

ECONOMIC PROSPECTS FOR KALININGRAD

BETWEEN EU ENLARGEMENT AND RUSSIA'S INTEGRATION INTO THE WORLD ECONOMY

EVGENY VINOKUROV

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EVGENY VINOKUROV*

Abstract

The Kaliningrad oblast of Russia is currently an important focal point of discussions between the European Union and Russia. Although small in terms of geography and population, Kaliningrad has grown in importance due to the EU enlargement process. Since the break-up of the Soviet Union, the oblast has become an exclave of Russia, and it is now set to also become an enclave within the EU. This paper examines the state of Kaliningrad's economy and trade. The economic crisis that took place in Russia in the 1990s had severe consequences for Kaliningrad, as old patterns of production and trade were disrupted. Since 1999, however, the regional economy has grown with impressive speed. Kaliningrad's Special Economic Zone (SEZ) status has played a crucial role in determining its new patterns of production and trade specialisation. The paper argues that the SEZ regime has made the region's economic growth faster but also vulnerable.

The paper also looks at the potential impact of EU enlargement and Russia's WTO accession. Here, Kaliningrad may be vulnerable to twin shocks. However, the impact is likely to be mixed, representing dangers to Kaliningrad in the short-run but providing it with new opportunities for economic development in the medium- and long-term. Various scenarios are reviewed that include factors such as the existence/abolition of the SEZ regime, Russia's WTO accession and an EU-Russian common economic space. The paper concludes with an argument for an increased appreciation of Kaliningrad's position by both Russia and the EU and for a careful approach to drafting a new SEZ regime that provides for a long transition period.

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1. Introduction

The Kaliningrad region is currently an important focal point of discussions between the European Union and the Russian Federation. Although small in terms of geography (15,100 km²) and population (955,000 residents in 2002), Kaliningrad¹ has grown in importance due to EU enlargement. Since the break-up of the Soviet Union, the Kaliningrad oblast has become an exclave of Russia. And with the accession treaties for Poland and Lithuania effective May 1, 2004, Kaliningrad became a Russian enclave within the EU.



Kaliningrad is situated on the southeast coast of the Baltic Sea. It is a part of Russia detached from the mainland (an exclave). The Kaliningrad Region came into being after WWII when East Prussia was divided between Poland and the Soviet Union. Approximately two-thirds of former East Prussia (an exclave of Germany itself since 1919 and until 1939, when Poland was annexed) was integrated into Poland, with the remaining one-third (Nordostpreussen) initially becoming Königsberg and then renamed Kaliningrad. The German population was convoyed out of the region, and hundreds of thousand of migrants were brought in from all over the Soviet Union. Since the economy as well former

trade patterns were virtually extinguished, a new economy was built integrating Kaliningrad into the Soviet economic system. Nevertheless, some remnants of the German economic legacy are still in evidence (e.g. port activities, amber mining and the pulp and paper industry).

The Russian economic crisis of the 1990s had severe consequences for Kaliningrad. By 1999, industrial production fell by 62% compared with 1990, as old patterns of production and trade were eroded. Since then, however, the economy has been growing with impressive speed. New trade and production specialisations have evolved over time. Much of the region's economic development is attributed to the existence of the Special Economic Zone (SEZ). Despite its many controversial aspects, the SEZ regime has accomplished its main purpose: to keep the oblast afloat in the midst of economic disruption in the 1990s and then to allow it to recover strongly since 1999. The sustainability of the present SEZ regime as a model regional economy is doubtful, however, since the Kaliningrad oblast does not have much influence on either Moscow or the EU. The most important external factors that determine its economic

¹ In this paper, the terms Kaliningrad, Kaliningrad Region, and the Kaliningrad oblast are used interchangeably.

future include Russia's federal policy towards Kaliningrad (with the SEZ regime as a core element), EU enlargement, Russia's WTO accession and development of an EU-Russian Common European Economic Space (CEES).

In a wider context, the Kaliningrad Region, being part of the Russian Federation, finds itself between Russia and the EU. As such, the oblast is vulnerable to twin shocks from, on the one hand, the EU enlargement, and, on the other hand, Russia's struggle for integration into the world economy, of which the WTO accession and the creation of EU-Russian common spaces are instances. These processes could represent serious dangers to Kaliningrad's regional economy. On the other hand, they might provide the oblast with new opportunities for economic development.

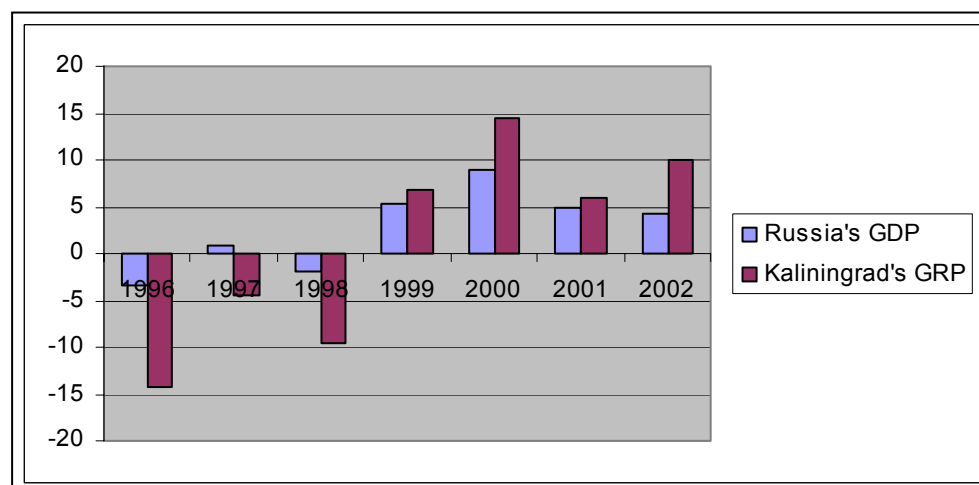
The paper is organised along the following lines. It starts with an overview of the state of the Kaliningrad regional economy, focusing on trade and production specialisation (Section 2). It goes on to assess the potential economic impact of the forthcoming EU enlargement and Russia's entry into the WTO on Kaliningrad's economy (Section 3). This is followed by a discussion of external factors and processes that may have an important impact upon Kaliningrad. On this basis, scenarios for economic development are then drawn (Section 4). Finally, main conclusions are summarised (Section 5).

2. Economy and trade: Strong but vulnerable growth

2.1 Economic growth since 1999 and SEZ regulations

Recent economic developments are encouraging. Output has been growing constantly since the 1998 financial crisis and devaluation of the ruble. Gross regional product grew 6.8% in 1999, 14.4% in 2000, 6.4% in 2001 and 10.1% in 2002. It is worth mentioning that, whereas until 1998 the Kaliningrad GRP (gross regional product) tended to fall faster than the national average, it has grown considerably faster since 1999. This tendency has held constant in 1999-2002 (see Figure 1). Despite the fact that the impact of the ruble devaluation has considerably lessened over time – as important as it was especially for import substitution industries in Kaliningrad – economic growth has steadied.

Figure 1. Kaliningrad's GRP in comparison with the Russian GDP, 1996-2002 (%)



Sources: Kaliningrad Regional Committee for Statistics (2002); Kaliningrad Regional Committee for Statistics (2003) and Russian Federal Government.

The flow of Russian and foreign investment is generally on the rise. The larger part of investment comes from mainland Russia, with foreign investment still being very scarce (Table 1). Besides, a significant part of foreign investment coming from countries such as Cyprus or the Virgin Islands is in fact investment from Russia accessing the region through off-shore entities. While exact data for investment coming from mainland Russia are lacking, it is likely to be several times higher than foreign investments.

Table 1. Foreign investments in Kaliningrad, 1998-2002 (\$ million)

	1998	1999	2000	2001	2002
Foreign investments, total	39.4	18.3	19.1	24.6	47.7
FDI	17.8	3.4	4.2	4.3	26.6

Source: Kaliningrad Regional Committee for Statistics (2003), p. 128.

Trade flows are growing rapidly. By 2002, foreign trade has returned to its highest levels initially reached in 1995-96. Trade with mainland Russia is now as intensive as ever, growing by 10 to 30% every year. Kaliningrad enterprises have set up in the Russian market as producers of processed goods (foods, furniture, consumer electronics and cars), whereas Russian regions supply Kaliningrad with energy and all kinds of raw materials ranging from fuels to metals and wood.

