



**EU-Russia Cooperation Programme
(formerly known as Tacis)**

**Support for the Regional Development of Kaliningrad
(EuropeAid/114287/C/SV/RU)**

ECONOMIC BULLETIN №1

**Kaliningrad Region external trade:
present and future**



This project is funded by the EU



A project implemented by
a consortium led by Inno



Project partner

Economic Bulletins Series

**Kaliningrad Region external trade:
present and future**

Introduction

One of the main objectives of the Tacis Project “Support for Regional Development of Kaliningrad” and the Regional Development Agency is to assist in formulating regional economic development policy. In the framework of this direction a number of studies are planned and, on their basis, a series of bulletins will be prepared dedicated to the most important problems for the economic development of the Kaliningrad Region.

The first issue of the Bulletin, offered to your attention, focuses on eventual changes to external-trade regulations in light of the EU enlargement process and Russia’s accession to the WTO. The results of the survey, carried out by the project in summer 2003, have shown that over 50% of stakeholders highlighted this theme as the most urgent and important priority in developing economic policy for the Kaliningrad Region.

In this bulletin you can find answers to the following questions:

1. What are the current external and inter-regional trade flows in the Kaliningrad Region?
2. What kind of regional trade specialisation is being created?
3. Is the draft law on the Special Economic Zone (SEZ) compatible with world external-trade regulations, and what are the problematic points with this law?
4. What are the short-, medium-, and long-term prospects for the Kaliningrad economy in light of eventual changes to external-trade regulations?
5. How do the SEZs in EU member-countries adapt to international requirements?

Hopefully, the results of our study can be useful for your everyday work and will extend your awareness of the nature and consequences of the changes awaiting the region.

This bulletin is prepared by experts from the Project *EUROPEAID/114287/C/SV/RU* “Support for Regional Development of Kaliningrad” and the Regional Development Agency, namely E. Vinokurov, A. Kharin, A. Yershov, and A. Usanov.

Sincerely yours,

Fiorenzo Sperotto
Project Team Leader

This publication has been produced with the assistance of the European Union. The contents of this publication is the sole responsibility of the authors and can in no way be taken to reflect the views of the European Union.

Table of contents

1. Analysis of Trade Flows in the Kaliningrad Region.....	5
1.1. Structure of Trade Turnover and the Geographical Distribution of External Trade in the Region.....	5
1.2. Inter-regional Trade Flows (Trade with other Russian Regions)	6
1.3. Dynamics of Aggregate Trade Flows and formation of Regional Trade Specialisation	8
2. Kaliningrad SEZ Regulations: Present and Future	9
2.1. SEZ Regulations in the Kaliningrad Region	9
2.2. Draft of a new Federal Law on SEZ in the Kaliningrad Region and its Compatibility with the World External-Trade Regulations.....	11
3. Main External Factors Which Influence External Trade Conditions in the Kaliningrad Region	12
3.1. Factors of the External Trade Regime in the Kaliningrad Region: Short-, Medium-, and Long-Term Prospects.....	12
3.2. Changes of Import Tariffs in Russia and in her Trade Partners: Influence on the Regional Economy.....	14
3.3. Non-tariff Trade Barriers.....	15
3.4. Other Changes of External-trade Conditions in the Region	17
4. Liberalisation of External Access to the Services Market: Consequences for the Regional Economy...	17
5. Scenarios, Experience, Results	19
5.1. Development Scenarios based on Changes of Import Duties and Quantitative Restrictions.....	19
5.2. Experience in Adapting Special Economic Zones (Free Custom Zones) to International Requirements in EU Candidate-Member Countries	23
5.3. Results and Recommendations	26

1. Analysis of Trade Flows in the Kaliningrad Region

1.1. Structure of Trade Turnover and the Geographical Distribution of External Trade in the Region

The small size of the internal market and limited resources of the regional economy explains the considerable asymmetry between internal production and consumption in the Kaliningrad Region. Therefore trade flows play a special role in the provision of regional economic activities and in maintaining the welfare of its population. The Kaliningrad Region has found itself highly dependent on imports, primarily from European countries. At the same time, being part of the Russian Federation, the region is maintaining close economic and trade relations with other Russian regions.

