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## **THE POLICY OF DEVELOPMENT OF THE DOMESTIC MARKET AND EU-UKRAINE ASSOCIATION AGREEMENT: COMMON AND CONTRADICTING OBJECTIVES**

*The author investigates the regularities of growth of Ukraine's domestic market, analyzes the experience of the corresponding government policy in 2000-2013, and evaluates its performance after Ukraine's accession to the WTO and Association Agreement with the EU. Also the authors assesses this policy's ability to solve two key problems of the national economy, i.e. simultaneous raising the consumers' purchasing power and stepping up investment in the sector of commodity production<sup>1</sup>.*

**Key words:** economic growth, domestic market, structural changes in demand and supply, investment, consumers' purchasing power, public policy, protectionism

**JEL: O110, O250**

**Posing the Problem.** Domestic markets<sup>2</sup> are one of the most effective means to develop national economies. This is because the national products and services are moved first to the domestic sectoral markets, where their production becomes massive, and then it begins to further expand through exports. Therefore each country, which aims to raise the competitiveness of the national economy and ensure its accelerated growth in the future, starts to implement the corresponding plans with increasing its own domestic market, turning it into a platform for expansion for the national innovation based and better quality products in the world economy.

**The study's relevance.** Ukraine has over twenty years' experience of domestic market regulation. Objectively, it is an important task of economic science to assess the achievements and failures on that path. The need to resolve this task is emphasized by the signing of the Association Agreement between Ukraine and the EU and its ratification by the Verkhovna Rada of Ukraine and the European Parliament. Ukraine's implementation of the Agreement stipulates quite a substantial reform of the domestic institutional environment of the domestic market with a view to becoming part of the Single European Market of the EU Member Countries.

Upcoming major tasks of economic policy on the domestic market will inevitably give rise to the question: how will it meet the national economic interests of Ukraine related to the development of its national economy and increased welfare? There is only one way to respond to it - to explore the common and contradicting between the political tasks to providing future growth of the domestic market and observing the provisions of the Agreement.

**Research Methodology<sup>3</sup>.** To summarize the regularities of growth of Ukraine's domestic market and its impact on the development of the domestic economy, the author has used observations of the State

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<sup>2</sup> In economic literature, the concept of "domestic market" is used to generalize the totality of sectoral markets on the economic territory of the country, where its residents are engaged in goods turnover to meet consumer and production needs in resources, goods and services, including imports. The volume (size, capacity) of a domestic market is interpreted as an indicator that allows to estimate the total market value of final goods and services purchased by a country's residents on its economic territory for a certain period.

<sup>3</sup> In the article, the subject of study is the domestic market, and the subject matter is the state regulative policy. In economic science, diverse phenomena are studied by means of positive economic theory. Its main purpose consists in, using hypotheses or generalizations based on facts or models, to reveal regularities of the development of an economic phenomenon. If, in the economist's opinion, it is advisable to change such regularities, he starts to develop his judgments as to what they should become in the future, and what institutional or resource levers (at the society's disposal) should be used for that purpose. This line of research relates to the normative economic theory. It gives no place for sophisticated economic hypotheses, models or generalization, because it is based solely on the wishes of the future change of the research subject and set of policy measures that should be used for that purpose, the experience of their use in other countries and so on.

Statistics Service of Ukraine, experts of the World Economic Forum and World Bank, and assessment of Ukrainian scientists H.Volynskiy, K.Kurbanova, O.Pushkar, V.Tohtarova, O.Vyshnevskiy on differentiation of incomes, which were selected and systematized based on the methodology of researching market structural changes. To develop proposals to change the vector of development of the domestic market, specific arguments and evidence on the feasibility of the introduction of the protectionist policy of import substitution in Ukraine are used, which are contained in the works of Ukrainian scientists I.Dunayeva, V.Babayeva [1] Ya.Zhalilo, and V.Hatska [2].

**The main purpose of the study** is defining the main problems of the domestic market, analyzing the retrospective experience of their solution and within future political measures to be implemented in accordance with the provisions of the Association Agreement with the EU.

**The main results of the study** is identifying the key problems of Ukraine's domestic market by using the facts, which characterize, in the international dimension, the dynamics of its expansion and its impact on welfare.

#### **Ukraine's domestic market of in international comparisons**

During 2000-2013, average annual growth of Ukraine's domestic market was 3.6%. In 2013, its volume reached 88.7% as compared to 1990. The value of Ukraine's domestic market is not lesser than in many countries participating in the world economy. Thus, according to specialists of the World Economic Forum, in 2013-2014, by the size of domestic market, Ukraine ranked 36th among 148 countries, which is illustrated by the table.

Table

**Ukraine in the world ranking by size of domestic market**

Country	World ranking	Country	World ranking
USA	1	Turkey	16
China	2	Poland	20
India	3	Sweden	34
Japan	4	<b>Ukraine</b>	<b>36</b>
Germany	5	Romania	43
Great Britain	6	Czech Republic	46
Brazil	7	Kazakhstan	55
Russia	8	Azerbaijan	77
France	9	Georgia	102
Italy	10	Moldova	126

*Source:* constructed using data from: The Global Competitiveness Report 2013–2014 / World Economic Forum. – 2014. – P. 518. – available at: <http://www.weforum.org>

At the same time the trend in this ranking is disappointing for Ukraine. Thus, in 2007-2008, by the size of the domestic market, this country occupied 27th place among 131 countries [p. 88]. Explaining the fall of Ukraine's ranking exclusively by the consequences of the global financial crisis of 2008-2009 is impossible, because it simultaneously affected all countries. This leads to the conclusion that in the last six years, the domestic market in Ukraine grew slower than in other countries.