Bearing in mind the official goal of both the Russian Federal government and the Kaliningrad Regional administration – to match living standards in neighbouring Poland and Lithuania – it is of great interest and practical importance to know the ratio of the living standards in Kaliningrad in relation to those in Lithuania and Poland in purchasing power terms. Research by Samson et al. (2002) has shown that living standards in Kaliningrad approximate 90% of those in Lithuania and 75% of those in Poland.² There is definitely a big difference (75% is also the figure for Spain in relation to Germany), but it is not as drastic as it was believed to be.

However, much of the region's economic development is attributed to the existence of the Kaliningrad Special Economic Zone (SEZ) (see Box 1). Overall, the SEZ has accomplished its main purpose: to allow the oblast to stay afloat and to survive in unfavourable exclave conditions through some extremely difficult years.

Box 1. The Kaliningrad Special Economic Zone (SEZ)

The Kaliningrad SEZ is very specific and unlike most other special economic zones throughout the world. The regime of a special (free) economic zone was introduced in the Kaliningrad oblast in 1991. Since 1996, the main legal document specifying its design is the Russian Federal Law "On a special economic zone in the Kaliningrad Oblast". The SEZ is a part of the Russian state and customs territory. Basically, the contents of the Law on the Kaliningrad SEZ were reduced to those of a free customs zone, but one of a somewhat unusual nature. As is typical in a free customs zone, there are no import taxes in Kaliningrad. However, goods deemed to be of local manufacture and exported to the Russian Federation will be exempt from customs duties. It should be noted that under the heading of

² Samson et al. (2002); Samson (2003); Lamande et al. (2004). The research, in compliance with Eurostat methodology, was done on the basis of comparisons of living standards in Lithuania and Kaliningrad. According to the results, the ratio of Rur/Lit in 2001 was 0.95. However, one should take into account the applied research methodology: only consumer spending was questioned. The inclusion of governmental spending, etc. would lower the figure to probably 0.9, according to the above sources.

‘Customs Duties’ the following taxes are included: duty, excise and VAT. In order to enjoy customs privileges, the goods must satisfy the following conditions:

- for electronics and household appliances: 15% value-added + changing the Tariff Nomenclature code’s 5th digit, and
 - for other goods: 30% value-added + changing the Tariff Nomenclature code’s 4th digit (and some additional criteria for automobiles, tractors, etc.)
- Custom privileges constitute the core of the SEZ regime. All other preferences, including the ones for investments, are just mentioned in the Law of SEZ and not included in other federal law. Hence, they do not function in practice.

The existing customs privileges gave impetus to entrepreneurial activities in the region and to foreign economic activities in particular. They created an incentive to use cheaper imports for their processing in order to enter Russian markets. On the other hand, the SEZ regime suppressed, i.e., agriculture that has hard time competing with cheaper imports. Another problem often raised in this respect is discrimination of Russian producers in favour of foreign producers. This happens because VAT is not raised on imports, whereas a Kaliningrad-based producer would pay VAT on goods produced in Russia.

One of the peculiarities of the Kaliningrad SEZ is the imposition of regional import quotas. Beginning in 1998, about 35 categories of goods are subjected to import quotas. The quotas, which are regularly auctioned, give the right to import goods duty-free. Imports above the quota limits enter Russian customs territory subject to the normal customs procedures. This restriction of the SEZ regime was initially introduced with the aim of protecting some local industries, with agriculture being the main concern. In practice, the quoting mechanism proved to be inefficient in reaching its main goal (see Vinokurov & Kuzin (2004).

To summarise, although Kaliningrad has its share of problems, it is not an island of poverty and decay within the enlarged European Union. It may become one, however, if it is not given attention in the context of the European-Russian dialogue. The economic problems of Kaliningrad attributable to its enclave/exclave status are manifold, as is reviewed in the remainder of the paper.

2.2 Intermediate position of Kaliningrad in European-Russian trade and high vulnerability

In 2000, Russia’s regions constituted a market for Kaliningrad goods equal in volume to that of foreign goods. The oblast’s economy is strongly connected to mainland Russia as demonstrated above. There exists a very positive trend in regional trade with mainland Russia. Volumes of trade have risen rapidly and constantly since the crisis in 1998. This trend of 1999 and 2000 continued unchanged in the years 2001 and 2002. Moreover, the trade flows with mainland Russia grew faster than foreign trade over the whole period of 1999-2002. The devaluation of 1998 explains part of this evolution. Imports have stagnated, whereas outflows to the Russian mainland led to increasing shares of the Russian domestic market. The strong increase of inflows is explained both by the volume (regional market share gains by firms from the Russian mainland) and by the price for raw materials. The customs preferences of the SEZ represent another part of the explanation.

In general, the oblast occupies an intermediate position in Russia-EU trade. With 40% of its total trade with the Russian mainland, 20-25% with the EU-15 states and about 20% with CEECs (practically all of it with its immediate neighbours, Poland and Lithuania), Kaliningrad’s trade is concentrated on the Russian regions and wider Europe. The region has

come to assume a relatively well-defined position, which accounts for a certain trade specialisation.

The intermediate trade position of the oblast is specific. Kaliningrad exports predominantly raw materials and goods with low value-added and imports more processed goods. Therefore, Kaliningrad takes a position of a typical developing country in relation to the more developed European economies. There are some specific aspects, however. For example, the rapidly growing food processing industry imports raw meat from adjoining Poland and Lithuania. On the other side, the region gets its supplies of raw materials (fuel, petrochemicals, energy, wood and metals) from Russian regions and sells processed outputs from food, furniture, cellulose and paper industries as well as assembly enterprises. This suggests that, in relation to the Russian mainland, the region plays the role of a trade partner possessing a comparative advantage in industrial production.³ This comparative advantage is based however on the existence of the SEZ regime and, to a lesser degree, on the factors of industrial endowments.

The use of a special methodology has allowed us to reconstruct numbers for trade with mainland Russia in 2000 (see sub-section 2.3 and the annex for results and methodology). Due to the lack of statistical data, it has proved to be virtually impossible to reconstruct trade with mainland Russia in the years after 2000. The statistical assessment based on the analysis of the customs certificate ‘SEZ IM 40 OEZ’ is however available. As shown in Table 2, the vast majority of outflow goes under this certificate in order to enjoy the privileges of the SEZ. In Table 2, we review the available data for 2000-2002. On the side of trade with mainland Russia, we use both the results of calculations for 2002 and data from the Customs Office for outflows.

Table 2. Kaliningrad's total trade flows, 1998-2002 (\$ million)

Year	RoW*-Kaliningrad		Russia-Kaliningrad	
	X	M	X	M
1998	297.5	1130.1
1999	281.7	800.1
2000	430.7	807.3	432.2 (424.0**)	468.9
2001	403.1	1010.5	618.9**	...
2002	408.5	1578.5	759.1**	...

* Rest of the world (excluding Russia).

** Numbers beside asterisk refer to the customs office data on industrial outflows to mainland Russia under IM 40 OEZ certificate.

Sources: North-West Customs Office (2002 and 2003) and calculations by the author.

Thus, Kaliningrad has a large trade deficit that amounts to as much as 20% of its GRP. The most obvious explanation would be the existence of vast transfers from the federal centre. Contrary to this claim, however, there are no direct net transfers from Russia. KO contributes to the federal budget approximately as much as it gets in transfers. In the opinion of the author, the trade deficit has several other explanations, with each one being responsible for a part of the phenomenon. First, Table 2 covers trade in goods only, whereas there exists a substantial surplus in services, as the transport industry makes up to 10% of the GRP. Second, there are federal transfers to support the Baltic Fleet and other compounds of the military and

³ Samson (2000 and 2002).

border guards stationed in Kaliningrad. These two factors might be responsible for a larger part of the phenomenon.

New calculations for trade flows with Russia allow us to re-access Kaliningrad's trade openness. It amounted to 267% in the year 2000 if we take official figures for gross regional product. Trade flows with mainland Russia add significantly to the regional trade openness making the oblast the third most open region in the Russian Federation.⁴ In international comparisons, Kaliningrad's trade openness is comparable to that of Hong Kong.⁵

Table 3. Kaliningrad's trade openness, 2000

	GRP (\$ million)	Total trade* (\$ million)	Trade openness**
Current Prices	837.6	2,241.7	267%

* Total trade = exports and imports plus total turnover with mainland Russia.