Two principal stages can be pointed out in the region's development, similar to Russia as a whole. The first stage - 1990-1997 – was a period of rapid growth in the region's external-trade turnover. It was based on the general liberalisation of the Russian economy and, specifically for Kaliningrad - on the benefits arising from the SEZ regulations. The region's external trade reached its peak in 1997, when the volume of exports made up about \$400 million, and the volume of imports over one billion USD. A significant portion of the turnover was transit shipments, primarily imports, when the region was used as a conduit for the duty-free importation of goods to mainland Russia.

The 1998 crisis caused a temporary drop in both imports and exports, and marked the end of the first stage of external-trade development. However it gave an impetus to the development of production, which created conditions for a new upsurge in external-trade activities. Starting with 1999, external-trade growth was stimulated not only by the SEZ's customs preferences but also by the growth in local production. By the year 2000, exports had already reached a record level of \$475 million, with imports reaching their maximum in 2002 when they made up \$1,561 million (see Fig. 1) but, since the year 2000, when the volume of exports has recovered to their pre-crisis level, this level has tended to decline.

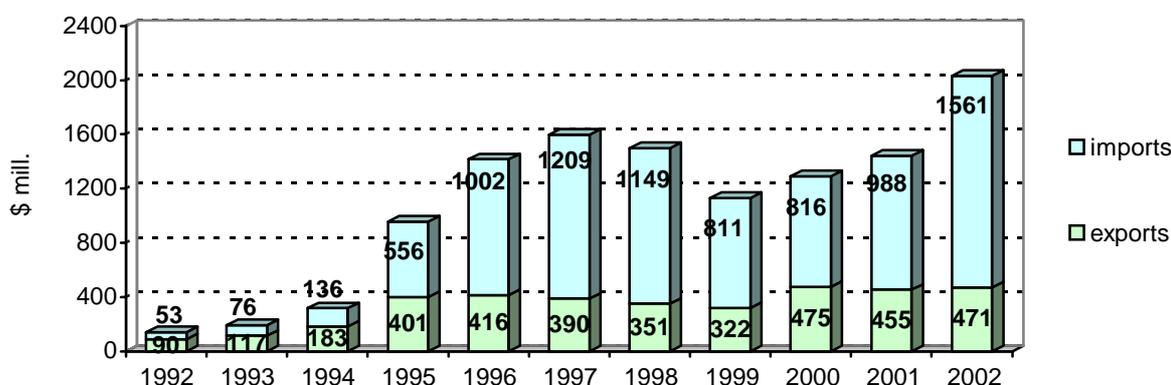


Fig. 1. Dynamics of the external-trade goods turnover in 1992-2002
Sources: the Kaliningrad Regional Committee of Statistics.

The dynamics of the regional-trade flows in recent years shows that shipments to mainland Russia have been growing, whilst exports to other countries have remained stagnant. Since 1995, a specific feature of the region has been the stable negative balance of external-trade turnover. On the one hand, this can be explained by the use of the SEZ as a suitable 'gateway' for importing goods into Russia. Another reason is the growth in the shipment of goods for processing and sale in the Russian regions.

The region's main export item is crude oil, which is extracted in the Kaliningrad Region and fully exported abroad. Other export items, most important for the regional economy, are:-

- Products from the paper/pulp industry, wood processing and forestry – primarily products from the local paper/pulp factories (wood pulp, paper, and cardboard) as well as timber.
- Machine-building products - the intermittent growth of exports from which is a result of the small scale of the regional economy rather than its "high technology". This industry is based on simple assembly production lines.
- Foodstuffs and raw materials for food production - mainly raw fish and local food industry products (canned fish and meat, etc.).

Imports comprise two main components (namely foodstuffs and machine-building products), whose share of the aggregate import volume is about 70%. The growth in the import volume for these sectors reflects recent regional development trends: firstly, the growing share of raw food material imports and component imports for the processing and assembly enterprises; secondly, the growing rate for technically re-equipping the regional economy and the increasing demand for technology equipment imports; and, thirdly, growing consumption (e.g. a significant part of the machine-building products, imported into the region, are used for internal consumption).