Slow growth of the national domestic market affects the welfare of Ukraine's population. One can assess its dynamics and level with the use of economic indicators that reflect the international dimension of the purchasing power of domestic consumers and GDP adjusted by purchasing power parity per capita (the GDP PPP per capita).

For example, according to the ratings compiled every year by the specialists of the World Economic Forum in 2007-2008, by the criterion of "consumers' purchasing power" Ukraine ranked 82nd, and in 2013-2014 – this country occupied 86th place [p. 485]. At the same time, according to the World Bank, in 2013, the GDP PPP per capita in Ukraine amounted to 8,78 ths USD, which is 4-6 times lower than in developed countries, almost three times lower than in Slovenia and Czech Republic, 2.5 times lower than in Poland, Latvia and Hungary and half the level of Turkey and Romania [5].

### The impact of the domestic market on the development of national economy

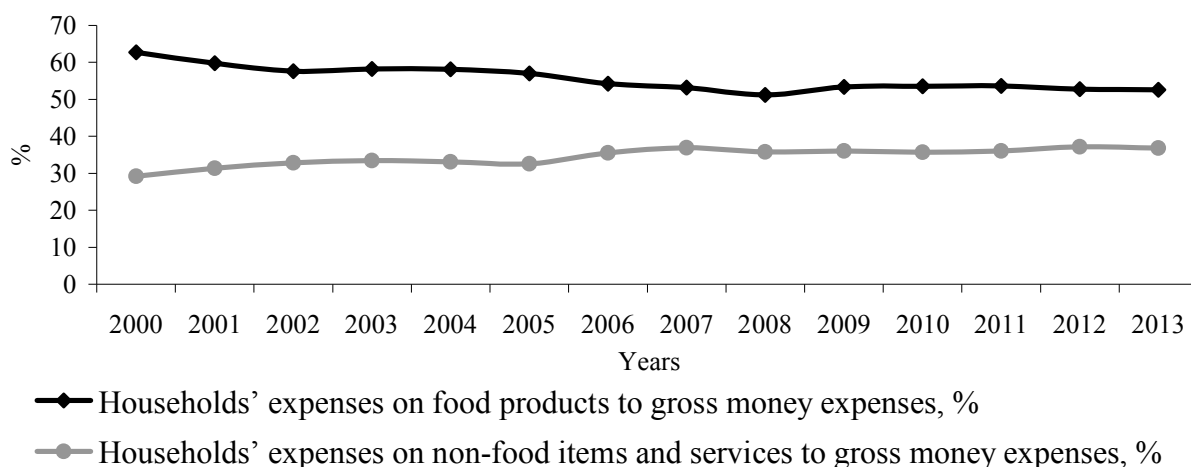
Dynamic economic growth is usually a consequence of the development of national economies. To assess its level, economic science uses the indicators enabling the accumulation of qualitative changes in commodity and non-commodity sectors of production. That is why the number of such parameters can be great ranging from output of high-tech products to services in the field of communication, health, education and so on.

At the same time, their number can be significantly reduced if one recognizes the national domestic market as the source of national economic development. This makes it possible to assert that *Ukraine's economy has been developing symmetrically to the expansion, on the domestic market, of structural change in aggregate demand and aggregate supply in favor of the innovation based and better quality products*. Let us follow the dynamics of changes of Ukraine's domestic market in 2000-2013.

**The intensity of structural changes in aggregate demand** on the domestic market of the national economy can be measured by the index of *discretionary income*. Its value reflects that portion of the households' net income, which can be spent after they satisfy their needs in basic consumption goods and services.

The greater the households' discretionary income, the more money they can allocate to purchase innovative and better quality products on the domestic market. Small discretionary income means that the households spend the lion's share of their incomes on food and utilities, which, as is well known, is a sign of the society's poverty.

From the above it follows that increase in households' expenses on consumer goods and services with a simultaneous reduction of the expenses on food is a sign of the growth of their discretionary income. One can evaluate how this indicator changed in Ukraine's economy in 2000-2013 with the help of data of Figure 1, which reflects the dynamics of the households' expenses on food and non-food products and services.



**Fig.1. Dynamics of the structure of the households' expenses on Ukraine's domestic market in 2000-2013**

*Source:* constructed based on data provided by the State Statistics Service of Ukraine for the respective years.

Fig. 1 shows, as the, the dynamics of the households' money expenses on food products (upper curve), and, on non-food items and services (lower curve) in 2000-2013. Studying these curves allows to reveal the following economic trends.

Over the recent thirteen years, in Ukraine's economy, the share of the households' expenses on food has decreased by more than 10 per cent points. Despite this, it still exceeded a half of the households' consumer budget. At the same time, the households increased their spending on non-food items and services by 7.6 per cent points, i.e. those expenses grew on average by only 0.58% a year. In its essence, this value can be considered as the average annual growth rate of the households' discretionary income (which they can spend at their own discretion).

