However, the actual stream of investments is walled up by the Russian invasion and the ongoing war. According to the OECD classification (OECD, 2023), Ukraine has the highest possible risk level, on par with Afghanistan, Belarus, Cuba, Iran, Iraq, and some African republics. Reconstruction and recovery needs are estimated at 411 billion USD as of February 24, 2023 (WB, 2023), including critical steps toward becoming a modern, low-carbon, disaster- and climate-resilient country aligned with EU policies and standards.

With its proximity to the largest consumer markets, skilled labour, natural resources, and well-developed logistical network, having received a European perspective with its candidate status, Ukraine has gained enormous growth potential within a well-established pattern for transition economies joining the EU. Experts argue (Janus, 2022; Gorodnichenko et al., 2022) that war risk insurance would be a necessary (but not sufficient) condition for facilitating investment inflows and allowing these strengths to develop.

Before February 24, 2022, the Ukrainian insurance market lagged behind its Central European counterparts and local banking services (www41). However, insurance and reinsurance coverage for war-related risks were available, even in areas near the line of contact in Ukraine's Donetsk and Lugansk regions, according to several market players. The policies were sold by Ukrainian companies and reinsured on the international market. Logistics, including marine and aviation, were the most commonly covered packages, but property insurance was also available. This all changed with Russia's invasion of Ukraine. While there is still a market for some risk coverage, like fire damage, health, or risks in automotive insurance, it become impossible to get insurance coverage of war-related risks on Ukraine's territory, with few exceptions.

Currently, part of the international debate is focused on a possible solution to this problem. On June 21, 2023, the European Commission, Norway, Switzerland, TaiwanBusiness – EBRD Technical Cooperation Fund, the EBRD, and Ukraine signed a statement of intent on cooperating to relaunch the private insurance market in Ukraine by working with key market and public-sector stakeholders to develop a guarantee facility (www42). While, so far, the move is only a statement of intention regarding the joint efforts, it is an essential step toward coordinated policies in the future. It has found further support in the European Commission's Proposal (Proposal for Regulation, 2021) for a four-year support programme to Ukraine (Ukrainian Facility) as

"The Ukraine Guarantee". It shall be used to cover the risks for the following types of operations: (a) loans, including local currency loans; (b) guarantees; (c) counter-guarantees; (d) capital market instruments; (e) any other form of funding or credit enhancement, insurance, and equity or quasi-equity participations – earlier moves from. The World Bank's insurance branch MIGA[3] and the US DFC[4] and export guarantees from a few governments were also aimed at insuring against the war risk.

Nevertheless, organised efforts are still at an early stage. Moreover, Ukrainian investors still find themselves in even more unfair market conditions: they not only have much higher borrowing costs than European or US companies, but they are also unable to get the protection against risks available to foreign investors.

In general, the following set of principles should create an efficient war risks insurance scheme that will enable Ukraine to achieve a faster, inclusive, and sustainable economic recovery driven by foreign and local investment (Gorodnichenko, Stepanchuk eds., 2023):

- An **international guarantee scheme** for war risk insurance in Ukraine should be governed by a special vehicle with robust corporate governance, funded by international donors as a money pool that acts as a carrier of war-related risks, and implemented by a global consortium of reinsurance companies to ensure investor confidence. State guarantee from the Ukrainian government would not be enough to gain the trust of foreign investors. Given the incalculable and non-insurable nature of the risk, the private market is not an option, either. The only viable approach would be to seek trustworthy guarantees from third-party entities, such as G7+ governments, to initiate market operations. These kinds of assurances would also help keep insurance premium rates affordable since, under market terms, the cost of war-related insurance in Ukraine would be prohibitively high for most companies. Additionally, a mechanism for claims against Russia should be established, allowing guarantor countries to recover their funds from the responsible party.

  The insurance should only cover the risks associated with war, such as physical damage to goods and assets, hostile occupation, and contract obligation breaches for war-related reasons, including bank loans, goods, or services supply. Not only a total loss of the property should be covered, but also moderate damage, which is not currently the case (Janus et al., 2022). Commercial risks, the risk of assets being nationalised

[3] MIGA is working almost exclusively with foreign companies, providing them with political risk insurance. It was not very active in Ukraine, with fewer than 20 in total during the past 23 year, until now. It is now looking to mobilise several hundred million dollars of equity to build a special trust fund dedicated to Ukraine. It will focus on high developmental impact projects and providing foreign investors with insurance.

[4] The US International Development Finance Corporation (DFC) currently cooperates with the Economy Ministry of Ukraine to prepare investment projects from the private sector and is conducting a preliminary selection of projects, cooperating with Ukrainian applicants. The DFC has also provided Ukrainian Bank Lviv with a guarantee on the pool of loans for SMEs.

and/or the imposition of capital controls by the Ukrainian state, as well as any risks of the non-honouring of financial obligations by the sovereign/quasi-sovereigns, should be excluded from this scheme.

The insurance should be equally accessible to Ukrainian and international investors, with coverage for all investments, large and small. While coverage at the initial stages might be prioritised and channelled towards strategic industries, the goal is to open the market to all players, including SMEs, which can purchase insurance policies from their local suppliers.

Private insurance companies' participation will be necessary. The scheme should not rely on a single state-owned insurance company, as its capacity would not be enough to cover all the demand, while governance and corruption-related issues might undermine its credibility. Local insurance companies could broker standardised SME deals, while larger international ones could approach large companies and PPP projects on an individual basis. Proper oversight made possible by the prewar "split" reform, where the National Bank of Ukraine became the insurance market's supervisor, would be crucial.

Leadership by Ukraine's government in the process would be valuable at the conceptual stage, when the criteria for assessing investors' eligibility to the international guarantee scheme would be determined. It should also be involved in all the stages of the negotiations and scheme design. Supervising local insurance companies during the implementation stage and providing transparency and access to information is also the Ukrainian counterpart's task. Still, the funds and the direct management should be out of its hands to remove any possible sovereign-related risks that might affect investors' trust.

Overall, steps towards a dedicated and well-coordinated effort to implement a working international mechanism of war risk insurance for Ukraine's economic recovery are being taken. For it to succeed, work must be done on three challenging levels simultaneously. Firstly, establishing a guarantee umbrella by international financial institutions and donors that would also be available for Ukrainian companies. Secondly, involving the private sector by creating a pool of reinsuring companies and insurance brokers. Lastly, establishing a credible and effective mechanism for striking deals in Ukraine that ensures equal access for state and private players, strong market supervision, and an eligibility framework developed to support Ukraine's resilience and recovery.

2.3. Fiscal incentives and foreign direct investment

Poland and Ukraine should strive to intensify economic cooperation in order to boost investment flows, which are instrumental for Ukraine's recovery. Obviously, due to the ongoing war and the massive reconstruction needs, much of this effort will have to be shouldered by Ukraine's government. Investing

during a fragile peace or during an armed conflict is seen as a high-risk venture, and this risk needs to be mitigated by specially-crafted investment incentives and/or reduced tax rates for new foreign investors. These incentives need to alleviate the initial financial burden for investors and encourage them to establish their operations in Ukraine. More specifically, the investment promotion tool-kit should include:

1. various forms of tax relief, including investment allowances for foreign investors,
2. income tax reduction for foreign firms operating in Ukraine, including capital income,
3. making it easier to set up a business in Ukraine,
4. Polish-Ukrainian economic zones that would enable joint investment projects to be planned and executed,
5. other forms of cooperation and transfer of know-how related to tax system reforms; for example, designing a new corporate income tax mechanism, such as the "Estonian CIT".