**Trade openness = total trade/GRP.

In general, our analysis of Kaliningrad's trade flows leads to the following conclusions:

- Kaliningrad concentrates mainly on trade with Russian regions and with the European states.
- In this trade Kaliningrad takes an intermediary position, trading with Europe as a less developed partner and with the Russian mainland as a more developed partner.
- The enlarged EU is a dominant partner in the regional foreign trade counting for approximately 75% of total foreign trade.
- Trade with Russia plays a significant role in the trade balance of Kaliningrad, representing 40 to 50% of overall trade flows.
- Inter-regional trade flows, especially outflows to Russian regions, tended to grow substantially over the next four years after 1998.
- The growth of trade is to large extent connected to the existence of the Special Economic Zone and development of import substitution industries oriented to Russian markets.

While these developments might allow us to be optimistic for further upward economic trends, it is open to doubt whether such a model of regional economic development can persist in the long run. The Kaliningrad economy has become more and more dependent on outflows to the Russian market. These outflows, in turn, largely depend on the continued use of the SEZ regulations as they are at the present time. Of course, one cannot say that the future of the SEZ status is certain. It is possible that this regime will be changed in the coming years. This may be due to Russia's WTO entry or due to further federal attempts to unify Russian economic space. Further pressure on the Kaliningrad economy arises from the EU enlargement. Any changes that put in question the possibilities of tax-free deliveries of goods to 'big Russia' would seriously endanger import-substitution industries of Kaliningrad, which have recently become prevalent in the overall regional economic structure.

⁴ After Ingushetia Republic as well as Khalmikia, which have gained their highest degrees of trade openness due to fiscal paradise functions (see Samson, 2002).

⁵ In Hong Kong, trade in goods and non-factor services reached 277% of GDP in 2001 (*WTO Trade Policy Review*, Hong Kong, China, pp. 8-9, available at http://www.wto.org/english/tratop_e/tpr_e/s109-1_e.doc). The comparison of Hong Kong with Kaliningrad is justified in this case since the WTO's calculations for the former include trade with mainland China as well as trade with the rest of the world. However, the comparison is not straightforward because trade in non-factor services is included in the Hong Kong's figure.

2.3 The enlarged EU and mainland Russia as principal trade partners

In this sub-section, we will start with the reassessment of Kaliningrad's trade with mainland Russia and then go on to characterise Kaliningrad as having the two principal trade partners, Russia (the Russian mainland) and the European Union.

Trade with the Russian mainland is of great importance for Kaliningrad – with Russia, on the one hand, serving as main supplier of raw materials, fuels and energy, and, on the other, as the 'importer' of regionally manufactured production. At the same time, the data available from either the State Committee for Statistics or the customs authorities are incomplete, which can distort perceptions of regional trade by understating numbers for trade flows with the Russian mainland. As interregional trade flows with mainland Russia are of crucial importance for the Kaliningrad region, a more exact qualitative and quantitative assessment is necessary. For the purpose of assessing the regional trade flows with mainland Russia, a special methodology was used that allowed us to estimate inter-regional trade flows on the basis of available data (see annex). This methodology is discussed in detail elsewhere.⁶

The results of the calculations in Table 4 should serve only as estimates, since they are based on many approximations. Moreover, due to peculiarities of practical usage of our methodology, the received data are *minimum estimates* of inter-regional trade flows. In other words, these figures are likely to underestimate actual flows due to the fact that only material goods are counted; the final figures do not include electricity supplies from mainland Russia nor trade in services including transport and port activities as well as tourism, as these are not reported in the turnover of Kaliningrad to mainland Russia.

Table 4. Kaliningrad's regional trade with mainland Russia, 2000

TN VED	Sectors	Inflows (\$ million)	Outflows (\$ million)
01-24	Food products	89.1	340.8
27	Fuel and energy industry	185.2	13.2
28-35, 37-40	Petrochemical industry	72	1.5
41-43	Raw leather and furs	0.1	1
44,47,48	Wood and products	34.4	18.6
72-81	Ferrous, non-ferrous metals, and products	24.3	1.5
	Other sectors	63.8	55.6
	Total	468.9	432.2

Sources: Vinokurov (2002) and Lamande & Vinokurov (2003).

These figures show that the region has strong economic ties to mainland Russia both in inflows and outflows. In 2001 it amounted to \$901.1 million at least, making up 40.2% of the overall trade (\$2,241.7 million for 2000). The additional data from the customs office support these calculations. The Customs provide the figures for goods registered according to customs' regime 'IM 40 O EZ', according to which the vast majority of goods produced in the Special Economic Zone is shipped to other Russian regions. For the year 2000, \$424 million

⁶ Vinokurov (2002, pp.12-16) and Lamande et al. (2004, pp.72-73).

worth of goods were shipped with this certificate. It is worth mentioning that this figure grew to \$618.7 million in the year 2001 and to \$759.1 million in the following year, which indicates clearly that trade with mainland Russia has continued to grow rapidly. It represents a growth rate of 43.1% and 22.7%, respectively. The products shipped to mainland Russia under 'IM 40 SEZ' in 2002 were automobiles (14.1%), television sets (11.4%), canned meat and fish (22.9%), means of transport for railroads (7.1%) and floor coverings (4%). This remarkable growth made the outflows to Russia already exceed regional exports in 2001.

The liberalisation of foreign trade in connection with a special customs regime provided by SEZ Kaliningrad led to rapid growth of foreign trade flows in the first half of the 1990s. A not inconsiderable part of these flows, however, were transit goods. The oblast was partly used for channelling tax-exempt goods into mainland Russia. This could be seen most clearly in the data on cigarette imports. The 1998 crisis has led to much lower trade flows. Nevertheless, the crisis gave a strong push to developing import substitution industries. In recent years it has become the base for renewed growth of imports and, to a lesser extent, exports. Already in 2000 exports reached the record number of \$519 million. Imports exceeded \$1 billion in 2001 and \$1.5 billion in 2002.

Generally, we can separate two stages in the development of Kaliningrad's foreign trade. The first one is 1990 to 1998 when foreign trade flows in the region grew more than ten-fold. There were two reasons for this: a) the opening of the economy and b) specifically owing to Kaliningrad SEZ privileges. Russian default in August 1998 and the devaluation of the national currency brought the first stage to an end. Beginning in 1999, strong growth of internal production supported by SEZ regulations has become the motor of trade. Export volumes grew due to higher volumes of produced and exported raw oil, cellulose and paper, fish and fish products and machine-building production. Imports grew rapidly due to a number of factors. The most important of these was the presence of growing industries that operate on imported raw materials and components and sell their production in Russian markets.

The first and the second period (1990-98 and 1999-present) have some trends in common. Beginning in 1995, the foreign trade balance was constantly negative. Having peaked in 1997 at 46.7% of total flows, the negative balance has tended to be less drastic in the last five years. Nevertheless, if in 2000 the balance was at \$-306.9 million or (-22.8%), in 2001 it again grew to -526.5 million or (-34.2%). A part of the explanation is certainly that SEZ Kaliningrad is still used as a convenient 'grey' gate into Russia, but the contribution of this factor has considerably lessened over time. Another and more important part of the explanation would be the growing processing industries aimed at the Russian market. Even those companies that used to 'misuse' Kaliningrad for smuggling of goods are currently beginning to set up processing facilities in the region.