Main specific features of the external-trade geographical structure:

- Kaliningrad’s external-trade activities are generally with a small number of countries. Seventy per cent of the region’s exports and imports is with the first ten trade partners.
- For several recent years, the region’s largest external-trade counterparts have been Germany, Poland, and Lithuania. Poland is the leading exporter. In 2000, exports to this country made up 32.4% and, in 2001, 27.5% of total exports from the Kaliningrad Region. Germany is the leading importer, amounting to 22-25% of the region’s turnover.
- The aggregate share of EU and EU-candidate member countries (EC-25) in Kaliningrad external-trade turnover reached 70-75%, the share of EU-member countries’ being 25-35% of the region’s exports and 40-50% of its imports.
- CIS countries are not the region’s largest trade partners but, recently, an increase of exports to those countries was registered despite the volume of imports remaining small. The aggregate share of the CIS countries amounted to 7% of regional trade turnover.

1.2. Inter-regional Trade Flows (Trade with other Russian Regions)

The Kaliningrad Region maintains close economic relations with other Russian regions, which in recent years have become more intensive, because of the growth in “import-substitute” production. Future changes to external trade conditions would surely influence not only the region’s foreign trade but also inter-regional trade relations. The available statistical and analytical data are limited, and contradictory, and thus one can only approximate the significance of local economic entities’ trade with other Russian regions on the regional trade balance. Starting with 1999, the volume of products shipped from the Kaliningrad Region to other Russian regions has been growing. In 2001, the physical volume of goods imported to, and exported from, other Russian regions was 117.5% and 118.5% of 2000 levels respectively. Based on indirect indicators, one can assume that this growth was much higher in price terms due to a shift towards the export of goods such as cars and machine-building products.

The growth of inter-regional trade flows is confirmed by Kaliningrad Customs’ data. In 2000, the value of goods produced and cleared to be shipped to mainland Russia, under the SEZ regulations, was \$424 million which, in 2001, grew to \$618.7 million (a 43.1% increase). On the basis of 2001 data, the volume of shipments to mainland Russia was 1.5 times greater than that to other countries. In 2002, the growth of shipments to Russia continued to grow and reached \$759 million.

Table 1

Interregional trade flows by economic sectors in 2000

	External economic activities custom codes	Goods	Shipments from Russia, mill. USD	Shipments to Russia, mill. USD
1.	01-24	Foodstuffs and raw food materials	89.1	340.8
2.	27	Fuels and energy	185.2	13.2
3.	28-35, 37-40	Petrochemical products	72	1.5
4.	41-43	Tannery products, furs	0.1	1.0
5.	44, 47, 48	Wood and products thereof	34.4	18.6
6.	72-81	Metals and articles thereof	24.3	1.5
7.		Other goods	63.8	55.6
		TOTAL	468.9	432.2

Source: V. Lamand, E. Vinokurov “Formation of the Kaliningrad Region external-trade specialization”, Economic Issues, 2003, No.2, p.p. 53-63.

Note: the data is limited to trading of goods, and do not include sales/purchases of services and energy deliveries to the region.

Table 1 presents data on the structure of inter-regional trade flows by economic sector. The main products, cleared for shipment to mainland Russia, were passenger cars (14.1% of the total value), TV sets (11.4%), canned fish (10.5%), transport vehicles for the maintenance of railway tracks (7.1%), frozen fish (4.6%), tuft carpets and flooring materials (4%).