First, it is important to consider tax stability guarantees that offer investors much-needed predictability while bringing their capital to Ukraine. These guarantees should ensure that tax rates and regulations will not be subject to change for a specific period of time. Investors also expect to enjoy financial benefits as soon as they invest in Ukraine. This might be achieved by offering a number of tax amendments. For instance, a tax incentive for individual investors allocating funds for investments through venture capital funds might be considered. The proposed tax reduction measures must include a combination of profit-based and expenditure-based incentives. They might, for instance, include CIT and WHT-related incentives for all foreign and domestic investors, sector-targeted and based on a minimum investment threshold.

In terms of business facilitation, the arrangements should primarily include:

- Temporary exemption (or a high tax-free threshold) from income tax for individuals and SMEs from Poland in Ukraine and for Ukrainian individuals and SMEs in Poland.
- The ability to conduct tax settlements according to domestic regulations, rather than the rules applicable in the partner country.
- Simplification of VAT tax settlements and administration by implementing a mechanism allowing VAT to be paid in the home country instead of the partner country.
- Integration of electronic systems supporting e-invoicing.

Other forms of cooperation could include:

- Establishing Polish-Ukrainian special economic zones, particularly in conflict-free areas in the western part of Ukraine or regions less affected by the war, to attract export-oriented businesses. Investors in these zones

could enjoy customs duty exemptions or/and reduced taxes on goods intended for export. They could also benefit from loss carry-forward provisions that allow businesses to offset their current or future taxable income by deducting losses incurred in previous years. Two modalities should be considered: free trade zones or export processing zones.
- Creating a joint database of taxpayers and implementing automated information exchange in this regard.
- Developing a shared vision of a contingency tax system in case of emergencies.
- Facilitating in-depth knowledge transfer and sharing solutions related to the tax system.

As Ukraine's postwar effort requires a technological push, the investment schemes should promote technology transfer from foreign investors. This could be facilitated by introducing forms of R&D tax credits. In this vein, tax deductions for training and skill development among the local workforce should be advanced, which could further stimulate FDI inflows.

EU accession requires compliance with EU tax law. Even though this area is only regulated to a limited extent by EU law due to Article 114(2) of the TFEU, there are still multiple European acts that need to be addressed in Ukrainian legislation. Notably, the Ukrainian tax system will need to comply with Directive 2006/112/EC (the VAT Directive) (Council Directive 2006), Directive 2016/1164 (the Anti-Tax Avoidance Directive) (Council Directive 2016), and Directive 2020/262 (the Excise Duty Directive) (Council Directive 2020). The regulations concerning excise duties and VAT must be carefully assessed, considering their importance for government revenues. Unsurprisingly, Poland was granted several transitional periods for applying VAT and excise taxes during its accession. Transitional periods were granted, for example, for VAT on books and magazines, gastronomic services, agricultural inputs, construction and renovation services, and the application of excise tax reductions for green fuels. The current Polish VAT regulation came into force on March 11, 2004, indicating the adjustment of Polish regulations to EU requirements.

2.4. Investment vehicles

Ukraine's reconstruction will not be possible without the substantial involvement of private capital from the broadest possible range of partners and institutions to help mobilise capital at scale. The investment engagement of Western countries and investors from this region will not only accelerate the reconstruction but also stabilise the economic foundations and help integrate Ukraine into European ecosystems. Two of the investment avenues that might be instrumental to tapping into private capital are private equity (PE)

and venture capital (VC). In general, equity investment is a viable option for high-risk, high-growth firms lacking access to traditional finance or ineligible for credit. This makes it particularly well-suited for warn-torn countries, such as Ukraine, where business potential is high, valuations have dropped, and the risk associated with the ongoing war is acute. Importantly, as documented by various studies (Santos et al., 2019), its impact on strategic decisions to innovate and on growth in companies' turnover is higher, compared to other sources of financing.

According to many studies (Aldatmaz, Brow, 2020), there is a statistically significant link between PE investment and the real economy. The former not only leads to higher employment growth, productivity, and profitability of business ventures, but also incentivises firms to improve efficiency and use new technologies. Equally, the evidence of the macroeconomic impact of VC is considered robust (van Pottelsberghe de la Potterie and Romain, 2004), as it contributes to economic growth through innovation and companies' increased absorptive capacity. Furthermore, the social rate of return on VC is significantly higher than that on business or public R&D (van Pottelsberghe de la Potterie and Romain, 2004).

Having said that, PE and VC funds, which constitute collective investment schemes, pooling investment from various investors, may be instrumental to catering to Ukraine's reconstruction needs and plugging the investment gap. In fragile, transitional, and conflict-affected states, they may have a significant catalytic impact (IFC, 2018), spurring the emergence of new sectors and decreasing the costs of doing business for others. Their strength also lies in absorbing some risks that traditional lenders are unwilling to accept.

Traditionally, Luxembourg has been the most popular and, so far, incontestable jurisdiction for PE and VC investment vehicles for both European and non-European funds. Approximately 90% of the European PE and VC funds are domiciled in Luxembourg, with assets under management reaching EUR 400 billion and an average fund size of EUR 200 million (www43). To ramp up finance for critical reconstruction needs, certain changes in the global realm of PE and VC that would help move beyond the usual suspects, such as Luxembourg or the Netherlands, might be considered. One proposal is to use EU mechanisms to channel funds needed for reconstruction projects; another is to designate Central European countries such as Poland as PE/VC jurisdictions.

The latter would, however, require a set of institutional and regulatory reforms. The actual role of Poland in the reconstruction process hinges on creating a legal and business environment for effective investment activities in the private market. The existing solutions in Poland do not fully meet the requirements for international investors, requiring legislative actions to

establish appropriate measures, with significant support from experienced institutions operating in the VC and PE markets.

These efforts should lead to the introduction of a legal framework in Poland that satisfies the following criteria:

1. **Operating under the AIFMD.** The framework for achieving business objectives should be created using universal structures available in the EU, namely vehicles operating under the AIFMD Directive. While these structures are implemented in various forms, depending on the jurisdiction, their operational frameworks remain consistent across all the member states. In Poland, these facilities include alternative investment funds, created as specialised open-end or closed-end investment funds or alternative investment companies. However, the current structures do not fully meet the other requirements necessary for international investors; legislative actions are needed to establish adequate solutions.
2. **For professional investors only.** The fundamental characteristic of the vehicle should be limited in terms of legislative and supervisory roles, with a focus on transferring appropriate competencies and operational capabilities to investors. This postulate can only be met if investors are not only aware of investment risks but also capable of ensuring the existence and use of mechanisms that safeguard their interests. The current solutions do not fully meet this requirement. Investment funds can be acquired by individuals who are not professional investors, and regulations pertaining to alternative investment companies can lead to identified abuses in practice by management entities and pose a risk of investors for whom these kinds of investment products are unsuitable being admitted.
3. **A flexible investment policy.** The creation of the vehicle's investment policy and strategy should be left to the manager and be dependent on the investors' intentions. The legislator should not impose restrictions in this regard. Investment goals, time horizons, as well as investment policies and strategies, are a result of correctly assessed management competencies and investors' expectations. Within the Polish jurisdiction, these postulates are not adequately met, particularly in the case of investment funds, where the law defines permissible investment categories and investment limits that must be adhered to, even against the will and interest of participants.
4. **Tax efficiency.** The attractiveness of the vehicle is dependent on the actual returns investors obtain. For the purposes of international investments, the vehicle should be tax-transparent, ensuring that taxation occurs upon completion of the investment and cases of double taxation do not arise – firstly, at the vehicle level, where taxation would apply to investment activity income, and secondly, at the investor level, where returns from completed investments would be taxed. Presently, none of the vehicles operating under Polish law satisfy this condition.