Table 5. Dynamics of trade flows 1992-2001, Goskomstat data*

Year	X+M (\$ million)	X (\$ million)	%(X+M)	M (\$ million)	%(X+M)	X-M (\$ million)	%(X+M)
1992	145.4	91.4	62.9	54.0	37.1	37.4	25.7
1993	202.0	126.0	62.4	76.0	37.6	50.0	24.8
1994	380.0	234.0	61.6	146.0	38.4	88.0	23.2
1995	1,044.5	459.4	44.0	585.1	56.0	-125.7	-12.0
1996	1,510.8	480.0	31.8	1,030.0	68.2	-549.2	-36.4
1997	1,743.5	457.7	26.3	1,285.8	73.7	-824.0	-47.6
1998	1,617.2	429.3	26.6	1,187.9	73.4	-758.6	-46.8
1999	1,207.7	383.6	32.8	824.1	68.2	-440.5	-36.4
2000	1,344.9	519.0	38.6	825.9	61.4	-306.9	-22.8
2001	1,541.6	507.5	37.3	1,034.0	62.7	-526.5	-34.2

*There is a difference between the figures provided by the customs office and the Committee for Statistics (Goskomstat) because of the different methodologies employed by the two agencies. Customs' statistics are trustworthy but incomplete, due to the peculiarities of the basic customs documents. The State Committee for Statistics takes data provided by the customs office and corrects the figures by adding services, trade flows with Belarus, goods sold by Kaliningrad enterprises outside the region (fish and crustacean in overseas ports), shuttle trade, etc.

Notes: X = exports, M = imports, X+M = total foreign trade and X-M = trade balance.

Sources: Calculated on the basis of: Kaliningrad Regional Committee for Statistics (2001 and 2002).

Table 6. Main foreign trade partners in 2001

Exports			Imports		
Partners	Volume of transactions (\$ thousands)	Share (%)	Partners	Volume of transactions (\$ thousands)	Share (%)
Poland	125215.2	33.12	Germany	22276.70	22.74
Germany	46274.2	12.24	Poland	156052.70	15.95
US	32112.1	8.49	Lithuania	82043.50	8.38
Lithuania	31393.5	8.30	USA	41163.50	4.21
Italy	15124.7	4.00	Austria	39540.70	4.04
Cyprus	12114.1	3.20	Republic of Korea	35459.70	3.62
France	11817.2	3.13	Netherlands	31785.80	3.25
Netherlands	9505.9	2.51	Italy	31517.30	3.22
Belgium	8813.1	2.33	Mauritania	24214.60	2.47
Ukraine	8347.0	2.21	Belgium	22711.50	2.32
Total 10 main partners	300717.0	79.55		686966.00	70.20
Total EU-15	119939.8	31.73		450470.4	46.03
Total 10 accession countries	182661.1	48.32		288719.5	29.50
Total EU-25	302600.9	80.05		739189.9	75.54
Total	378 025.5	100.00		978558.2	100.00

Sources: North-West Customs Office (2001) and author's own calculations.

As follows from Table 6, Poland is a leading export partner, mostly due to the fact that it serves as the main recipient of Kaliningrad's raw oil. In 2000, Poland counted for 32.4% of exports and in 2001, 27.5%. Germany and Lithuania follow. On the import side, Germany leads with supplies of 22-25% of total imports over the last years, followed by Poland and Lithuania. EU-15 counted for 31.7% of exports and 46% of imports in 2001. The new member states (with major shares of Poland and Lithuania) make up 48.3% of exports and 29.5% of imports. As a matter of fact, the import-export ratio of the CEECs is opposite from that of the EU. Hence, EU-25 counts for 80% of Kaliningrad's exports and 75% of its imports. Thus, the enlarged EU represents the dominant trading partner, whose share may only be compared to that of mainland Russia. The trade balance with the EU-15 as well as the accession countries is negative.

Table 7. Kaliningrad exports and imports in main sectors, 1999-2001

TN VED codes	Sectors	Exports (\$ million)				Imports (\$ million)			
		1999	2000	2001	Change 1999-2001 (%)	1999	2000	2001	Change 1999-2001 (%)
01-24	Food products	30.5	36.1	46.9	153.6	265.5	356.3	348.3	131.2
27	Fuel industry	91.7	159.1	133	145	22.6	12.7	5.9	26.1
28-35, 37-40	Petrochemical industry	26.8	33.7	44.4	165.8	47.5	64	77.7	163.6
41-43	Raw leather and furs	3.7	5.2	7.3	191.9	5.7	6.3	7.5	131.6
44,47,48	Wood and related products	28.4	59	56.8	200	27.4	33.1	42.9	156.6
61-64	Clothes and footwear	20.3	19.7	21.2	104.4	16.5	20.3	26.6	161.2
72-81	Metallurgy	31	35.8	21.3	68.7	24.3	40.5	49.4	203.3
84-90	Machine-building	47.2	86.8	58.7	124.4	359.8	270.6	343.6	95.5
	Other goods	7.9	17.2	13.6	172	105.9	83.4	108.7	102.6
	OVERALL	287.7	452.2	403.1	140.2	875.2	888	1,010.5	115.5

Sources: North-West Customs Office (2000 and 2001).

In regional commodity trade, there is a clear difference between exports and imports in terms of numbers as well as in structure.

Numbers for imports are considerably higher than those for exports. Large quantities of food products and machine-building production are imported by the region. Imports of goods include two major components: foods and machine-building production. Taken together, they account for 70% of overall imports. Growing import volumes reflect three trends in regional development in recent years. First of all, modernisation of industry has sped up, which causes imports of technological production, equipment and machinery to rise. Secondly, consumption is growing in the region. Consumer goods constitute a considerable share of imports. Thirdly, it reflects the emergence of a certain production and trade specialisation. A large proportion of imports are destined to be processed and sold in Russian markets (beef, pork, chicken meat and fish in a wide variety of processed foods including canned products;

manufactured components used in assembling automobiles, household electronics, etc.). As Kaliningrad strives to find its place in the international division of labour, it demands more imported components, which are then processed and sold as finished products in mainland Russia. Most businesses of this kind are largely based on SEZ customs privileges.

Exports are dominated by raw materials and products with low value-added – oil drilled in the region, wood, pulp and frozen fish, as described in the following. First, raw oil is drilled in the region and up to 100% exported, mostly to Poland, by Lukoil. The production costs make it uneconomical to build a refinery plant in the oblast. Oil exports amounted to \$159 million in 2000 and \$133 million in 2001. The second export, ‘wood and products from wood’, is a traditional sector of the regional economy that goes back to cellulose and paper factories in the German time. Cellulose, paper and paperboard are exported. Third is machine-building production. The unsteady pace of machinery exports reflects their modest volumes and dependence on the performance of a few regional plants. The fourth largest export, food consists largely of (frozen as well as fresh) fish. A relatively small share of regional production of canned products is also exported. These export volumes are growing steadily, however.

2.4 Effective rate of protection

The purpose of calculating the effective rate of protection (ERP) is:

- first, to provide estimates of the magnitude of protection extended to industry and to distinguish protection in terms of the value-added from mere nominal tariffs, and
- second, to provide a way of determining how the entire protective structure has influenced the allocation of resources among industries within the economy and how the removal or other charges in such protection might alter resource allocation in the future.

While the nominal tariff rate of the industry (t) is defined as $t=(p'-p)/p$ where p' and p are the unit prices of the industry's output with and without tariffs, respectively, the rate of effective protection (g) is defined as $g=(v'-v)/v$ where v' and v are the value added per unit of output with and without protection, respectively. The effective rate of protection is greater the smaller the value-added of a process. Similarly given the size of the value-added, the effective rate is an increasing function of the nominal protection rate.

In Table 8, we calculate ERPs for the broad sectors under the defined requirements for the value-added. We take three cases of 15, 30, and 50% of the value-added (VA) that is (or might be) required for the Kaliningrad goods to enter the Russian markets without paying import tariffs. Under the present customs regime, the prevalent case is 30%; however, for electronics and household appliances, which fall under the category of ‘machine-building’, the rate is set at 15%. The ERP calculations for 50% of value-added should allow us to test a potential policy option of raising the thresholds of the added value.

The calculations below are limited in that they do not take into account another requirement under the present SEZ regime, namely that the goods must change their tariff nomenclature's codes.

Table 8. Effective rates of protection under various value-added requirements (2001)*

TN VED Codes	Sectors	Imports (\$ million)	Share in total imports (%)	Nominal tariff rate (%)	ERP at 15% VA (%)	ERP at 30% VA (%)	ERP at 50% VA (%)
01-24	Food products	348.3	34.5	14.7	(113)	63.7	(44.1)
28-35, 37-40	Petrochemical industry	77.7	7.7	8.5	(65.2)	36.8	(25.5)
44,47,48	Wood, pulp, paper, furniture	42.9	4.2	8.7	(66.7)	37.7	(26.1)
61-64	Clothes and footwear	26.6	2.63	11.7	(75.6)	50.7	(35.1)
72-81	Metallurgy	49.4	4.9	19.3	(148.0)	83.6	(57.9)
84-90	Machine-building	343.6	34.0	14.8	113.5	64.1	(44.4)
	Total	1,010.5	87.9	12.4**	(95.1)	(53.7)	(37.2)

* The unbracketed values are those presently applied.