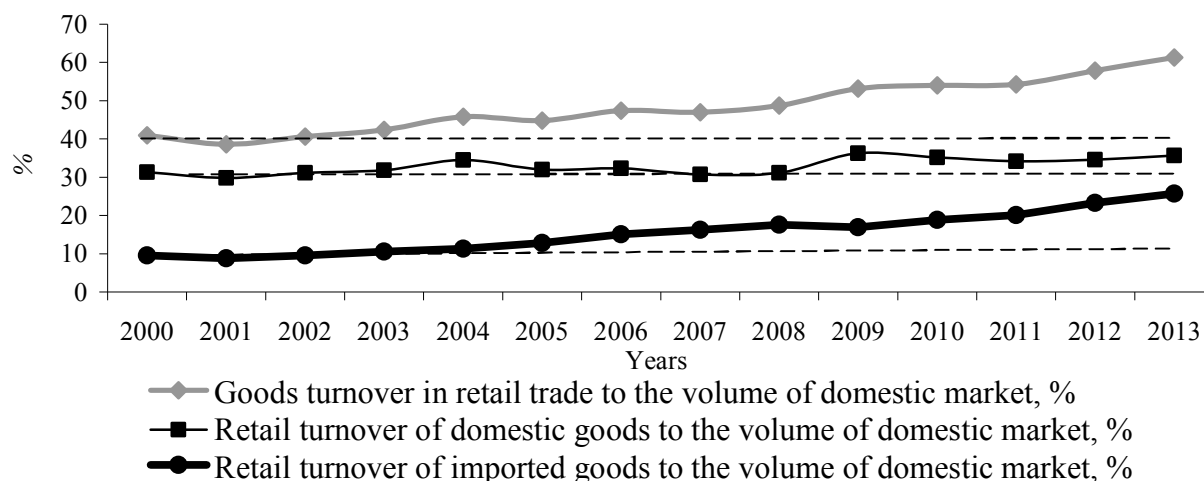
The slow growth rate of the households' discretionary income considerably limited their possibilities to purchase large volumes of innovative and top quality products and services. As is known, in the global economy, most such items are produced in the high-tech industries such as: microelectronics, telecommunications, mechanical engineering and instrumentation, air transports, pharmacy, and are related to the production of new structural materials, creation of integrated high-speed transportation systems and so on.

So it is no wonder why, in Ukraine, with its numerous higher education institutions and research centers, and a large number of highly qualified scientific personnel, the structure of commodity production has never changed in favor of the sectors that most intensively use the modern scientific and technological progress.

At the same time, Ukraine has a significant potential to increase the discretionary income of its consumers. However, its implementation is possible only with the increase of the households' incomes to the point where food consumption will be reduced to 12-20% of total consumer spending, as happened in the developed world.

**The intensity of structural changes in aggregate supply** on the domestic market of the national economy can be investigated using indicators characterizing the adaptation of commodity production to consumer demand patterns. To study this process in Ukraine, the author selected various indicators reflecting the volume of retail turnover and the shares domestic and imported consumer goods in its structure.

In the process, it was taken into account that the growth of purchases of imported items on the domestic market is a sign that the domestic producers poorly react to the changes in consumer demand patterns, that is, they fail to adapt to them. The dynamics of the above indicators in Ukraine's economy in 2000-2013 is presented in Fig. 2.



**Fig. 2. Dynamics of Ukraine's retail turnover and shares of domestic and imported consumer goods in its structure in 2000-2013**

*Source:* constructed based on data provided by the State Statistics Service of Ukraine for the respective years.

Fig. 2, with the use of curves, presents the time series of Ukraine's indices of retail trade and shares of domestic and imported consumer goods in its structure in 2000-2013. For a visual comparison of their dynamics, the author has placed the dotted lines that capture the value of these indicators in 2000. Studying the data of Fig. 2 makes it possible to prove the existence of the above mentioned economic trends on Ukraine's domestic market.

In 2000-2013, in Ukraine's economy, favorable conditions were formed for increasing the output of consumer goods. In particular, during that period, the households' consumption expenses tended to increase, which is evidenced by an increase in good turnover in the retail trade. Thus, while, in 2000, the value of retail trade turnover was 40.9%, in 2013 it constituted 61.1% of the domestic market, i.e. the increase amounted to 20.2%.

At the same time, the increase in consumer spending on the domestic market failed to produce a symmetrical expansion of the supply of domestically made items. Thus, while, in 2000, retail sales of domestic consumer goods amounted to 31.3%, in 2013 it was 35.5% of total volume of domestic market meaning a growth of 4.2%. This fact shows that *Ukraine's domestic market failed to fully perform the function of the adaptation of domestic commodity production to the changes in consumer demand*. As a result, in 2000-2013, the rapidly growing consumer demand was largely satisfied by imports. Thus, in 2000, the share of imported consumer goods in the total volume of domestic market was 9.6%, and in 2013 - 25.6% meaning a 16% growth.

***The consequences of the slowdown of structural changes in aggregate supply on Ukraine's domestic market*** are well known because they are often discussed in the media and scientific literature. Among them, the most important and frequently commented are the following:

*1. Differentiation of people's incomes.* If the owners of domestic enterprises have no sufficiently strong incentives to produce innovative and high quality items, they begin to spend their incomes on consumption, such as purchasing expensive realty (including abroad) and luxury goods instead of investing. As a result, in the national economy, income begins to aggravate, which raises social tensions and motivation to active social protests.

In the domestic market are all signs of distorted redistribution of income in favor of employers - owners of large enterprises. This is shown by the difference (differentiation) in different income strata. It is often measured as the ratio of wealth levels - 10% of the wealthiest to 10% of the poorest (decile coefficient). In Ukraine, it is difficult to calculate the decile coefficient because of the "shadowing" of incomes both of employers and employees. As a result, in the scientific literature, can find different estimates of income differentiation Ukraine.