Double taxation frequently occurs despite exemptions, especially in investments involving foreign structures. Additionally, in the case of alternative investment companies operating as commercial law companies, taxation occurs at the level of capital contributions made by investors as a tax on civil law transactions based on the increase in share capital.

5. **Implementation of VC standards.** Within the legal environment that has been created, ensuring the efficient implementation of key principles of the VC market in the vehicle's activities is crucial. These key principles include:
   a. **The commitment-based nature of contributions.** The VC fund standard is for an investor to commit to an unconditional upfront payment (commitment). Actual payments are made in parts according to the demand for subsequent investments and cover the vehicle's operational costs. Presently, no solutions in the Polish jurisdiction fully meet all the necessary criteria. Specifically, Polish law lacks an institution equivalent to commitment, payments can be subject to taxation, and the process of receiving payments is essentially equated with admitting new investors, requiring capital increases, and waiting for registration or the issuance of investment certificates in compliance with the requirements for new investors.
   b. **Investors' ability to remove the manager immediately.** The ability to remove the management entity is a fundamental institution ensuring investor protection. This allows investors to have a tangible impact on the manager and enforce the proper execution of the agreement. This is particularly important in cases of abuse by the manager, conflict of interest, or failure to exercise required diligence. Polish law does not have statutory solutions guaranteeing that this postulate is implemented, and removing the manager requires his or her cooperation.
   c. **Transparency towards investors.** Investors should expect full access to information about the vehicle's activities from the manager. This is crucial for maintaining control over the manager's activities and supervision of the entrusted funds. Polish legislation requires that information on investment funds' investments be treated confidentially, making the implementation of this postulate impossible.
   d. **Freedom to shape the distribution of investment proceeds among investors.** The vehicle should allow returns to be shaped in line with VC market standards regarding both stakeholder groups and the value of obtained proceeds. In particular, the vehicle should enable mechanisms like preferred returns, performance-based management fees linked to the total value of commitments, or variable remuneration tied to returns for investors (carried interest). Presently, these solutions are challenging to implement under Polish alternative investment fund structures due to the need for

proportional settlements between investors or limitations in the distribution of funds related to reducing share capital in alternative investment companies.

e. **Manager's capital involvement.** A key guarantee for VC fund investors is the alignment of interests between them and the manager. The standard is for the manager to participate in the vehicle's capital, providing an additional incentive to manage the assets diligently. In the Polish jurisdiction, implementing suitable solutions remains restricted due to limitations on the acquisition of investment certificates of investment funds by the managing company.

6. **Minimal formal and administrative requirements.** The investment vehicle's postulated characteristics should also reflect the principles stemming from the AIFMD Directive and related EU regulations insofar as possible, while avoiding excessive regulations or obligations on the part of the vehicle or its management entity (avoiding "gold plating"). Ensuring operational efficiency while limiting operating costs is also essential in this context. In this regard, desirable characteristics include:
   a. **Official valuation cycles conducted annually.** This remains consistent with AIFMD requirements without precluding the possibility of providing investors with more frequent information. However, additional information would not be available without involving external entities such as a depositary or an appraiser, significantly impacting operating costs.
   b. **A transparent liquidation process.** The ability to conduct liquidation by the management entity or settle with investors by transferring assets is crucial for concluding VC market investments efficiently. Current legal structures limit the possibility of conducting liquidation by the management entity, requiring actions by a depositary or settling with investors in kind.

3. Long-term challenges

In the third chapter, we outline the main potential barriers to Ukraine's effective integration into the EU in the long run. First, we examine Poland's relevant experience to draw up a roadmap for independent monetary policy, strong local institutions, efficient public procurement mechanisms, and well-developed capital markets. Next, we look at various scenarios for Ukraine's integration with the Single Market.

3.1. Adaptive learning

3.1.1. Independent monetary policy and creating a truly free-floating currency

Independent monetary policy is vital and should work without any interference or influence from the government or other external entities. Poland has sought to strengthen the independence of its central bank over the years. Since 1998, the country has been implementing an inflation target strategy to achieve price stability (since 2004, it has been 2.5% with a symmetric band of ±1 p.p.) (www44). Over the past two decades, after decelerating inflation in the late 1990s, the National Bank of Poland (NBP) has managed to keep it within the target (www45).

The National Bank of Ukraine (NBU) has done a good job, too. It introduced an inflation-targeting regime and floating exchange rate in 2016 (www46). Four years after its launch, in 2020, the NBU had already achieved its inflation target of 5% (www47).

However, the full-scale Russian invasion of 2022 led to changes in Ukraine's monetary policy framework: the exchange rate was fixed to the US dollar, and it has become the main anchor in the economy, some FX restrictions were imposed, and the key policy rate has become a complementary tool (NBU, 2022a). All of these have helped to safeguard the macroeconomic stability of Ukraine (NBU, 2023) and have even led to the deceleration of inflation since December 2022, when it reached 26.6% year on year (www48) (in June 2023, inflation was 12.8% year on year) (www49).

In Ukraine's current circumstances, returning to inflation targeting requires gradually reducing unconventional measures in the interest rate and exchange rate policies implemented during the war, closely linked to the phasing out of FX restrictions and a transition to greater exchange rate flexibility. The NBU's goal should be full-fledged inflation targeting, reaching the 5% year-on-year target when favourable preconditions align with the updated macroeconomic forecast.

In the Strategy for easing FX restrictions, transitioning to greater exchange rate flexibility, and returning to inflation targeting (from now, on referred to as the Strategy), the NBU stated that the key policy rate will continue to serve as an auxiliary tool for a while. The main reason for this is to stabilise the exchange rate regime and protect international reserves. The rate will be kept sufficiently positive in real terms to maintain the attractiveness of the hryvnia as a savings instrument, reducing demand for foreign exchange. For now, the NBU plans to gradually normalise the operational design of monetary policy by reintroducing the main operation at the key policy rate (two-week NBU certificates of deposit) and restoring a symmetrical interest rate band. It will be synchronised with the key policy rate cuts cycle, eventually adopting a floating exchange rate regime under inflation targeting. Besides, the ban on the monetary financing of the state budget will be reinstated (www50).

Additionally, **effective communication and anchoring inflation expectations to the target value are crucial in an inflation-targeting regime, fostering confidence, stability, and informed decision-making for sustainable economic growth.'** Poland's experience with inflation targeting is a valuable example of how effective communication and anchoring inflation expectations have contributed to their economic success, with the NBP consistently communicating its commitment to achieving the inflation target, resulting in a high degree of anchoring long- and medium-term inflation expectations, especially to the inflation projections and monetary authorities` decisions by the central bank (Chmielewski, Kocięcki et al., 2020), and relatively stable low inflation rates prior to 2022 (www45).

Foreign exchange liberalisation will be another important part of the country's rapid recovery in the postwar period, as it will help to attract foreign capital to Ukraine. The liberalisation of cross-border capital movement will speed up economic development by attracting foreign investment to finance current account deficits and diversify investments. Empirical studies show the positive impact on economic growth, especially for developing and transitioning economies. In the long term, capital inflows stimulate the development of the financial sector, enhance domestic investment opportunities, and facilitate economic progress. Countries that have liberalised capital movements have experienced sustained economic growth (Repko, Kasho, Piontivska, 2016).