** Weighted average tariff.

The ERPs are substantially higher than the nominal tariffs. As explained earlier, the ERPs are a decreasing function of the value-added and an increasing function of the nominal tariffs. The most important sectors are food processing and machine-building, which comprise the bulk of Kaliningrad's imports and outflows to the mainland Russia. It can be seen that the ERPs in the food processing and machine-building at 30% of value added are 63.7% and 64.1%, respectively. The value rises to 113.5% in the case of electronics and household appliances where the 15% requirement is applied, which makes rather primitive assembly plants a profitable business under the current conditions.

It is not by accident that Kaliningrad's weighed average tariff is higher than that established for Russia overall (12.4% vs. 10.9%). This can be interpreted as a sign of the regional economy's adaptation to the SEZ regime. This difference might indicate that, since companies have an incentive to import and process goods with the higher levels of protection, they will do it, thereby effectively changing the structure of imports and outputs over time.

The relative dynamics of ERPs are as important as the absolute numbers. First, Table 8 shows that the ERP would rise on an increasing scale if the threshold for the added value were lowered. Such a policy option as envisaged in the draft law on the Kaliningrad SEZ (see Box 2) would conserve the primitive character of industrial processing in Kaliningrad. It runs counter to the interests of Russia, as it creates an incentive to use the oblast as the 'grey gate' to Russian markets. Nor does it correspond to the long-term interests of Kaliningrad either. Although it would boost business activities in the short-run, it would drive up Kaliningrad's dependency on customs preferences and suppress other economic activities in the process – making it extremely vulnerable to any changes in policy.

An opposite policy option can be considered. It is possible to diminish the ERP progressively by raising the threshold for the value added. Table 8 shows, for example, that raising the threshold requirement to 50% would lower the ERP for machine-building from 64.1 to 44.4%.

Thus, the economy would be given an incentive to substantially raise the value-added (making the production truly ‘Kaliningrad-produced’) without abandoning the current customs regime altogether.

3. Impact of EU enlargement and Russia’s WTO accession on Kaliningrad’s economy

3.1 EU enlargement and Kaliningrad’s economy

In a wider context, the Kaliningrad Region, being part of the Russian Federation, finds itself between Russia and the EU. As such, the oblast is vulnerable to twin shocks from, on the one hand, the EU enlargement, and, on the other hand, Russia’s struggle to become integrated into the world economy, of which the WTO accession is an instance. These processes could represent serious dangers to Kaliningrad’s regional economy. On the other hand, they might provide the oblast with new opportunities for economic development. All the dominant theories of trade and industry location – from the neoclassical model to the new economic geography – predict that integration will trigger specialisation. Both processes as well as the implementation of such ideas as the Common European Economic Space (CEES) may influence the Kaliningrad economy and its trade patterns significantly.

For Kaliningrad, having the EU as its main foreign trading partner is quite natural. Now that the surrounding countries have acceded to the European Union, the latter has become Kaliningrad’s dominant trading partner. About 40% of regional foreign trade is currently realised with the countries of EU-15, 30% fall on Poland and Lithuania together, and another 5-7% on the rest of the newly acceding states. Thus, the enlarged EU will account for 75% of Kaliningrad’s foreign trade.

What effect might the EU enlargement have on Kaliningrad from an economic point of view? As a matter of fact, the discussions on the EU-Kaliningrad theme concentrate more on the political issues of border regime, transit, visas, etc. However, the economic side of the question remains virtually unexplored.

There are several aspects that we would like to make some preliminary comments on: a) the consequences for Kaliningrad’s exports once Poland and Lithuania apply the EU’s MFN regime in trade with Russia, b) the competitiveness of local producers in local markets, c) the competitiveness of local producers in Russian markets, d) visa, cargo transit, and energy supplies as separate issues and e) the impact on shuttle trading.

(a) *Exports.* The authors of the Commission’s Communication to the Council of Ministers issued in January 2001 came to the conclusion that the EU’s enlargement would create favourable conditions for the Kaliningrad oblast, improving market access in Poland and Lithuania as well as other acceding countries. The argument is that, having acceded to the EU, both Poland and Lithuania will treat the Partnership and Cooperation Agreement as part of the *acquis*. They will then have to apply the common external tariff. The MFN regime in trade with Russia is 4.1% ad valorem, whereas existing tariff levels of Poland and Lithuania are 15.8% and 5.3%, respectively. Therefore the Russian products would receive more favourable treatment in these markets. The Communication argues that, taking into account the geographical proximity of Kaliningrad, it will create better conditions for market access.⁷

⁷ European Commission (2001a).

The level of tariff protection of acceding countries' markets will be lower. However, lowering tariffs down to the European external tariff rates will not automatically create better conditions for Kaliningrad enterprises. This is because one has to take into account regional exports to the above-mentioned countries which consist for the most part of raw materials. For example, raw oil drilled in Kaliningrad dominates regional exports to Poland. Pulp, paper, paperboard and metals account for the most of Kaliningrad's exports to Lithuania. With overall tariff structures commonly possessing a cascading nature, the tariffs for raw materials are already either equal zero or are close to zero. Thus, lower tariffs of the EU's new members will probably not benefit Kaliningrad's existing exports. That might mean that the future application of the Partnership and Cooperation Agreement (PCA) to the new members would not result in a rise in exports in the short and even medium terms. In the long run, it might create some potential for industrial exports, with this potential yet to be realised under a number of conditions.

(b) *Local markets.* Due to the existence of the SEZ regime, which actually operates like a free customs zone, changes in Russian imports tariffs (while expanding the application of MFN treatment to the new members of the EU) will not directly affect the Kaliningrad local market. The reason is that it is already open to the maximum degree, with no import tariffs currently applied. A weaker indirect impact is possible, however. If the competitive strength of Polish and Lithuanian producers will generally rise as a result of the economy of scale and easier access to financial and other resources in comparison to Kaliningrad's local producers, it could allow Central and East European companies to acquire better competitive positions in the Kaliningrad market even though tariffs are already at zero.

(c) *Russian market.* In contrast, the competitiveness of the regional producers in Russian markets may go down for the following reasons. First, the tariff barriers for the goods and services of CEEC producers will eventually be lowered – not only due to the expansion of PCA to the new members of the EU but also as a result of Russia's eventual WTO accession. Second, the production costs of Russian producers located on the mainland will also go down in some cases (components, equipment). Third, accession to the EU and the extension of the CAP for CEECs might become an additional engine for agricultural imports to the Russian markets, whereas up to 75% of Kaliningrad outflows to the mainland consist of processed foods.

(d) *Visa, transit, and energy supplies.* Each of these issues is problematic. On the trade side, there are issues of border and shuttle trading as well as of overall economic cooperation to be handled. For example, the introduction of a visa regime on all borders has already raised transaction costs for local companies. While this problem is minor, the issue of cargo transit for goods being shipped to Russian markets and vice versa through Lithuanian territory is of greater importance. The EU-Lithuanian-Russian technical negotiations are on-going. As for energy supplies, Kaliningrad currently receives up to 90% of its energy requirements from Leningradskaya nuclear power station, with energy supplies being delivered through the Lithuanian territory. While it has not caused any problems so far, energy security is nevertheless an area of concern, which has led to the decision to start building a TEZ-2 power station with the capacity of 900 Mw. It would cover the needs of the oblast completely. The decision to build the station was political, however, rather than economic. It does not stand up to a critique from the economic point of view. The factory should operate on gas, which will require an upgrade of gas pipelines and raise the volume of gas delivered to the Kaliningrad oblast from the mainland Russia. Construction of the station has already begun.

e) *Shuttle trading* at the borders. Since Polish and Lithuanian borders have become external borders of the Union, stricter customs regimes will most probably cause lower volumes of black and gray trade on the borders. Certainly, as long as heavy price imbalances exist, this kind of border trade (cigarettes, vodka, spirit, gasoline) will not vanish entirely, but their volume must shrink considerably. In the long run this may be judged to be a positive phenomenon, but in the short and medium term, it will create enormous difficulties for an estimated 20,000 to 40,000 families in the region that currently make a living on shuttle trading. This would create an extremely serious structural problem at the regional level because a disproportionate part of these families live in smaller border towns where other employment possibilities are severely limited. Thus, larger programmes of structural help for smaller border towns possibly from the EU and Russia are highly desirable and appropriate.