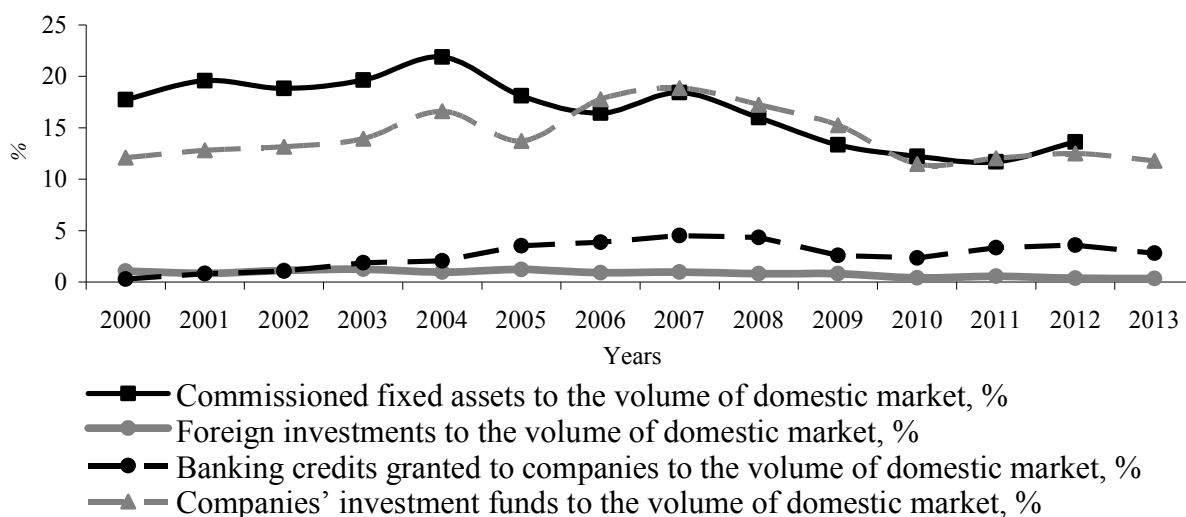
According to calculations by scientists, in 2008, in Ukraine, the incomes (including "shadow" ones) of 10% wealthiest citizens were 12 [ ] and in 2011. - 11 times higher than those of the 10% poorest citizens [p. 71]. From the experience of developed countries we know that the optimal value of that ratio should be much lower. For example, in the US, final incomes of the 10% wealthiest are 5.5 times higher than the those of the poorest, in Great Britain - 4.1 times, and Germany, Canada and Japan - 3.7 times, and in Sweden - 2.7 times [p. 80].

The problem of big income differentiation in Ukraine is also suggested by other experts. It is believed that the most accurate assessment of income differentiation by country is provided by the index reflecting relative income of 1% of the richest citizens to total national income. In Ukraine, such information is absent. Indirectly, by experts' estimates, the number of citizens with a wealth exceeding 1 bln USD increased, in 2009-2012 from 8 to 21 [9].

However, the problem of abnormal income polarization Ukraine has not been recorded by State Statistics Service. According to its data, in 2000-2013, the income difference between the wealthiest 20% and the poorest 20% declined from 6.0 to 3.7 [1, p. 187].

*2. Technological backwardness of domestic commodity production.* On Ukraine's domestic market, the largest buyers of investment products are the producers of consumer products and services. With changing patterns of consumer demand in favor of innovative and better quality products, they have to make a choice: either to master the production of such products, or cede its domestic market to the importers. If a company decides in favor of the importers, in future it will lose potential additional incomes from the production of new items. In case the company decides to produce new items, it immediately faces the problem of change of technologies, machinery and equipment, i.e. renewal of fixed capital. This encourages the companies to enter the markets of investment products.

For the purchase of advanced investment products, the companies can use their own or banks' financial resources or attract foreign investors. To demonstrate the behavior of domestic companies on the market of investment products, Fig. 3 shows the dynamics of renewal of fixed assets in Ukraine's economy and capital investments from various sources.



**Fig. 3. Dynamics of the renewal of fixed assets and capital investments by sources of financing in Ukraine's economy in 2000-2013**

Source: constructed according to data from the State Statistics Service of Ukraine for relevant years

However, data of Fig. 3 show that, beginning with 2005, domestic companies began to rapidly lose incentives for the renewal of fixed assets. Consequently, the domestic sector of commodity production quickly began to slide to the margins of technological progress, as evidenced by the following statistics. While, in 2000-2004, the wear rate of fixed assets in Ukraine increased from 43.7% to 49.3%, in 2005-2012, the increase was from 49.0% to 76.7%. The highest rate of deterioration of tangible assets occurred in the technological sectors of Ukraine's economy. For example, in 2005-2012., the level of deterioration of fixed assets in transport and communications increased from 48.5% to 96.0%, or almost twice [10, p. 81]. The above mentioned effects of the slowing dynamics of structural changes in aggregate supply on Ukraine's domestic market are not the full list. Such consequences also include: the steady growth of the payments and trade balances due to increased imports to the domestic market, periodic devaluation of Ukraine's national currency, inflation, dollarization of the households' savings etc.. As a result, they all have been hampering the development of the national economy preventing its dynamic growth.

### **Current national policies on Ukraine's domestic market: implementation experience, achievements and failures**

Negative economic effects resulting from slow structural changes in aggregate demand and aggregate supply on Ukraine's domestic market can be overcome by means of national policy. To this end, it should be focused on solving two key problems: *increasing the households' incomes and purchasing power and raising investments in the sector of commodity production for its modernization and expansion of its capacity to meet the structural changes in consumer demand.*

A comprehensive implementation of such policy within a closed economy is practically impossible. If, in such an economy, households' incomes and consumer spending rapidly grow, it automatically causes a reduction of investments and, conversely, increased investment hinders the growth of incomes. Therefore, to enhance investment and production, the governments of closed economies have to conduct a policy of restrictions of wages and social benefits.

Ukraine has an open economy, which gives this country a chance to realize, on its domestic market, a policy involving a *simultaneous* increase in purchasing power and investments. The first step towards its realization was Ukraine's accession to the World Trade Organization (further referred to as the WTO). The relationship between these events can be explained in the following way.

On the one hand, the accession of any country to the WTO is the elimination of *protective tariffs* and opening the domestic market to importers. In turn, the reduction of import duties entails a reduction of prices for foreign goods and services on the domestic market, which automatically causes an increase in the households' purchasing power.