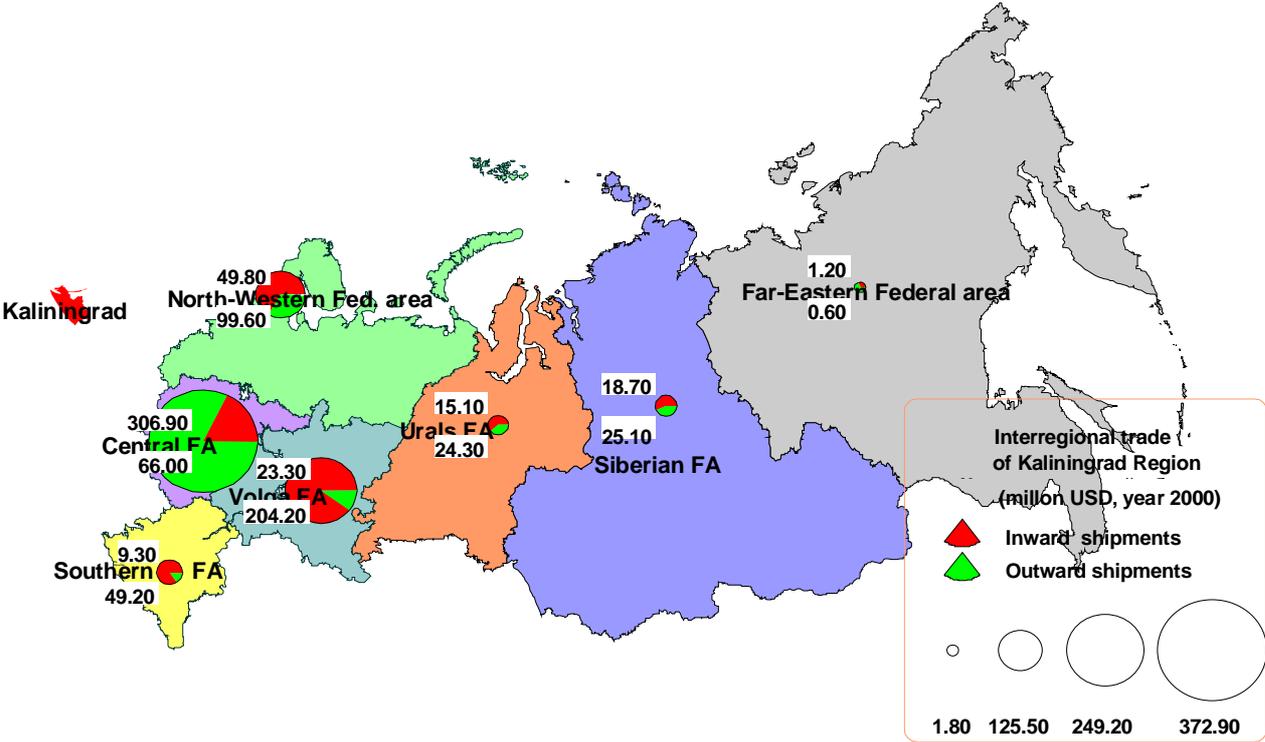


Fig. 2. Inter-regional trade, by Federal Areas (FA), 2000.

Source: V. Lamand, E. Vinokurov “Formation of the Kaliningrad Region external-trade specialization”, Economic Issues, 2003, No. 2, p.p. 53-63.

More than 90% of the region’s aggregate inter-regional trade is with regions in the European part of Russia (see. Fig. 2), of which 41.7% is with the Central Federal Area – the main recipient of Kaliningrad goods. This is explained by the comparative geographical closeness of the region and its role as the main consumer market and re-distribution centre. As to inward shipments, the prominence of the Volga (Privolzhski) and North-Western Areas can be explained by the structure of these deliveries, i.e. fuels, petrochemicals, and other raw materials. The imports from the Central FA contain more processed products: over half of the machine-building products are imported to the Kaliningrad Region from these territories.

The analysis of Kaliningrad interregional trade flows allows for the following conclusions:

- Trade with Russia’s regions plays a significant role in the trade balance of the Kaliningrad Region, accounting for over 40% of all goods traffic.
- Russian regions are the main supplier of fuel and petrochemical products, as well as raw materials. At the same time, ‘bigger’ Russia is the consumer market for finished products manufactured in the region and, in contrast with imports from Russia, exports from Kaliningrad to Russia are devoid of raw materials.
- The inter-regional trade of the Kaliningrad Region - in both respects – shows a stable “up-trend”. This reflects the strengthening of trade ties with mainland Russia.
- The growth in trade volumes is mostly due to the development of import substituting production industries, which are developing on the basis of custom privileges provided by the SEZ regulations.

1.3 Dynamics of Aggregate Trade Flows and formation of Regional Trade Specialisation

Figure 3 shows the main external and inter-regional trade flows in the Kaliningrad Region for the year 2000.