Poland is an example of good coordination between capital control regulation and macroeconomic policy. Financial liberalisation in Poland during the 1990s was a key reform that attracted FDI, especially in the banking sector, driving the development of a robust financial system. The country implemented gradual capital account liberalisation in line with macroeconomic development and monetary policies, prioritising long-term flows over short-term ones. This cautious approach to liberalisation helped Poland avoid currency and financial crises, even during regional and international economic downturns (Sulmierska, 2008).

Poland eliminated entry barriers, liberalised external trade, and aligned its legislation with OECD and EU standards. This integration allowed Poland to participate in the global economy and benefit from international resource allocation. Complete adoption of the OECD and EU capital movement principles occurred in 2002, lifting restrictions on short-term capital flows and implementing new currency legislation (Currency Act of July 27, 2002) (Sulmierska, 2008), which remains in effect today (Ustawa, 2002).

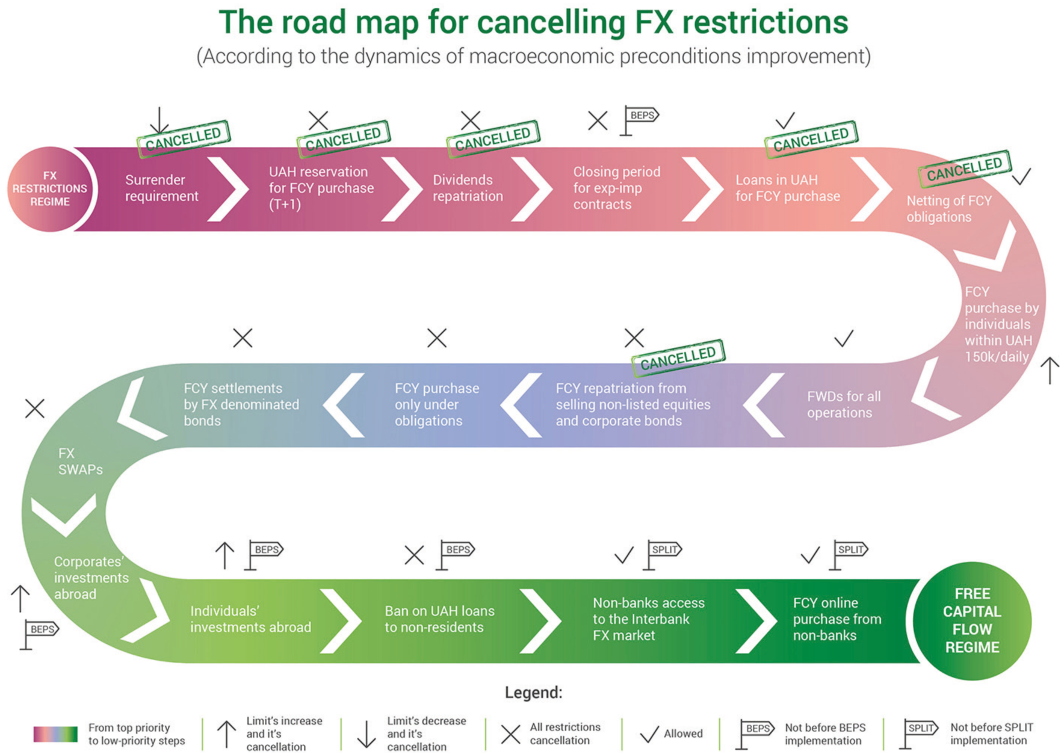
At the beginning of 2019, the NBU launched a new FX regulation regime that operates based on the "what is not forbidden is allowed" principle, which is at the core of the new philosophy behind the Ukraine's law on currency and currency operations, adopted in 2018. It contains eight key regulations that stipulate the process and procedures for FX operations by residents and non-residents, corporates and individuals, foreign and local investors, the implementation and cancellation of safeguard measures, and so on (www51). (see Figure 17).

As a result of the Russian invasion, the NBU fixed the exchange rate and imposed FX restrictions to ensure the Ukrainian financial system's stability. While the pegged exchange rate has helped stabilise inflation and exchange rate expectations during the war (NBU, 2022b), **its long-term costs might outweigh the benefits, leading to market distortions, increased currency risks, and hindered economic growth.** The prolonged peg could also prevent the economy from adapting to changing conditions through exchange rate flexibility and limit the central bank's policy options (www52).

The NBU should therefore, as conditions permit, return to inflation targeting with a floating exchange rate to achieve long-term price and financial stability goals while supporting sustainable economic growth.

While implementing this strategy, the NBU will carefully assess past effectiveness, potential impact, and macroeconomic factors to minimise risks and facilitate economic recovery while maintaining exchange rate sustainability as a critical priority (www52).

Figure 17. The roadmap for cancelling FX restrictions (as of the end of 2021)



Source: NBU, *The road map for cancelling FX restrictions*, https://bank.gov.ua/en/files/LuXiWdmtPPQbqbK [accessed: 27.11.2023].

I. Easing FX restrictions

The Roadmap for easing FX restrictions involves a step-by-step approach based on macroeconomic preconditions. It considers the impact on the foreign exchange market and stability, avoids undermining the effectiveness of other restrictions, and refrains from using FX restrictions as a substitute for essential macroeconomic adjustments. If needed, the implementation of the Roadmap may be suspended, and FX restrictions may be reintroduced or tightened (www52).

The Roadmap includes three stages with a focus on different aspects of liberalisation:

- **Stage 1:** minimising the practice of multiple exchange rates, liberalising trade transactions, and facilitating new loans and investments;
- **Stage 2:** liberalising trade finance, managing currency risks for banks, and enabling the repatriation of interest on "old" debt obligations and investments;

- **Stage 3:** enabling payments on loans and investments, liberalising household transactions and transactions with derivatives, and allowing lending to non-residents and investments abroad.

At the same time, **the Roadmap prioritises easing restrictions on trade transactions over capital flows and on own FX currency transactions over purchased FX currency (www52).**

II. Moving to greater exchange rate flexibility

In the early stages, the NBU will use the exchange rate as a nominal anchor, gradually introducing greater exchange rate flexibility based on macroeconomic conditions. As the preconditions are met, the inflation target will take over as the nominal anchor and the exchange rate will act as a corrective mechanism. The increase in exchange rate flexibility will be gradual, maintaining exchange rate stability to avoid shocks, supported by tight monetary policy, and easing certain FX restrictions while minimising the use of multiple exchange rates.

It is clear that Ukraine cannot move straight from a fixed exchange rate to a floating one. Something will be needed during intermediate period for a smooth transition. Poland's experience serves as a valuable example.