3.2 Russian accession to the WTO and its possible impact on Kaliningrad's economy

Since Kaliningrad is part of Russia, most of the general consequences of Russia's eventual accession to the WTO will also apply to Kaliningrad. Nevertheless, the impact of WTO accession might be different for the oblast in some important matters compared to other Russian regions. Let us briefly mention some of them: a) compatibility of the SEZ regime with WTO provisions, b) changes in import tariffs rates, c) regional import quotas and d) anti-dumping.

(a) *Compatibility of the SEZ regime with WTO regulations.* Some problems might arise on the issue of equal access requirement. In contrast to other free customs zones (e.g. in Poland, Lithuania and China, to name several of the new WTO members), the territory of SEZ Kaliningrad is not excluded from the Russian customs territory; on the contrary, it is treated as a part of the latter. Goods produced in the SEZ, if they satisfy certain conditions (30% of added value, etc.), can be shipped tax-exempt to the mainland. According to GATT regulations, internal taxes and fees may not be applied such that they effectively provide for protection of domestic goods (§1 Art. III GATT). Imported goods may not be subjected to internal taxes and fees in excess of those applied to domestic goods (§2 Art. III GATT). In GATT and other normative documents of WTO, there is no explicit prohibition of such a customs regime as Kaliningrad possesses, but one cannot rule out the possibility that an objection will be raised against it on the basis of Art. III. To the best of our knowledge, this issue has not been raised during the accession negotiations yet, but the negotiators on the Russian side do not exclude such a possibility. For the moment, Russia has promised to bring all of its special economic zones into accordance with the WTO regulations.

It would be natural to think of the nearest neighbours of Kaliningrad – Lithuania or Poland – raising the issue. Kaliningrad is their smaller, but still substantial competitor in Russia's food markets (with \$340 million worth of outflows in this sector already in 2000, and the trend continues upward). Kaliningrad possesses some competitive advantage in the sector precisely due to the existence of SEZ regulations. However, both Lithuania and Poland profit substantially from the openness of the Kaliningrad market. Moreover, they already use Kaliningrad actively as an entry point to Russian markets by setting up joint ventures and processing lines. Thus, it is the legal issues and the attempts to get additional trading leverage in accession negotiations that may raise the issue of SEZ compatibility with GATT provisions.

(b) *Changes in import tariff rates*

- *Exports.* Kaliningrad exports consist primarily of raw materials and semi-finished goods with low value added. Kaliningrad as a transport hub works largely on the trans-shipment of Russian raw materials and also semi-finished goods. The tariffs for these kinds of goods are already very low, so Russia's accession to the WTO will not alter them. WTO accession should not therefore have any appreciable immediate impact on regional exports.
- *Imports.* Regional imports, on the other hand, consist of consumer goods, foods, various vehicles and various equipment and machinery. Russian import tariffs will not necessarily go down immediately after the accession; on the contrary, it is feasible that some of them will even go up to some extent. In the medium-term, however, tariffs will be lowered. As long as imports to the Kaliningrad oblast are already tax-exempt, the reduction of Russian import tariffs will not directly affect local markets. However, it might well affect Kaliningrad's producers in Russian markets. The Kaliningrad regional economy is oriented to a large extent to the markets of Russian mainland, mostly for food products but also for furniture, consumer electronics, etc. Kaliningrad-produced goods directly compete with imported goods in these markets. Lower tariffs in these sectors may lead to greater competitiveness of foreign goods in Russian markets and thus endanger the position of regional producers. Of course, we should take into account the fact that there are protection mechanisms for domestic producers within the WTO, and Russia will almost certainly make use of these. Moreover, there will be a transition period of up to seven years with gradual changes in the tariff structure, which will give the enterprises an opportunity to adjust to new conditions.

(c) *Regional import quotas.* Regional import quotas have existed since 1998 for 35 product groups. The WTO accession should put pressure on regional quotas. While there are a number of permissible ways to apply quotas on the state level (balance of payments, security, health protection, etc.), these mechanisms and exclusions are not easily applicable at the regional level. Russian accession to the WTO may lead to the dropping of regional import quotas altogether. As an overall assessment of the impact of quotas on the regional economy tends to be negative, pressures leading to their abolition can be judged to be a positive factor for the Kaliningrad economy.

(d) It is expected that accession to the WTO should make it relatively more difficult for other states to apply *anti-dumping procedures* against Russian producers. Although there have not been any anti-dumping investigations affecting Kaliningrad's immediate interests yet, Kaliningrad as a transport hub for Russian exports will profit – at least in transit aspect – from assuring better framework conditions for Russian exports (e.g. in metals and fertilisers).

In general, Russia's entry to the WTO will trigger institution-building, which is important for its economic development. It should also lead to greater investment activity. WTO obligations make it more difficult for federal and regional authorities to take voluntary action. In general, WTO membership makes a case for more stability, better transparency and less uncertainty and should thus have a positive general impact on Kaliningrad's economy as well.

On the whole, the preliminary conclusion is that EU enlargement and Russian WTO accession will not provide any immediate advantages for Kaliningrad's regional exporters and will create some dangers for enterprises aiming at Russian markets. However, the EU enlargement creates some potential for development of industrial exports, with this potential yet to be realised under a number of conditions, whereas Russian WTO membership might become a necessary, though not sufficient, prerequisite for the regional companies to successfully enter

foreign markets. Russian accession to the WTO should make it easier to develop export production and to diversify exports.

Nevertheless, while creating the potential for diversification of presently raw material-dominated exports, both EU enlargement and WTO accession will lead to imminent dangers for Kaliningrad. The most important negative consequence may be reduced competitiveness of the regional producers in Russian markets. Besides, WTO accession raises the issue of the compatibility of the SEZ regime with WTO regulations.

4. Kaliningrad's regional economy in the 2000s: Main external factors and scenarios

4.1 External actors, factors and processes

The economic and political regime of the Kaliningrad region is determined by a range of internal and external actors, factors and processes. As an ordinary oblast of the Russian Federation without any additional competencies (not even possessing a republican status within the Federation), it does not have any authority in determining its external policies. It contributes to the decision powers that Moscow exercises over Kaliningrad. However, external powers and the EU in particular play a crucial role in defining the economic and political framework of the Kaliningrad problem. The most important factors are, first, Russia's federal policy concerning Kaliningrad (with the SEZ regime as its core element); second, EU enlargement; third, Russia's WTO accession; and fourth, development of EU-Russian common economic and political spaces. Table 9 below describes what impact these four factors might have on Kaliningrad in the short, medium and long run.

Table 9. Factors of regional economic regime in time perspective

Factor (process)	Short-term (1-3 years)	Medium-term (3-7 years)	Long-term (7+ years)
EU enlargement	Immediate impact in short-term. Largely in effect already since many EU norms and tariffs are incorporated in legislation of acceding states prior to accession.	Impact of further integration of CEECs in the EU; growing competitiveness of CEE companies in the common market as well as in Russian markets.	
Russian accession to the WTO		Will probably take place in 2005-07. Necessary to take into account the transition period of up to 7 years for gradual changes of tariffs and lifting of existing restriction on both sides.	End of transition period, lower tariffs and participation in the next round of trade negotiations.
Russian federal politics towards Kaliningrad	New federal law on the Kaliningrad SEZ; Federal Task Programme (FTP); and other measures of federal policies on Kaliningrad.		