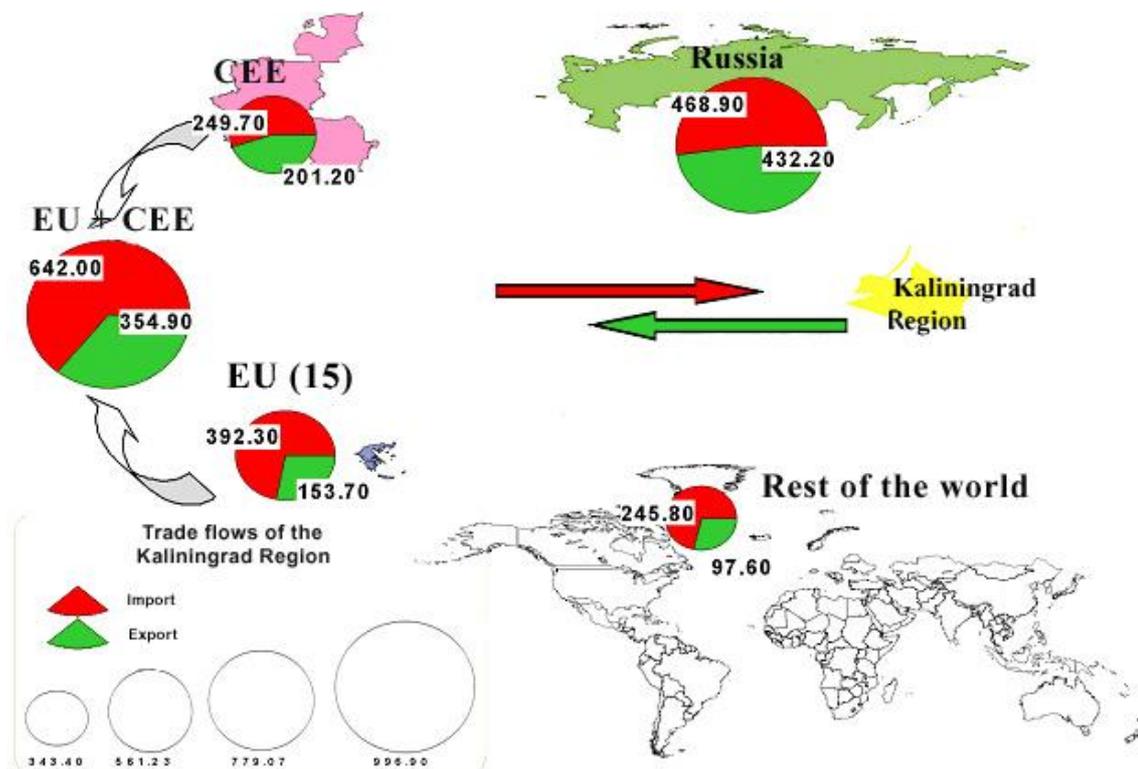


Fig. 3. Foreign and interregional trade flows in the Kaliningrad Region in 2000

Source: V. Lamand, E. Vinokurov "Formation of the Kaliningrad Region external-trade specialization", Economic Issues, 2003, No. 2, p.p. 53-63.

- **Imports from other countries.** The share of imports is growing rapidly. In 2002, imports made up 1578,5 mill. USD. The share of the European Union of the region's external imports is about 40%. After EU enlargement to the east, this share is expected to grow to 75-80%, primarily at the expense of Poland and Lithuania.
- **Exports to other countries** are stagnating after a short period of positive dynamics, in the past three years the volume has varied within a \$455–475 million range (according to State Customs Committee (SCC), in the year 2002 the volume of exports to other countries decreased by nearly 20% to \$408,5 million).
- **Shipments to Russian regions** manifest a stable upward trend and, in 2002, accounted for at least 759.1 mill. USD.
- **Shipments from Russian regions:** precise data for the years 2001-2002 are not available. Indirect information allows one to assume substantial growth of these imports, particularly raw materials and electrical energy.

Table 2

Trade openness of the Kaliningrad Region, data for the year 2000.

	GRP, million USD	Trade volumes, million USD	Trade openness
Nominal value	837.6	2241.7	267%
PPP value	6025.0	2241.7	37%

*Trade openness = Trade volumes / GRP

Source: V. Lamand, E. Vinokurov "Formation of the Kaliningrad Region external-trade specialization", Economic Issues, 2003, No. 2, p.p. 53-63.