On the other hand, it is the *unhindered exports* of goods and services to the WTO member countries. In turn, increased exports raise the companies' earnings and their investment opportunities. At the same time, the emergence of a large number of importers on the domestic market inevitably raises the risk of bankruptcy of companies producing uncompetitive items.

This encourages owners to upgrade their companies from their own or borrowed funds or at the expense of *foreign investors* to expand production of innovative and better quality products or sell their businesses and invest the released capital in other, more effective economic activities, including the production of export products.

In any case, thanks to investments in new or modernized enterprises, the output of goods and services increases for both domestic and foreign markets. As a result, the national economy simultaneously solves two problems: the growth of households' incomes and consumption expenses and expanded investments in the economy.

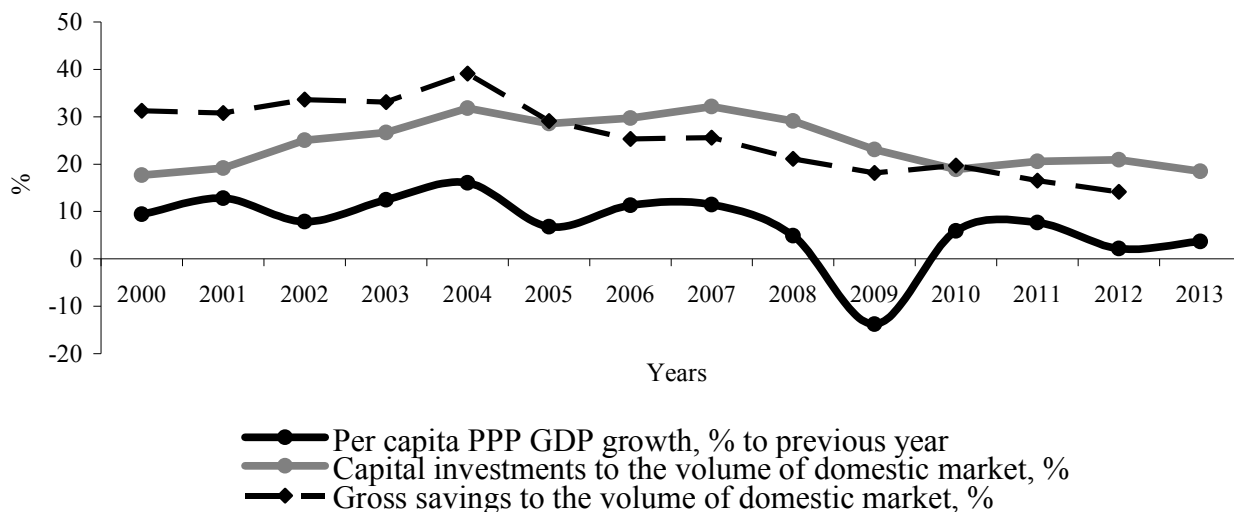
In May 2008 Ukraine acquired the status of full member of the WTO. This event was preceded by nearly fourteen years of preparatory work, thanks to which Ukraine fulfilled a significant part of the mandatory conditions for membership in this organization. In particular, during this period bilateral talks were held with countries - members of the WTO, adopted over 50 laws to adapt Ukrainian legislation to the WTO, liberalize the import duties and so on.

The seven-year period of Ukraine's membership in WTO raises, in Ukrainian society, a logical question: how did the membership in this organization affect the economic development in Ukraine? The question is difficult to answer because the long preparatory work makes it difficult to assess what Ukraine's economy was like *before* this country's accession to the WTO and *after* it.

The question is even more difficult to answer because Ukraine's accession to the WTO took place when the financial and economic crisis of 2008-2009 began to affect the world economy. Under its influence, Ukraine's economy suffered a deep recession and has not been able to recover to the 2008 level until now. In addition, the crisis in Ukraine was accompanied not only by a sharp fall in foreign trade, but also by the devaluation of the currency, banking crisis, etc.

Despite the above mentioned difficulties, one can still make some estimates of Ukraine's membership in the WTO. For that purpose, it is necessary to examine the achievements in implementing the policy of increasing this country's domestic market. The estimation is possible using indicators that reflect the trends in the households' purchasing power (in terms of GDP PPP per capita), gross savings and capital investments.

In the process, it was taken into account that gross savings of a national economy is the only domestic source accumulating all the available material and financial resources of the society, which can be used for investment activities. The dynamics of the above indicators in Ukraine's economy in 2000-2013 is presented in Fig. 4.



**Fig. 4. Dynamics of per capita GDP adjusted by PPP, gross savings and capital investments in Ukraine in 2000–2013**

*Source:* constructed based on data from: World Development Indicators [electronic resource] / The World bank - 2014. - Available from: <http://databank.worldbank.org/data/home.aspx> and the State Statistics Service of Ukraine for respective years

Data of Fig. 4 indicate that, in 2005, on Ukraine's domestic market, the growth rate of consumer purchasing power began to slow down, and gross savings and capital investments began to decrease compared to the volume of the domestic market. The development of those negative trends was not affected by Ukraine's accession to the WTO in 2008. This means that the said event did not open, for Ukraine's government, any additional opportunities to simultaneously address the two global economic problems, namely, increasing purchasing power and stimulating investments. Let's try to consider the reasons for those failures.

Visually studying the data in Fig. 4, it is easy to conclude that the negative trends associated with slower growth in purchasing power, reduction of gross savings and capital investments, began to develop simultaneously in 2005. This means that the common cause of those trends could be one event, which took place in 2005.

The economic history of Ukraine shows that, in 2005-2006, several important steps were taken to prepare the national economy to access the WTO. In particular, the Laws of Ukraine [11,12], which provided a significant reduction of protective tariffs and opening the domestic market for the importers. The scope of those laws can be described as follows:

In 2005-2006, in Ukraine, average customs tariffs for MFN trading partners were reduced from 15.9% (before changes in 2005) to 6.6% (after changes in 2005). As a result, the level of protection with tariff import of domestic economic activities significantly decreased.