In the early 1990s, Poland also had a fixed exchange rate regime for economic stabilisation and to curb price growth. After several years, the shortcomings of the pegged exchange rate began to outweigh its advantages, and a crawling peg was adopted. It was an important step toward exchange rate flexibility and was preceded by the liberalisation of foreign exchange regulations. During the late 1990s, the fluctuations bands were widened several times. Finally, in April 2000, the złoty was formally allowed to float freely (the foreign exchange interventions were amended in 1998-1999) (Gadomski, 2019; Pruski, Szpunar, 2005). **Accordingly, the NBU could adopt a crawling peg with bands widening gradually as an intermediate regime, before returning to the floating one.**

3.1.2. The role of the regions, the power of local government, and strengthening local institutions

Decentralisation is one of the most important reforms in the realm of governance. One of its paramount benefits lies in nurturing the growth of local political leaders while facilitating the democratisation of power structures. By empowering local authorities with decision-making responsibilities, decentralisation creates an environment where promising leaders can emerge, ensuring a more inclusive and participatory governance system. A decentralised

government is more efficient, more accountable, and transparent. Furthermore, decentralisation is crucial in bolstering a country's capacity to absorb foreign funds and increasing the overall effectiveness of international aid initiatives, which is especially important in the context of the Ukrainian postwar recovery. When resources are channelled directly to the local level, they can be used more efficiently and effectively to address region-specific challenges and promote sustainable development. As exemplified in various successful cases, most notably that of Poland, strategic decentralisation empowers communities, fosters political maturity, and paves the way for more robust partnerships with the global community in pursuit of shared prosperity.

Poland has experienced successful administrative reform, with *gmina* (the municipal level) reformed in 1990 and *powiat* and *voivodeship* (the county and regional level) reformed in 1997. The Polish Constitution states that the local government shall fulfil the functions assigned to it on its own behalf and shall bear responsibility for those functions itself (Regulski, 2003). These principles are consistent with the ones that Ukraine has been implementing, as Poland was selected as a role model for its decentralisation reform.

Ukraine embarked on decentralisation reform in 2014, but it has not yet been completed. Ukraine was a highly centralised, Soviet-style country in which the centre decided on almost every issue. With decentralisation, Ukraine has adopted a "bottom-up" decision-making model (www53). More power has been given to the local communities (*hromadas*), which now have direct budget relations with the state. However, the principles under which first- and second-level administrative divisions (*raions* and *oblasts*) operate still need to be reformed. Moreover, the constitution should be amended to complete the legislative changes needed for the reforms, which is not possible during the war.

The main lesson for Ukraine is the need for decentralisation to be managed and supervised properly. At the start of the administrative reforms in Poland, Professor Jerzy Regulski was appointed undersecretary of state and plenipotentiary for territorial local governments reform. He was already a well-known expert on local government, which he had spent years researching in academia. As the undersecretary of state, he managed the preparation of the administrative reform and then supervised its implementation. Proper management of the reform is vital for its success. Ukraine has lacked this kind of management since the reforms began in 2014.

With fully functional and reformed *hromadas*, *raions* and *oblasts* are stuck in limbo between the old and the new systems. Like the Polish voivodes, prefects who would conduct state supervision of local governments' actions still need to be introduced.

Decentralised local communities are also better at overcoming various natural disasters, as shown by the Polish experience following the 1997 Central European flood (known in Polish as *Powódź tysiąclecia*). The disastrous flood served as an additional argument against the centralised government system, as precious hours and days were lost in the halls of various Warsaw ministries trying to coordinate different emergency processes. This served as an additional impetus for further reforms, and local governments' emergency powers were expanded. In the case of Ukraine, decentralisation is essential, both for the immediate local response to various war-related emergencies and the postwar reconstruction (Regulski, 2003).

3.1.3. Public procurement and anti-corruption mechanisms

Transparent public procurement and anti-corruption mechanisms are needed to provide a level playing field for business in Ukraine, decrease compliance risks, and attract investment, as well as facilitate effective and efficient postwar reconstruction. Fighting corruption and making further progress in deoligarchisation of the state are also preconditions for Ukraine's EU accession. This challenges are described in section on EU integration; below, we look at the tools that could make public procurement procedures more transparent.

Ukraine's current procurement system is based on the Public Procurement Law adopted in 2015. It lays a good foundation for the public procurement system, is aligned with international standards, and partially complies with the EU *acquis*. The European Commission's latest report recognises that Ukraine has made good progress in implementing the first two phases (out of five) of the indicative schedule for procurement under the Association Agreement, which is needed for reciprocal market access between Ukraine and the EU for supplies for central government, state, regional and local authorities and bodies governed by public law (Association Agreement, 2023).

Yet **Ukraine still has to ensure that all public procurement of goods, services, and works in Ukraine is transparent and open to all EU economic operators based on nondiscrimination and equal treatment.**

The Prozorro e-procurement, which has gained global recognition as one of the best public procurement solutions, has operated in Ukraine since 2016. It is a fully digital platform, mandatory for all government procurement above a threshold of UAH 50,000.[5] It enables public oversight over announced procurements and publishes all the related data after the tenders are finalised.

[5] During martial law public, procurement can be concluded through direct awards and simplified procedures. Currently, more than 70% of non-military procurement is processed through competitive bids.

It is crucial that Prozorro remain a single platform for all the public procurement in Ukraine, including recovery and reconstruction spending, as the creation of multiple procurement platforms may fragment procurement practices and weaken controls, leading to abuse in reconstruction projects. Prozorro is therefore expected to be included as an e-procurement instrument for DREAM – a single digital pipeline for reconstruction projects.

One of the lessons for Ukraine may be the efficient application of non-price procurement criteria. Since the launch of e-procurement, over 99% of all successful procurement in Ukraine has been awarded based on price criteria (Davydenko, 2021), while in Poland, only about half of procurement is awarded based on price criteria, close to the EU average of 55%.

Relying solely on price criteria often leads to suboptimal procurement in terms of overall economic impact. Ukrainian customers avoid using the non-price criteria due to perceived ambiguity in the definition and absence of an exhaustive list of non-price criteria in legislation, a lack of understanding when it comes to evaluating non-price criteria, and the lack of a unified approach in court practice and anti-monopoly committee appeals.

The use of non-price criteria is also one of the prerequisites to implementing local economy support measures compliant with the EU public procurement legislation. The Socially Responsible Public Procurement (SRPP) framework, provided by 2014 EU procurement directives (www54), allows procurement policy options aimed at supporting local employment, for instance. This approach can balance the threats for local businesses due to opening the public procurement to EU suppliers.

It is also important to further enhance transparency in public procurement by improving the effectiveness of the beneficial ownership regime. In the programme with IMF, Ukraine has committed to aligning respective definitions with FATF standards and implementing the verification procedures for submitted beneficial ownership information. These measures are expected to help detect conflicts of interest and limit the manipulation of tenders by company misuse.

Interests of individuals with significant wealth and, consequently, political power (oligarchs) are frequently not aligned with social collective choice and long-term development goals. The excessive power of oligarchs serves as a barrier to economic and political transformation (Puglisi, 2010, pp. 99-123), making it one of the key obstacles to Ukraine's integration into the EU (European Court of Auditors, 2021).

The Bill on Oligarchs (THE LAW OF UKRAINE, 2023) was passed in 2021 and amended in 2022, after the full-scale Russian invasion began). According

to the bill, a person included in the official and publicly-available register of oligarchs is prohibited from privatising state assets of substantial value, making contributions to the election funds of candidates (except their own funds) and political parties during elections, and financing political agitation campaigns. All the state governors are obliged to report any contact with individuals listed in the register of oligarchs.

The bill was meant to demonstrate the Ukrainian authorities' readiness to handle corruption. Yet its actual implications may be much more controversial. The definition of "oligarch" is rather vague, implying that anyone with substantial assets could be included in the register, which undermines the incentives for reporting one's assets openly and transparently. An efficient market regulation framework and anti-trust policy might serve as a better instrument for limiting the power of the oligarchy, but it would require meticulous design and much more legislative effort.