Common European Economic Space (CEES)			For the time being, there is a concept for the EU-Russian common spaces. Implementation remains a long-term prospect. A free trade zone (FTZ) may become a core economic element of CEES. An EU-Russian FTZ can seriously affect regional trade flows and specialisation.
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4.2 Scenarios for economic development: Tariffs, Russia's WTO accession and the future of the SEZ

We have reviewed the state of Kaliningrad's economy and trade. Based on the overview of the most important factors of Kaliningrad's regional economic regime in the short, medium and long run (Table 9), five distinctive scenarios concerning the economic, legal, and policy factors that are relevant to the economic development of the Kaliningrad Oblast are sketched below.⁸

- A status quo scenario which assumes that the existing SEZ regime remains and that Russia does not accede to the WTO.
- Abolition or cardinal changes in the SEZ regime as a consequence of the WTO accession or drastic changes in federal policies toward the oblast.
- Preservation of the existing SEZ regime (possibly in a new edition, but without cardinal changes), whereas Russia enters the WTO.
- Establishment of Kaliningrad as a pilot/model region of European-Russian cooperation.
- Formation of a comprehensive EU-Russian FTA.

Scenario 1. Status quo. This scenario assumes that the existing SEZ regime will not be materially altered and, in addition, Russia will not become a WTO member. This scenario lets us extrapolate current trends of regional economic development, with the most significant being a further growth of imports in the oblast with parallel growth of industrial outflows to the Russian markets. Thus, the current orientation of Kaliningrad's producers towards Russian markets will be further strengthened and the one-way movement of goods (excluding raw materials) from the enlarged EU to Russia through Kaliningrad will become even more characteristic than is the case now. As long as Russia does not accede to the WTO, the existing tariff and non-tariff barriers in combination with the SEZ regime will provide a comparative advantage for Kaliningrad producers. The comparative competitiveness of

⁸ For scenarios of Kaliningrad's economic development, see also Kaliningrad Regional Development Agency (2003).

Central European producers in Russian markets will rise even in the inertia scenario, since the new EU members will become parties to the EU-Russian PCA in due course.

The negative consequence of such a scenario would be the continued or even increased vulnerability because of the oblast's dependency on SEZ privileges, which can be altered or abolished due to both the WTO accession and changes in federal fiscal or trade policies.

We judge this scenario to be the most likely to materialise in the short-term perspective and unlikely in the medium- and long-term run.

Scenario 2. Abolition of the SEZ. Abolition of the SEZ regime in Kaliningrad could be a consequence of either Russia's WTO accession or changes in federal policies concerning the oblast. Under this scenario Kaliningrad will operate under an ordinary economic regime.

What is the possible outcome of the revocation of the SEZ? There is a widespread consensus among economic experts, state officials and regional businesspersons that the abolition of the SEZ would have an extremely negative impact on the regional economy and could even lead to economic catastrophe. Should the custom preferences be revoked, a large part of industrial activity in the region will either be discontinued or relocated elsewhere. It can be assumed that some industries will be able to survive. Two groups in particular have the best prospects: export-oriented industries (principally oil extraction and the pulp and paper industry) and, industries with certain cluster advantages evolving over time, the most distinctive example being the furniture industry. While sharing the common patterns of operating with imported components and servicing the Russian market (83% of total sales), the furniture industry has developed as a cluster and thus has better prospects of survival in the event that custom privileges are abolished for Kaliningrad-based producers.

On the whole, however, the abolition of the SEZ would lead to a deep and protracted crisis. Hence, if it becomes a necessity to drop customs privileges for Kaliningrad, it should be done very cautiously introduced gradually over a long transition period. Other mechanisms encouraging economic development and particularly exports, while being fully compatible with Russia's obligations under international agreements, should be introduced.

Box 2. Official initiatives on Kaliningrad's future: Draft law on the SEZ and the Shuvalov Group

A draft law on the Kaliningrad SEZ was developed during 2003. If adopted, it will replace the old law of 1996. The final draft, as does the current law, elaborates a special legal regime for the whole of the territory of the Kaliningrad oblast. The core of the regime, that is, a free customs zone, essentially remains the same.

Some important features of the SEZ regime embodied in the draft law are:

- 25 years guarantee of existence.
- Direct control exercised by Federal authorities with the Director of the SEZ being appointed by the Federal Government.
- Free custom zone's norms with lower thresholds for value-added required for outflows in mainland Russia to be tax-exempt (15% generally and 10% for electronics); no requirement for a change in tariff nomenclature.
- Federal budget ought to compensate extra expenses for cargo and passenger transit.
- The SEZ is exempt from limitations on participation by non-residents in banking and insurance sectors, as well as establishing pension and investments funds, enshrined in Federal laws.
- Lowered refinancing rate as well as the rate for bank reserves.
- Simplified regime for foreign investors and foreign workers (in SEZ companies), including

issuing visas on the borders.

- The Kaliningrad port should acquire the status of most-favoured-regime port (simplified registration, lower payments, lower property tax for shipping companies, etc.).

The draft law has been extensively criticised on several grounds. It seems that the draft secures the status quo not taking into account the dangers created by the region's heavy dependency on import substitution. Its incentives are considered to be inadequate to promote exports. Besides, the law does not settle any of the potential legal problems that might arise due to Russia's accession to the WTO.

At the end of 2003, Mr Shuvalov, Deputy Head of the Presidential Administration, was put in charge of working on a federal development concept for the region. The *Shuvalov Group* is in the process of working at the time of writing. The introduction of the law on the SEZ to the Russian State Duma was postponed, at the beginning due to the elections at the end of 2003 and then in order to reconcile it with the concept, which is yet to be created. The underlying idea is to gradually re-profile the SEZ, supporting export-oriented production. For a period of ten years, the SEZ residents would be given a choice whether to stick to the old customs privileges or to move into the advantages of a preferential tax regime (tentatively, no tax on profits for the first six years and 12% for the second six-year term). In order to be eligible for these preferences, it would be necessary to invest at least €10 million within the 10-year period. Such a dual regime would be installed for a period of 10 years and then be dissolved, i.e. only tax and investment preferences would remain.

Scenario 3. Preservation of the SEZ regime combined with Russian accession to the WTO.

Despite some optimism regarding Russian WTO accession, it is constantly being postponed to some later date. On the one side, there are several controversial issues, particularly in negotiations with the European Union; on the other, Russia is becoming more conscious of its trade interests. Despite difficult negotiations with its trading partners, the accession is likely to happen by 2007. As a consequence, import tariffs should gradually go down to lower levels. There are several scenarios of how this can happen but, according to recent research,⁹ the impact of changes in import tariffs on the Russian economy is expected to be on a modest scale in all cases. However, due to the peculiarities of the Kaliningrad regional economy, the results of the analysis on a national level are not applicable to a full extent (see section 3 above).

An important characteristic of the Kaliningrad regional economy is its heightened sensitivity to changes in tariffs. As the regional production structure has developed on the basis of duty-free imports coupled with duty-free outflows to mainland Russia, it is expected that lower import tariffs would lead to cut-backs in the profitability of industrial activities in the region.

Despite the potential dangers of lower import tariffs to the competitiveness of regional production in the Russian markets, there is a certain length of time available for adjustment and transition. The adaptation of Russian legislation and tariff structure to the WTO standards will take time. The length of the transition period in the framework of the accession process will probably be set at five to seven years. It is also expected that tariff binding will initially affect about 60-70% of goods nomenclature, and initial tariffs can be set at even higher levels than they are now. A protracted transition period for the accession coupled with favourable conditions can provide adequate time for the necessary adjustment provided that there are both a sound economic strategy and a political will.

⁹ Russian Academy of Sciences, National Investment Council (2002).

Attempts to correct Russian policy toward its Baltic exclave do not seem to take into account the new realities of the 2000s, including EU enlargement and WTO accession. The draft law on the Kaliningrad SEZ (see Box 3) proposes changes in details while not altering its main principles. Basically, the substantive core of the draft is the same as it is now, that is a free customs zone with the possibility of duty-free exports to mainland Russia. The proposed thresholds for the goods to be of local manufacture are lowered, the management structure is changed and compensation mechanisms are established. All this, however, does not fundamentally change the concept. Experiences of the last decade suggest that the present concept provides incentives for import substitution but does not give enough boost for intensive development of export-oriented industries.