For example, during 2005-2006, average tariff rate on imports of: agriculture decreased from 22.34% to 8.03%; food industry - from 34.16% to 12.2%; for other industries, in 2006, it fluctuated in the range of 5.95% (textile and leather industries) to 0.04% (coke production and oil refining) [p. 92-94].

However, the opening of the domestic market, and subsequent facilitation of the access of Ukraine's products to the markets of over 150 countries - WTO members resulted in somewhat unexpected consequences for Ukraine's economy of:

1. The households' purchasing power, despite the reduction of import duties, did not increase significantly because domestic producers began to increase exports at the expense of the products, which



previously used to be sold on the domestic market. As a result, sales of domestic products on it decreased, and prices began to approach to the world level<sup>4</sup>.

The rise of domestic prices to the global level became a factor of the reduction of the households' purchasing power. Moreover, this reduction could not be offset by the decreased rates of duty on imported products, because they mainly applied to the non-food segment of the households' consumer spending whose share was times lower than that of food products;

2. Investment activities on the domestic market failed to intensify as well, despite the growth of the revenues of domestic exporters and enhanced competition on the part of foreign producers. One can mention many reasons hindering the development of the investment process in the sector of commodity production, including incidental the reason related to the effects of the global financial crisis of 2007-2008. However, they all somehow complemented the main ones, which, in our opinion, include the following:

The first reason consists in unduly high risks for investment activities on the domestic market. Among the factors that transformed investments in Ukraine's economy into an unpredictable process, experts and scientists often mention: non-compliance with the law by the authorities and selective approach to the control over business; unstable legislation, which often changed in favor of individual business groups; imperfect legal system that did not protect investors from their competitors' illegal benefits achieved through corrupted judicial decisions, other kinds of corruption, institutionalized raiding practice, shadow business schemes and so on.

High risks of investing in Ukraine led to the fact that foreign strategic investors never appeared in the real sector, while some major domestic financial-industrial groups continued to monopolize the biggest commodity markets [14. p. 31].

The second reason is *the availability of opportunities for additional revenue on the domestic markets of traditional products*. The window for such opportunities was associated with the imperfect institutions of the domestic market, which failed to create appropriate legislative barriers to eliminate imperfect price competition on public procurement markets and abuses with the government aid granted to individual producers of goods and services.

For example, the market of public procurement has become one of the largest and most closed in Ukraine. While, in 2010, its volume amounted to 10.2% of total domestic market, in 2012 the figure increased to 18.5%. According to expert estimates and data of anonymous surveys of businessmen, in 2012, due to corruption related abuses, certain businesses and authorities managed to earn illegal incomes in the amount of 77 to 104 billion USD [p. 82].

Those amounts are almost equal to the annual volume of commissioned new fixed assets in the whole Ukraine's economy. However, it should be borne in mind that income obtained in this way are never invested in commodity production, because it was not the source of their origin. Corruption incomes are lost investment opportunities for Ukraine's economy, which are most likely spent on expensive real estate, cars, luxury goods and alike.

The third reason is the fact that *Ukrainian system of technical regulation failed to motivate producers to bring new products to the domestic market*. In Ukraine, the system of technical regulation began to reform in early 2000s in accordance with the international obligations contained in the agreements with WTO member countries on Technical Barriers to Trade and Sanitary and Phytosanitary Measures. However, the progress of the reforms in the system of technical regulation were very slow and never completed. So the unreformed system of technical regulation, on the one hand, continued to create, for local businessmen, insurmountable barriers to the movement of new products to the domestic market, and, on the other hand, did not prevent imports of cheap and therefore low-quality products.

Under these conditions, domestic producers began to lose economic incentives for expanding the outlets of their own products through improvement of their quality. They tried to win the competition with importers exclusively through lower prices. They lowered the prices by reducing the labor costs, deterioration of the products' qualitative characteristics, by moving to the "shadow" sector in order to save on taxes and so on. Eventually this led to the stabilization of the share of sales of domestically produced items on this country's domestic market.

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<sup>4</sup> A striking example of the leveling of domestic and external prices in Ukraine can serve this country's vegetable oil market. In the second half of 2007 and early 2008, due to intensive exports, the domestic consumer price for vegetable oil almost tripled.

The fourth reason is *the lack of state protectionist policy to expand domestic markets for goods and services generated by domestic producers*. After 2005, the public authorities easily opened the economy for importers and, referring to WTO rules, categorically refused any programs to support national commodity through satiation of the domestic market with new domestically produced items, including import-substituting ones. The result of this policy came very soon.

The constant increase of imports caused a negative trade balance. In order to cover the deficit, the government had to resort to periodical borrowing on the international markets. At the same time, the NBU had to use its forex reserves to support the hryvnia exchange rate.

### **Association Agreement Ukraine - EU: new opportunities to enhance the policy of growth of the domestic market**

The Association Agreement between Ukraine and the European Union and its Member States (further referred to as the Association Agreement Ukraine - EU) fundamentally changed the purpose and objectives of the national policy on Ukraine's domestic market. Its growth is a "litmus test" that eventually will answer the question whether it made sense to conclude the Association Agreement between Ukraine and the EU, and whether it is worth the social losses that Ukrainian society is suffering today for the sake of its implementation.

The Association Agreement Ukraine - EU is a unique international legal instrument, wherein the Ukrainian authorities publicly and voluntarily made a commitment to address domestic economic issues in a manner that historically formed and was used in Europe to create a common internal market. Today the European internal market is not only a free trade zone between the Member Countries, but also a customs union, an instrument providing free movement of goods, capital, services and people, a single system of technological regulation, and a common policy in the anti-monopolistic field, in regional and structural development and so on.