3.1.4. Polish capital markets development

Based on the Association Agreement between the EU and Ukraine, the latter took responsibility for capital and financial account liberalisation (Association Agreement, 2023); that is removing administrative and operational barriers to the free movement of capital between Ukraine and EU member states. Although the role of capital flow liberalisation is a complex issue in the case of small open economies, there is some consensus regarding the positive effects of capital market liberalisation within the EU (Mahmood, Rehman, 2019). Among the former communist Central European states that eventually joining the EU, Poland is an interesting case of the economy that has successfully achieved a high level of financial integration with the Single Market and taken full advantage of its benefits. Since 1991, the value of the Warsaw Stock Exchange (WIG) has increased more than 72-fold (www55) (the ratio of the stocks traded to GDP has risen from 0.05% to about 14%, according to the World Bank estimates) (www56). The rest of this chapter therefore attempts to formulate relevant advice for Ukrainian policymakers by looking at the case of Poland.

The history of the Polish stock market's development can be split into the periods before and after EU accession. During the first period, Polish policymakers introduced market-oriented reforms, including privatisation; as a result, former state-owned enterprises became the biggest and the most liquid companies listed on the WSE (Kowalak, 2004). The list includes Telewizja Polska, Powszechny Zakład Ubezpieczeń, Polskie Linie Lotniczne LOT, Bank Handlowy, and others (Gwizdała, 2013). In 2000, the introduction of modern computer systems allowed for the real-time release of quotes; later, the WarSet trading system was implemented. Moreover, investment instruments such

as futures, corporate bonds, options, and warrants were launched (Małecka, 2017, pp. 34-43). At the same time, one could argue that excessive regulations on the stock market in Poland created a barrier for SMEs and narrowed positive spillover for the real sector (Kowalak, 2004). In addition, insufficient liquidity and efficiency on the stock market favoured banking sector savings (Szczukocka, 2004), which might explain why debt financing outweighed equity in Poland before 2004 (Kowalak, 2004).

Joining the Common Market in 2004 created significant opportunities for Poland to overcome the weaknesses above. Within a decade, Poland had become the leader in Central Europe by developing a set of competitive advantages, namely: strong regulations (to a great extent mimicking the EU regulatory framework), transparency, and adequate tax regulation (i.e. VAT exceptions and moderate transaction fees) (Gwizdała, 2013). By being part of the Single Market, Poland was able to attract companies located in neighbouring countries with less efficient stock markets. As a result, in 2022, 11% of companies listed on the WSE (accounting for 46% of market capitalisation) were registered abroad (www57). Moreover, the transparency of regulations attracted savings from non-institutional investors, such as Polish households (Gwizdała, 2013).

To sup up, the following factors contributed to the success of Polish-EU stock market integration after the start of Poland's transition and soon after it joined the EU:

- The privatisation of the state-owned enterprises, which, apart from increasing efficiency, boosted overall market capitalisation and supported economies of scale.
- A transparent, strict, and straightforward regulatory environment.
- Low transaction costs associated with stock trading.
- The ability to attract non-institutional investors, thereby increasing the popularity of stocks, as an alternative to banking products.

To conclude: given the underdeveloped state of Ukrainian stock (and capital) markets, adopting the policies introduced in Poland three decades earlier might significantly contribute to successful capital market integration.

3.2. Integration with the EU Single Market

Ukraine's effective integration with the EU will be one of the most salient factors shaping and increasing the quality and pace of postwar reconstruction. Ukraine will be able to accept private investments more rapidly and on a larger scale, having already adopted EU regulations, creating legal stability, the rule of law, the credibility of the judiciary, and tools for adequate investment protection. Integrating Ukraine's economy with the Single Market will

provide it with a stable foundation for economic growth. However, the accession path is not clear; many challenges still need to be overcome, both by Ukraine and its partners. We therefore present three potential long-run scenarios for Ukraine's integration with the European Single Market.

The recommendations for Ukraine and Moldova show the very strong support of the European Commission, and above all its president, for the formal opening of accession negotiations with them. The proposal to make the adoption of the negotiation framework by the EU Council conditional is intended to convince countries sceptical about the start of talks (especially Hungary) to change their mind (the decision requires unanimity). Although the key challenge related to Ukraine's future membership is the lack of agreement among member states on the need to expand the EU, it is clearly visible that the Commission wants to start negotiations quickly.

Ukraine's EU accession is also key to the future stability and peace of Europe, as a guarantee of sustainable development leading to the continent's socio-economic cohesion. At the same time, the process of negotiations will prompt a debate on the institutional balance in the EU and the efficiency of its decision-making process, and reinforce tensions over the financial and budgetary consequences of the enlargement. The fiscal limitations of the EU have already scaled down many important projects, from the post-pandemic recovery to the global race for clean technologies.

The political balance between enlargement to the Western Balkans and Ukraine and Moldova's accession negotiations will represent another dimension of the political process in Europe. In this report, we present a variety of measures that could be implemented to address objective economic or political obstacles that could be raised in EU member states to make the accession process acceptable to all EU countries. European issues are becoming more and more divisive in European capitals. The Treaty of Nice was rejected by Ireland in a referendum in 2001 (46.1% yes; 53.9% no). The Treaty Establishing a Constitution for Europe was abandoned in 2005 by France (45.1% yes; 54.9% no) and the Netherlands (38.5% yes; 61.5% no). Accession to the Economic and Monetary Union was rejected by Denmark in 2000 (46.9% yes; 53.1% no) and by Sweden in 2003 (41.8% yes; 56.2% no). The Treaty of Lisbon was rejected by Ireland in 2008 (46.6% yes; 53.4% no). The EU-Ukraine Association Agreement was rejected by the Netherlands in 2016 (38.2% yes; 61% no). Net position on the European budget is an important political vector for public opinion in at least four European countries, the "Frugal Four" during the last European multi-annual budget negotiations (Sweden, Denmark, Austria and the Netherlands). The same sentiment could shape some other capital's position during the next budgetary negotiations, where the costs of Ukraine's accession will play an important role. A common denominator in the group is limiting the scale of the EU budget to 1% of EU GDP, which

strong limit any significant increase of member states' direct contributions to the EU budget. The debt crisis in the eurozone merely increased opposition to financial transfers in the EU.

There are two other ways to expand the EU fiscal capacity: European taxes and debt issuance. We still do not know what experience capital will draw from the debt-based one-off fiscal instrument for the post-Covid recovery (Recovery and Reconstruction Facility, the centrepiece of Next Generation EU). After the pandemic-related economic crisis, the instrument was scaled down, especially in transfers. The Commission's initial proposal offered EUR 500 billion in grants and EUR 250 billion in loans to member states (European Commission, 2020). At the end of the negotiations, member states agreed to up to EUR 338 billion in grants and up to EUR 385.8 billion in loans.

European taxes represent another sort of controversy. For some countries, they give the EU unnecessary fiscal and political autonomy. For some countries, the regressive nature of tax models (especially those based on ETS allowances), where poorer economies pay more, is unacceptable from a justice perspective. Without a significant increase in the EU's fiscal capacity, it is impossible to find a smooth way of adapting the budget to Ukraine's accession.

3.2.1. Scenario 1. EU Accession

Ukraine's admission to the EU is the best possible scenario for country's economic relations with Western partners, as well as for the EU itself. Ukraine was granted EU candidate status on June 23, 2022 and received a positive assessment of integration progress by the European Council on February 9, 2023 (European Council, 2023). To date, Ukraine has not met all the conditions specified in the Commission's opinion on its membership application. As reported at the end of June 2023, Ukraine has "completed" two out of seven recommendations (reform of the media and judicial governance bodies). In the Constitutional Court reform, there was also "good progress". In the other areas identified by the EU (the deoligarchisation of the state, the reform of legislation on national minorities, and the fight against corruption and money laundering), the Commission has only noted "some progress".