Scenario 4. Kaliningrad as a pilot/model region of EU-Russian cooperation. The issue of Kaliningrad naturally lies within the scope of the EU-Russian cooperation. This is important because Kaliningrad's problems can be resolved only by way of bilateral actions. Another point is that the solutions that will be implemented within the general framework of the EU-Russian dialogue will necessarily apply to Kaliningrad. The pilot region concept represents an approach that takes into consideration the potential of the Kaliningrad oblast in the framework of EU-Russian cooperation in a variety of economic and political issues. The concept was elaborated and promoted by the East-West Institute, Kaliningrad Regional Development Agency, and other institutions and individuals. Its main conceptual authors are A. Ignatyev, N. Smorodinskaya and A. Usanov.¹⁰ Meanwhile, these ideas have found their way into the regional and federal concepts of Kaliningrad's regional development and have become a part of official statements. The principal idea is that the Kaliningrad oblast should become a pilot region of European-Russian integration – in terms of economic integration, movement of people, adaptation of European standards and so on.

The pilot concept has its limits, however. While the oblast may become a true pilot region on the issue of movement of people, the practical applicability of the pilot region concept in the field of economic and trade relations is more complicated. Due to its very special status and geographical location, Kaliningrad has specific conditions for its economic development, and, consequently, special needs. In discussing various measures of economic assistance and cooperation for Kaliningrad, we refer to tackling specific problems connected to regional insularity and Kaliningrad's enclave/exclave status. In such cases a plausible idea would be to approach Kaliningrad as a unique case of enclave/exclave, not as a pilot region.¹¹ Nevertheless, in some areas of cooperation – such as standards and certification – the idea of a pilot region can be successfully applied. In general, the Kaliningrad oblast would serve EU-Russian relations by serving as the testing ground for both free movement of people (e.g. facilitated visa regime within the *acquis* or visa-free regime) and of goods and services (e.g. FTA, rules of origins, norms and standards).

Scenario 5. Creation of a comprehensive EU-Russian FTA (long-term). Although the EU and Russia have agreed on the concept of a Common European Economic Space (CEECs), it is unclear what concrete design it would take. The most natural component of a common economic space would be a free trade area. Despite an EU-Russian FTA being a long-term rather than short-term prospect, it is important to include this element considering the future of Kaliningrad. The impact of an FTA on the oblast could be dramatic. The most important

¹⁰ See e.g. Smorodinskaya (2001), Kiel International Ad-Hoc Group of Experts on Kaliningrad (2002) and EastWest Institute (2003).

¹¹ Emerson et al. (2001, p. 31) and Vinokurov (2002a).

negative consequence would be the erosion of the regional customs privileges. An FTA presupposes zero tariffs applicable to trade between partners. As 50% of regional foreign trade flows are with EU-15 and an additional 25-30% with the new members of the Union, creation of an EU-Russia FTA would virtually eradicate current privileges under the SEZ regime confining them to imports from non-EU states (thus, to 20-25% of current imports). On the other hand, the positive effects of the FTA might include better opportunities for exports as well as advantages for Kaliningrad as an important transport hub due to overall growth of European-Russian trade.

In short, five scenarios have been singled out for the oblast, including the maintenance of the status quo, the abolition of the SEZ regime and establishing Kaliningrad as a pilot/model region for integration of the EU and Russia. While the first scenario seems to be most likely in the short term, in the medium and long term, a variety of factors come into play which make any prediction about the region's economic future very difficult. Being a small region, Kaliningrad is highly dependent on the policies of both Russia and the European Union. Among all the scenarios reviewed above, the pilot region concept implies the largest positive potential. Its attractiveness is also in its linkage to long-term prospects of EU-Russian relations.

5. Conclusions

Kaliningrad has experienced vigorous economic growth since 1999, thus compensating for the economic downturn in the 1990s. This growth is based on the overall healthy dynamics of the Russian economy. Moreover, the existing SEZ regime has played a crucial role in determining patterns of production and trade specialisation. With 40% of total trade carried out with Russian mainland, 20-25% with the EU-15 states and about 20% with the new members of the Union (mostly with neighbouring, Poland and Lithuania), Kaliningrad specialises in trade with Russia's regions and with the European Union. The growth of trade and its specific patterns are to a large extent connected to the existence of the SEZ which encourages import-substitution industries oriented towards Russian markets.

Both the EU's enlargement and Russia's accession to the WTO will have a serious impact on Kaliningrad's economy in the short to medium term. Neither event will provide any immediate advantages for the region's exporters. Moreover, both events could cause a lowering of competitiveness for Kaliningrad in the main Russian markets. Finally, Russia's WTO accession raises the issue of the compatibility of the SEZ regime with WTO regulations. However, both EU enlargement and WTO accession will create some potential for the development of new export markets, although it remains to be seen whether and under what conditions this potential can be realised.

The economic fortunes of the Kaliningrad region are determined by a range of internal and external factors. The most important of these are: first, Russian federal policy towards Kaliningrad (with the SEZ regime as a core element); second, EU enlargement; third, Russia's WTO accession; and fourth, the proposed (or possible) development of an EU-Russia common economic and political space. While a status quo scenario seems to be the most likely of the five possible scenarios for the region's economic development in the short-term, in the medium-to longer-term a variety of factors will come into play, making future changes in the SEZ regime highly desirable.

Being a small, isolated region, Kaliningrad's future will depend on the policies of both Russia and the European Union. Among all the scenarios mentioned above, the Pilot region concept

suggests the greatest potential. Its attractiveness lies also in its linkage to the longer-term prospects for EU-Russian relations. Despite the official optimism of the European Commission position, further pressure on the Kaliningrad economy will inevitably result from the EU's enlargement. Thus, the position of Kaliningrad calls for increased attention in the framework of EU-Russian cooperation.

The recent economic trends might allow us to be optimistic for further economic development, but it is doubtful that such a model of regional economic development can be sustained in the long run. Since Kaliningrad's economy is highly vulnerable to shocks, the SEZ regime should be altered very cautiously, with changes introduced gradually over a long transition period. Other mechanisms encouraging economic development and particularly exports, while being fully compatible with the Russian obligation under international agreements, should be introduced.

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Annex

Methodological Note on Reassessing Trade Flows with Mainland Russia

Kaliningrad's trade flows with mainland Russia can be measured with considerable difficulty. Statistical information on trade flows available from both customs authorities and the Committee for Statistics is fragmented. It either includes just some of the inflow-outflows, or provides figures in terms that are not suitable for direct use, that is to say not in price terms. The data sets combined by the Committee for Statistics are based on the information obtained from large and medium enterprises (LMEs). Only a part of inflows and outflows goes through LMEs. A larger part of trade is done through individual enterprises ("chastnye predriyatiya" – ChPs). This practice is particularly developed in some sectors, i.e. in the food sector, and less developed in some other sectors.

This may be seen rather clearly when one looks at the share of LMEs in regional exports. While the overall volume of exports (excluding services) amounted in 2000 to \$519 million (according to Goskomstat's methodology; the customs authorities give the figure of \$452.5 million in the year 2000), only \$237.5 million worth of goods has gone through the large and medium companies of the region. We see that the share of LMEs in 'white' exports is 45.8%. Moreover, it is reasonable to suppose that the share of LMEs would be higher in foreign trade than in inter-regional trade, due to administrative and other technical barriers that larger firms can more readily overcome. Another reason is the structure of their exports: dominance of raw oil and other raw materials in exports which are gained and exported by large enterprises in contrast to much more diverse inter-regional trade with mainland Russia.

The customs authorities collect and manage the data on goods leaving the territory of Kaliningrad destined for mainland Russia. Despite the fact that goods must cross foreign customs territories, the data are not given in price terms because a simplified declaration order is used for goods that are destined to return to the Russian customs territory. Thus, the large volumes of trade going through smaller companies are tracked on the basis of available information in order to reach a more realistic picture to the best of our knowledge.

The main method of calculation used in the paper is based on the assumption that the proportions of trade in terms of quantity and price are the same. On the basis of wholesale quantities, we can calculate the quantities for large and medium enterprises (LMEs). Since the data for physical volumes of trade inflows and outflows are provided by the customs office for trade with Russia and Belarus, the first operation was to clear the data in order to obtain exclusive numbers for trade flows with the Russian Federation. Second, non-metric measurements were recalculated in metric tonnes. For the sectors where such an operation was not possible for technical reasons, we referred to the assessment of specialists working in the industries concerned. The third operation was to recalculate gross weight into net weight, which again was done using expert estimates. Then, the volumes for each specific industry were totalled, so as to have the data for wholesale volumes of each industry according to a recognisable nomenclature. Then, we calculated sectoral coefficients.

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