However, in order to understand how the Association Agreement will work in the future, it should be subjected to a purely theoretical testing for the ability to solve the problems that now put under questioned the expediency of Ukraine's membership in the WTO.

1. The first problem is associated with *increasing the households' purchasing power*. Association Agreement EU - Ukraine envisages the creation of a deep and comprehensive free trade area (FTA) in accordance with the rights and obligations that derive from membership in the WTO. It should immediately be noted that, in the short term, the incomes from increased exports to the EU will not significantly affect the purchasing power of the consumer on the domestic market. At best, over time they may only compensate for the great loss that Ukrainian exporters are now suffering from the participation in the trade war imposed by Russia. For example, according to experts, due to reduced trade with Russia and other countries of the Customs Union, in 2013, Ukraine lost about 15% of exports compared to 2012 [16, p. 80].

The only factor of the FTA that will cause increasing purchasing power of Ukraine's households is the gradual lowering, by Ukraine, of import duties on goods from the EU to almost zero level during the next five years. For example, by 2019, due to the reduction of import duties to zero, on Ukraine's domestic market, the produce of light and food industries originating from the EU is cheapen by almost 10% [16, p. 14]. However, this factor may fail to work because of the inelasticity of prices towards decline.

2. The second problem is related to *the revival of investment activities*. In order to solve it, the Association Agreement Ukraine - EU should help eliminate or at least partially neutralize the causes that hinder the investment process on the domestic market. For the revival of investments, the Agreement has provisions stipulating that Ukraine will start:

- to reduce the risks of investment activities on the domestic market through: the rule of law and strengthening of institutions at all levels of management in general and law enforcement and judiciary in particular. In this area, cooperation between Ukraine and the EU will be aimed at strengthening the judiciary, improving its efficiency, guarantee its independence and impartiality and at fighting corruption (art. 14 of the Agreement);

- to reduce the opportunities for obtaining illegal additional incomes on the domestic markets of traditional products. In this area, cooperation between Ukraine and the EU will focus on creating a transparent system of state aid, which would be compatible with the rules of competitive behavior,

characteristic for the European internal market (Art. 262-267 of the Agreement), and consistent regulatory approximation of Ukraine's legislation on public procurement to the EU law, accompanied by institutional reforms and creation of an effective public procurement system based on the principles governing public procurement in the EU (Art. 148- 156 of the Agreement);

- to reduce technical barriers to the entrance of new types of domestic products to the domestic market. In this area, cooperation between Ukraine and the EU will focus on reforming the national system of technical regulation, bringing it closer to EU technical regulations and systems of standardization, metrology, accreditation, conformity assessment and market surveillance EU (Art. 53-74 of the Agreement). Based on the experience of EU countries, one could argue that the reformed national technical regulation will be able not only to remove obstacles to the entrance of new products to the domestic market, but also to create a reliable institutional barriers that make it impossible to import cheap and low-quality products of foreign manufacturers. Due to the latter, on the domestic market, it will be possible to eliminate unfair price advantages of foreign producers importing low-quality but cheap commodity products, in so doing damaging market competition.

At the same time, the Association Agreement EU - Ukraine contains provisions which do not completely match the tasks of the public policy on the domestic market. In particular, the Agreement denies the possibility of *active protectionist policies to expand domestic markets of domestically made goods and services*. It implies that the process of removing the domestic market of new types of domestic products should be regulated by the action of market mechanisms and investment resources of Ukrainian companies, banks and foreign companies and cannot be stimulated by policy measures. That statement can be proved by the following.

In the arsenal of the most powerful protectionist state measures to upgrade the structure of domestic production in favor of innovation and better quality products are the following tools: *high customs tariffs* on imports of similar foreign products, *government procurement* of only national products, *state aid* to enterprises which implement import substituting projects and bring new product designs to the domestic market. Now consider what opportunities to use the above mentioned protectionist measures are provided by the Association Agreement between Ukraine and the EU.

The provisions of the Association Agreement Ukraine - EU stipulating the establishment of an FTA between them are built on condition that Ukraine, within five years, will practically eliminate its import duties on goods from EU countries (supplements A, B to the Agreement). In addition, the Agreement provides for access of EU producers to the Ukrainian public procurement markets on the basis of national treatment at the national, regional and local levels for public contracts and concessions in the traditional sectors of the economy and in public services (Art.148 of the Agreement).

And the last point. Association Agreement Ukraine - EU is based on the condition that the Ukrainian government will be somewhat limited in its actions concerning state aid aimed at changing the structure of the domestic commodity production. Such restrictions will directly apply to the government aid to companies that sell their products on the domestic sectoral markets with the presence of products from the EU member countries.

This follows from paragraph 2 (c) of Art. 262 of the Agreement, which states that, in Ukraine, state aid may be granted to facilitate the development of certain economic activities or certain economic areas unless it adversely affects the terms of trade against the interests of the Parties (that is against the interests of Ukraine and UE member countries). In other words, signing the Association Agreement with the EU, Ukraine voluntarily assumed the obligation not to grant any form of state aid to domestic producers of goods and services that compete or may compete with importers from the EU.

For the sake of objectivity, one should acknowledge that the above provisions of the Agreement prevent Ukraine from repeating the mistakes made by a number of countries in 70-90ies of XX century, who tried to change the structure of domestic production through government protectionism. This refers to Argentina, Bolivia, Brazil, Chile, Indonesia, Uganda, Jamaica, Mexico, Turkey, Tunisia and others. Their protectionist programs primarily focused on import substitution, protection of domestic markets, which forced domestic consumers to buy less competitive items produced by domestic companies. Naturally, such products could not be exported to foreign markets and serve a source of foreign currency to import advanced technologies in these countries. As a result, the economic development of those countries slowed down and they were eventually forced to liberalize their domestic markets by drastically (several times) reducing the import tariffs [17].