A 2.7-times excess in trade volume over nominal GRP (see Table 2) proves that the region has a high degree of trade openness. Taking into account all relevant information about inter-regional trade, then this indicator is likely to be even higher such that the Kaliningrad Region can be considered the third most in Russia – after Ingushetia and Kalmykia - considered areas of domestic ‘tax paradise’. The high level of Kaliningrad’s trade openness is due to its geographical location, the small size of its local market, and the SEZ regulations.

In general, the regional trade flows of the Kaliningrad Region have the following characteristics:-

- Ø After a sharp drop, caused by the devaluation of the rouble in 1998, external-trade turnover started to recover rapidly. Growth in imports has been especially rapid, as has the shipment of goods to other Russian regions. The region’s imports have two main components: final-consumption goods and goods imported for processing by SEZ enterprises for subsequent shipment to other Russian regions.
- Ø The growth in the shipment of products manufactured by SEZ enterprises to mainland Russia is taking place against a background of stagnating regional exports.
- Ø The region’s trade has acquired certain specialisation. Compared with developed European economies, Kaliningrad is more typical of a developing country. On the other hand, with regard to mainland Russia, the region holds the position of a trade partner with comparative advantages in the field of industrial production.
- Ø The main factors determining the structure of the regional trade flows, and the position of the region in European-Russian trade, are the region’s geographical situation and the effects of the SEZ custom privileges which actively stimulate the traffic of goods, via the Kaliningrad Region, from “west to east”, i.e. from European countries to Russia.

The upsurge in the regional economy, reflected by the trade-flow dynamics, allows one to be optimistic for future economic growth. However the sustainability of such a model for regional economic development is doubtful because the activities of the basic import-substituting industries are, to a large degree, dependent on the stability of current SEZ regulations. Any change to these regulations (for example, as a result of Russia’s accession to the WTO or as a result of internal Russian reforms), which would question the possibility of duty-free shipments of goods (manufactured in the SEZ to mainland Russia), would most seriously undermine the import-substituting regional industries. At the same time, the influence of the two most important integration processes – EU enlargement and Russia’s accession to the WTO - on Kaliningrad’s regional economy, could be beneficial.

2. Kaliningrad SEZ Regulations: Present and Future

2.1. SEZ Regulations in the Kaliningrad Region

The status of the Special (Free) Economic Zone in the territory of the Kaliningrad Region was established in the second half of 1991. From 1996, the main document stipulating the conditions for economic activity in the Kaliningrad Region has been the Federal Law “On the Special Economic Zone in the Kaliningrad Region”.

From the economic point of view, this law is primarily designed to compensate additional costs caused by the region’s isolation from mainland Russia, and to create a favourable investment environment for development.

According to the law, a special privileged regime for entrepreneurship, investment, and external-trade activities was established in the Special Economic Zone, created “within the entire territory of the region, except for defence sites and/or strategically important sites for the Russian Federation – military bases, military settlements, defence industry sites as well as oil-and-gas branches of extractive industries on the continental shelf.”

The SEZ is part of the State and customs territory in Russia, but a special customs regime is effective in the Special Economic Zone, the essence of which is that goods produced in the SEZ territory, or imported into its territory from other countries, are exempted from custom duties and other custom charges.

Goods are considered to be produced in the SEZ, if the value added from their processing is greater than 30% (not less than 15% for some goods), and that such processing leads to a change in the goods code according to the customs classification. The procedure for determining the goods origin in the SEZ is subject to establishment by the Administration of the Kaliningrad Region jointly with the State Customs Committee of Russia.

Custom concessions are the principal component of the SEZ mechanism and, indeed, this is actually the basic feature of the SEZ. All other preferences, including privileges to investment projects, special taxation conditions for the SEZ subjects, etc. are only outlined in the Law and are ineffective because respective provisions are missing in the tax legislation.

The customs concessions, stipulated by the Law, are a powerful incentive for the development of business in the region, particularly external economic activities. Due to the effect of this Law, the regional economy has become specialised in import-substituting production: according to the Regional Administration's estimates, in 2002, 80% of the total volume of industrial products were produced using the Procedure of Determination of the Origin of Goods in the SEZ. At the same time, however, the SEZ regulations make a depressive impact on some branches of industry and agriculture by making them patently uncompetitive when compared to imports.