The war has weakened oligarchs' influence on the country's political and economic life. Most importantly, oligarchs' companies have suffered due to the hostilities and the economic crisis. Oligarchs' wealth has also decreased significantly because Kyiv decided to nationalise some of their assets and reduce their influence on politics and the media (such as that of Ihor Kolomoisky, who is now in custody, accused of a series of economic crimes). This trend will continue as long as the war continues, but it is too early to say that the oligarchs' decline is permanent. The fight against corruption also requires

intensified efforts, as shown by the series of corruption scandals that came to light in June and July 2023 in the Ukrainian Army.

There are still many other obstacles ahead that could delay the process of EU integration. In the scenario of a protracted conflict, territorial challenges cause constant political, social, and economic uncertainty. It holds Ukraine's economy in war mode, with most of public spending going towards military and security purposes. The territorial integrity of Ukraine might not be restored easily in the coming years, and this issue needs to be included in the discussions. The only previous example of non-recognised borders in the EU was Cyprus. The ongoing conflict increases the security arrangements needed and might prevent Ukraine from joining the Schengen area. However, this extreme crisis is an opportunity for to achieve social acceptance for institutional reform. EU accession will require huge steps when it comes to combating corruption and deoligarchisation (www58), as outlined in the previous chapter.

EU accession will be possible only if Ukraine fulfils the Copenhagen criteria, accepting the *acquis communautaire*, the EU ETS, and other necessary conditions. The negotiations took six years in the case of Croatia. In Poland, they took five years and, after they were completed, another two years before actual accession. Moreover, the new methodology of accession applied by the EU means that credible progress in negotiations is required, especially in fundamental reforms. There is a stronger focus on the rule of law, functioning democratic institutions, and reform of the public administration. Without progress in this negotiating chapter, other chapters might not be negotiated. Moreover, regression in the negotiations process is possible. If any backsliding in institutional reforms in Ukraine occurs, EU member states might decide to suspend negotiations, reopen chapters that had already been closed, decrease the scope and intensity of EU funding, or pause or withdraw the benefits of closer integration.

Nevertheless, Ukraine is implementing part of the EU *acquis* thanks to the Association Agreement.

Ukraine's admission will also require the EU to adjust. For example, the strong Ukrainian agriculture sector means that changes in Common Agriculture Policy are needed. Interestingly, after Ukraine's accession, the EU's share in the global wheat exports will rise to around 30% (www58), making the EU the dominant player in the world market.

The accession process will need to address the difficulties in political and social acceptance in Europe, as well as maintain support for the EU in Ukraine during the protracted negotiations. Every chapter needs to be accepted by every member state, so any political issues between partners or even within a member state might halt the negotiation process. Border issues could delay the process, as in the case of Croatia, when

accession was temporarily blocked by Slovenia. Another issue is the consent method in each member state. In some EU countries, full accession would trigger the need for a referendum on Ukraine's accession. As the Dutch vote on the Association Agreement shows, this might prove very unpredictable.

If Ukraine wants to join the eurozone, the Maastricht criteria might need to be fulfilled, too. However, this could take years, as the convergence criteria require the macroeconomic stability of the economy. With the war in Ukraine, these criteria cannot be met and are unlikely to be met in the next few years. Previous postwar experiences have shown that it took 25 years for GDP per capita to reach the prewar growth trend in half of the countries affected by armed conflicts (Polish Economic Institute, 2022a).

Some experts are calling for new procedures to be applied to the integration process, for example, prompt integration with the European Single Market (ECFR, 2022). However, this might prove to be an economic integration scenario in itself.

Measures supporting the transition will be needed, as outlined in sub-scenarios for both the first and the second integration scenarios.

3.2.2. Scenario 2. Joining the European Economic Area

Meeting the EU's seven recommendations for Ukraine will be the precondition for integration with the Single Market as well. Limiting integration to the EU single market might prove easier at a political level – it does not include the Common Agriculture and Fisheries Policies (as a whole), Trade or Foreign and Security Policy, or Justice and Home Affairs. It does not include Customs or Monetary Union. However, limiting the extent of Ukraine's integration with the EU could have a negative impact on public sentiment in Ukraine and its readiness to carry out difficult and necessary reforms.

Moreover, no country that is part of the internal market is neither an EU nor an EFTA member state. Switzerland is the only one that is not a member state of the European Economic Area (EEA) but still has a set of bilateral agreements that create a legal framework similar to the EEA. Benefitting from the four freedoms is only possible if every member of the Single Market applies the EU legal framework linked to the free movement of goods, services, persons, and capital. EFTA accession needs the EFTA council's approval by consensus. All the EFTA members contribute to the cohesion of the Single Market, but they are all developed economies. Ukraine would be the first EFTA member to need support, rather than give it.

3.2.3. Sub-scenarios of scenario 1. and 2., accession tools

In both the EEA and EU accession scenarios, integration creates big opportunities as well as economic challenges for the EU and Ukraine as they are in different stages of economic development. As in the previous EU enlargements of 2004, 2007 and 2013, there is a need to secure a smooth transition. However, both sides – Ukraine and the EU – do not have to fear the difficulties that may result from enlargement. Accession agreements contain safeguard clauses that allow the effects of potential shocks linked to integration to be amortised. The safeguard clauses are selected individually to meet the needs of each new member state. There is, however, a certain set of standard clauses that have appeared in Acts of Accession during previous enlargements. Based on these past experiences, a number of strategies can be used if there are any serious economic, societal, or environmental difficulties in Ukraine or the EU. Safeguard clauses might also be included in the EEA or EU accession agreement if Ukraine still needs to make progress in the obligatory fields when the document is signed.

In the case of Bulgaria and Romania's EU accession (2007), the remedies included:

- **The General Economic Safeguard Clause** is a standard trade liberalisation safeguard measure that aims to deal with economic adjustment difficulties between the old or new member states (Article 37 of Bulgaria and Romania Act of Accession (Act, 2005).
- **The Internal Market Safeguard Clause** applies to the four freedoms and includes sectors such as energy, transport, telecommunication, agriculture, consumer, and health protection (Article 38). It was the only clause used in the case of Bulgarian airlines due to serious safety deficiencies (Commission Regulation, 2006).
- **The Justice and Home Affairs Safeguard Clause** can be used in cases of severe breaches by the new member state when implementing EU rules in criminal or civil matters (Article 39).

These first three clauses were also in the Act of Accession of the member states that joined on the May 1, 2004. They apply mainly to the first three years after accession and may be decided on by the European Commission at a member state's request.

- **The Postponement Clause** allows accession to be postponed by one year, in case of the candidate being not ready for EU membership. This tool was first used during the EU membership negotiations with Bulgaria and Romania (Article 36). It was added due to the member states' lack of certainty that the appropriate reforms would be introduced in these countries before accession. The postponement clause in the Act of Accession was activated by the Commission in the post-negotiation period.

In addition, previous EU enlargements set the date of membership within one year of the signing of the Treaty. In the case of Bulgaria and Romania, the post-negotiation period was much longer and lasted 18 months (Nikolova, 2006). A dynamic period might be applied here as well; namely, reaching a previously set goal. This procedure was also applied to Croatia's EU accession (Article 36 of Accession Resolution, 2011).