Meanwhile the above discussed provisions make it possible to assert that the Association Agreement Ukraine - EU leaves only one guaranteed way of promoting domestic produce, namely *attracting foreign investments*. Why only foreign? Because Art. 145 of the Agreement provides that Ukraine has to create such conditions that would not impede the free flow of domestic capital in the form of direct and portfolio investments, loans and other financial assets to the EU. Under these conditions, there are increased risks that only a small share of domestic capital will be invested in expanding the output of Ukrainian produce.

In literature and mass media, foreign investments and are often regarded as one of the factors of a country's economic development, including technological development. To test this assertion, the researchers of the Department of Innovation Policy, Economics and Organization of High Technologies of State Institution "Institute for Economics and Forecasting of NAS of Ukraine" carried out an investigation on the relationship between foreign direct investments and scientific-technological and innovative activities in the recipient country. The source of information for the investigation was the database of the World Bank and UNESCO's Institute for Statistics. Given that certain data are not provided by all countries, the study only covered 70 countries, which, however, account for more than 90% of world GDP.

For many researchers, the investigation's results were somewhat unexpected. They show that FDI do not really lead to increased research activities in the recipient country. The reason is probably the fact that the investors investing in the development of a foreign business usually bring their own technologies together with their funds [1, c. 12]. So if, in the future, FDI will come to Ukraine, they should not be unambiguously regarded as a factor stimulating scientific and technological activities in the sector of commodity production and this country's technological development. On the contrary, such investments may increase the risks of Ukraine's further technological dependence on the developed countries.

**Conclusions and proposals.** Following Ukraine's accession to the WTO, Ukraine, the Association Agreement Ukraine - EU gives this country's government another chance to succeed in implementing the policy of the expansion of domestic market, increasing purchasing power, poverty reduction, investment encouragement and upgrading the sector of domestic commodity production. However, the actual results of this policy will be much smaller than those potential and expected in the society due to the negative effects of trade war and occupation on the part of the Russian Federation. The maximum advantage of the Agreement, in terms of the expansion of Ukraine's domestic market, can be gained by *optimizing the sequence of its implementation*.

From the standpoint of the objectives of state policy on the domestic market, in the first place, it is advisable to implement the provisions of the Agreement, which reduce the risks of investment activities, reduce the opportunities for illegal additional incomes on the markets of traditional products, and overcome technical barriers to the production of new types of domestic products. At the same time, the implementation of those provisions of the Agreement, which restrict Ukraine's possibilities to conduct state protectionist policies of the expansion of domestic production should be maximally postponed.

Without such a policy, the implementation of the Agreement would increase the risks of the scenario in which the financial support from EU investors will come to the most profitable domestic industries (mainly related to primary processing and exports of raw materials), while those less profitable (but capable of producing innovative and qualitatively better products) will bankrupt under the pressure of competition from the importers. In this case, Ukraine will not receive any significant benefits from the Association Agreement with the EU and will only consolidate the right to supply raw materials and semi-finished products to the European internal market.

In our opinion, a differentiated sequence of the implementation of the Association Agreement with the EU makes it possible for Ukraine to carry out medium-term structural changes in the sector of commodity production. They should start with the definition of medium- and long-term targets of the encouragement of domestic production, which would be subsequently embodied in specific national projects. For the maximum enhancement of the domestic market, their design and implementation should focus on the following guidelines.

*The first guideline is import substitution.* The process of import substitution on Ukraine's domestic market should start in the form of individual national projects, which should immediately

exclude the markets of imported raw materials, which are absent in this country and those, which are in small amounts purchased on foreign markets. The projects should extend only to the largest markets of imported products, which can be produced on domestic enterprises and whose purchases require considerable funds in foreign currency.

It is advisable to choose such types of products within the following product groups: land vehicles whose imports in 2013 amounted to 37.1% compared to the value of Ukraine's negative trade balance; boilers, machines, instruments and mechanical devices – 22.5%; polymers, plastics - 21.6%; pharmaceutical products - 20.9%; electrical machinery and equipment - 17.8%; meat, edible offal, fish - 8.2%; and footwear - 4.2% []. A more detailed study of these groups makes it possible to conclude that, in Ukraine, in order to reduce imports, it is advisable to start production of better cars, city buses, streetcars, trolley buses, machines and equipment, electrical appliances, power tools, construction materials, pharmaceutical and polymer products, shoes etc.

*The second guideline is the deepening of the existing processing of natural resources.* Probably the largest national project in this direction could be a program of livestock and poultry, within which part of coarse grains would be processing into feed to raise the output of animal products, including meat, milk, and eggs for the domestic market. Equally important national projects could be a program of energy and heat saving in municipal services, reduction of fuel consumption in transport services, natural gas consumption in the steel and chemical industries and so on.

*The third guideline is the increase in the output of high-tech products for the domestic market.* When you include such produce into the national projects, the public authorities should follow the uniform rule that state support should be only granted to those manufacturers who are able to bring to the domestic market high-tech products and services, which could be potentially sold in large volumes domestically and exported to the outside world economy. Such projects in Ukraine could be: organic production of agricultural products and foodstuffs from it, biofuel, gasoline Euro-4 and Euro-5, military equipment, weapons, hybrid car, passenger and transport aircraft, software, services of industrial recycling of urban wastes and so on.

Certainly, the outlined guidelines can be specified, detailed and modified, but without their definition and implementation using protectionist measures, including those used in the UE member, the European future of the domestic economy may appear very far from the modern expectations related to the signing of the Association Agreement Ukraine - EU.

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