In practice, these tools might be considered useful:

- **Transitional periods.** Transitional periods are often used as an instrument in any trade liberalisation and as a mechanism to increase readiness before the opening certain markets or certain forms of cooperation. This was used in the Ukraine-EU DCFTA and every accession, too. It might concern limited access to labour markets, for instance (seven years in the case of Polish citizens going to work in Germany or twelve-year land purchase restrictions in Poland), inclusion in access to financing (gradual convergence of direct payments under the Common Agriculture Policy), or other cooperation instruments. Static periods might be envisaged as well as dynamic ones – reaching a certain level of readiness, such as the Maastricht criteria in eurozone accession.
- **Safeguard clauses and conditionality.** In the event of any market abnormalities, risks, or strong competitive pressure in any sector as well as in case of a breach in the internal market or not meeting commitments of accession by the candidate and new member state, a safeguard clause might be applied that limits access to markets or penalises infringement. If the EU rules are not implemented properly in the area of Justice and Home Affairs (in scenario 1 only), a JHA safeguard clause might be applied. It might lead to the suspension of specific rights under the EU *acquis*. Shortcomings might also have automatic penalising effects, such as the member state's inability to use the EU funds or the temporary suspension of the payment of funds until the conditions set by the Commission are met (Regulation, 2020).
- **Different approaches to different sectors.** Sectors and policies need to be assessed one by one, not only when it comes to different aspects of the negotiations or different transitional periods during accession. For the EEA, the example is Iceland's and Norway's fisheries policy, independent of the EU. The countries have their own fishing quotas, for instance. For this reason, the EEA Agreement allows the EU to apply safeguard measures, such as antidumping duties, countervailing measures, and measures against excessive imports of fish products, in case it is necessary.
  Similar tools might be used by new member states or the old ones in the case of adjustment difficulties in the economic sector caused by their inclusion in the EU internal market. Both sides might ask to take protective measures to rectify the situation and adjust the sector to the economy of the internal market. New approaches should not be ruled out, with exemptions for some sectoral policies.

- **Emergency break.** Both sides agreed to adopt a new cooperation approach if any unexpected socio-economic difficulties appeared. It was used for Bulgaria and Romania and mainly concerned the three-year transition period after EU accession (Article 37), (Act, 2005). In this kind of situation, a new EU member state could receive permission to apply protective measures to rectify the situation and adjust the sector concerned to the economy of the internal market. A similar tool was also developed in the Croatia enlargement (Article 37) (Resolution, 2011) and the Brexit agreement (Article 773) (Agreement, 2021), but in the latter case, the validity period is indefinite. Another example is the safeguard mechanism agreed on by the European Council in 2016, which allowed limitations to be imposed when it comes to social benefits linked to the inflow of workers (Decision, 2016).

3.2.4. Scenario 3. Remaining at the Association Agreement (AA) level of integration

The full implementation of AA would provide some opportunities to deepen it; for example, by increasing TRQs (Tariff Rate Quotas) for certain agri-food products. Though EEA or EU accession would give more vigour to the reform's agenda and integration perspectives, the AA scenario is already effective in terms of economic development if implemented properly – and might also be in the future. It should only be a transitional scenario for the adaptation process. For example, it does not include joining the EU Emission Trading Scheme (ETS); rather, it involves launching Ukraine's own ETS in accordance with the EU ETS. Its implementation is being prepared, but if any obstacles prevent the launch of Ukraine's ETS, the Carbon Border Adjustment Mechanism might be applied by the EU. However, if the reforms in Ukraine stall and it does not meet the seven EU recommendations or has made no progress in the main fields identified by the EU in October 2022, this might become the only possible scenario. It might happen due to internal problems in the EU; as enlargement is a problematic issue, it requires consensus between the member states. If, for any reason, scenario 3 materialises, Ukraine will remain as part of the free trade area with the EU in force since 2017. The DCFTA entails vast access to both markets, with most transitional periods in duties coming to an end in 2023; however, a few exceptions are mentioned in the appendixes. The third scenario limits the possibilities linked to the movement of capital and migration, in contrast to the two previous scenarios. Nonetheless, there are still benefits offered by DCFTA's and AA's that are not being used. They can be reached with continued reforms, especially in non-trade areas (Rabinovych, 2022). Bringing the regulations in Ukraine closer to those in the EU might prove very effective in attracting investments and closing the gap between the EU internal market and Ukraine.

Conclusions

Ukraine faces a formidable task. In addition to the challenges posed by the war, there is an urgent need to enhance the functioning of the state during wartime, prepare for postwar reconstruction, and seek integration with the EU simultaneously. To address these objectives, our report identifies critical areas that require development in the short, medium, and long run.

In the short run, the main priorities encompass financial, military, and humanitarian needs, reconstruction support, and improving trade conditions. Presently, Ukraine operates within the context of a war economy. More than half the state budget for 2022 and 2023 has been allocated to financing direct war-related needs. The bulk of budgetary revenue stems from taxes and government bonds. Nonetheless, Ukraine also requires funding for social payments and other expenses, which are sourced from grants and loans provided by foreign partners. Since February 24, 2022, Ukraine has received over USD 56 billion in foreign financing through grants and loans. Continuous military assistance remains crucial for Ukraine, which requires increased ammunition deliveries, the replenishment of vehicles, support for Ukraine's air defence, and long-range weapons. Ukraine must also be prepared for various humanitarian crises, including chemical, biological, and radioactive attacks.

The ongoing discussions centre around Ukraine's reconstruction trajectory and stakeholders' involvement. The World Bank estimates the costs at USD 411 billion, a figure that keeps growing as the war continues. Three key conditions must be met: mutual trust among all the reconstruction stakeholders, adherence to the Build Back Better principle, and compliance with EU standards. Addressing trade challenges is also imperative; in the short term, this will mean increasing the capacity of intermodal transport terminals at the Polish-Ukrainian border and streamlining customs procedures. Medium- to long-term goals include the reconstruction of the Ukrainian railway network, adapting it to European standards, and the development of other transport infrastructure.

Ukraine will need to attract private investments to fully recover and ensure long-term, sustainable economic growth after the war. The investments might be war-, reconstruction- or EU-related. Drawing on Poland's experience, Ukraine can employ investment incentives, such as creating industrial

parks, special economic zones, and government grants. However, removing institutional barriers to investments, such as corruption, bureaucratic hurdles, judicial issues, and challenges in enforcing contracts, is even more crucial. Given Ukraine's high business risk level (according to OECD classification), establishing a war risk insurance mechanism with EU support is pivotal. Fiscal incentives for investments and investment vehicles also improve the investment climate in Ukraine.

In the long run, Ukraine's effective integration with the EU will be a pivotal factor influencing the pace and quality of postwar reconstruction. This integration could accelerate private investment on a larger scale. Aligning with the EU Single Market could serve as a stable foundation for Ukraine's economic growth. To achieve this, it must adopt EU regulations, achieve legal stability, strengthen the rule of law, bolster judicial credibility, and implement investment protection tools. Poland's experiences in independent monetary policy, robust local institutions, efficient public procurement mechanisms, and well-developed capital markets could provide valuable insights. Among these considerations, a move towards greater exchange rate flexibility is essential. Another critical facet of Ukrainian governance is decentralisation. The path to integration with the EU market could unfold through three distinct scenarios: EU accession, joining the European Economic Area, or maintaining integration at the DCFTA level. Nevertheless, Ukraine's EU accession remains the most favourable scenario, in terms of the country's economic ties with its Western partners.

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