The existing system of privileges directly discriminates against domestic enterprises. Import VAT is not levied for goods imported to the SEZ territory. However, at the same time, to buy Russian analogues of the same goods, an enterprise located in the Kaliningrad Region must pay the internal VAT. Given that the VAT is repaid to foreign exporters, and with all other conditions being equal, then it is clear that products manufactured in mainland Russia will always be more expensive for a Kaliningrad enterprise than equivalent imports. Such indirect subsidisation of imported goods by the Russian State for SEZ residents determines, to a large extent, the one-sided orientation of the region to import substitution¹.

A special feature of the Kaliningrad SEZ is the possibility, stipulated by the Law, to exclude certain types of goods from the SEZ regime. Beginning with 1998, on the initiative of the Regional Administration, the RF Government set quantitative restrictions on the import of some types of goods into the region. This measure is intended to partially compensate unequal competition for Russian producers trying to penetrate the Kaliningrad regional market.

The specific feature of the mechanism for allocating quotas in the Kaliningrad SEZ stipulates that imports are not fully exempt from customs charges but, rather, only within the limits of set quotas (for each type of privileged goods). Quotas are sold through specially organised auctions and the funds obtained are transferred to the Federal Budget.

It should be noted that the allocation of import quotas, in this form, contradicts WTO regulations and the world SEZ functioning practice. Moreover, according to competent experts, the quota allocation model used in the Kaliningrad Region is not efficient enough².

The existing customs privileges in the Kaliningrad SEZ violates one of the basic WTO principles – “no country can be given worse conditions of access to a market than any other country”. In contrast to the practice of special (free) economic zones in WTO member countries (e.g. in Finland, Poland, Lithuania, and Latvia), which operate on the principle of being an enclave in a customs territory (goods manufactured in the SEZ are subject to normal customs clearance procedures, including the levying of tariffs and taxes), the Kaliningrad SEZ is part of the RF customs territory. Therefore, under certain conditions, normal customs procedures are not applied to goods shipped in and out of the region to/from other parts of Russia.

In general, the SEZ legislation in the Kaliningrad Region is unstable. During the last decade, more than twenty regulatory documents were adopted (mostly Presidential decrees and Government directives), which alternately introduced or cancelled various privileges. The very fact that such a large number of documents were adopted impacted extremely negatively on the zone's functioning, because a stable legal framework is one of the principal conditions for creating a favourable environment for economic activities.

Another equally important problem relating to the functioning of the Kaliningrad SEZ is the contradiction between the Federal Law “On the Special Economic Zone in the Kaliningrad Region” and the Tax and Custom Codes. The essence of this contradiction consists in the fact that the Tax and Custom Codes do not prescribe the regime of the free customs zone existing in the Kaliningrad Region. It is clear that there is a serious conflict between the Law on SEZ and the rest of the federal legislation. As a result, the major-

¹ Assistance to transformation of the Kaliningrad Region into a pilot region for cooperation between Russia and the European Union. – Kaliningrad: East-West Institute, the KR Regional Development Agency. 2003, p.23.

² V. Zhdanov, O. Kuznetsova, V. Mao, M. Pliuhin, S. Prihod'ko. Problems of economic development of the Kaliningrad Region, as an exclave region of Russia. – M.: Consortium on issues of applied economic studies. 2002, p.17.

ity of the federal authorities represented in the region, issue directives and administrative orders which commonly do not correspond to the Law on the SEZ.

The lack of certainty as to how the federal authorities will act in respect of the existing preferences provided to regional entrepreneurs, and the constant threat of their cancellation, existing since the adoption of the Law, constitute the main instability factor acting on the Kaliningrad Region's economic development.

2.2. Draft of a new Federal Law on SEZ in the Kaliningrad Region and its Compatibility with the World External-Trade Regulations

The RF Government is currently considering a new draft version of the Law on SEZ in the Kaliningrad Region³ which, according to the authors, would be free of the faults existing in the current Law.

According to the draft of the new Law, the main objective is to create an efficient mechanism for the functioning of economic relations in order to provide accelerated development of the Kaliningrad Region as a pilot region for Russian-European integration. The Law is to create conditions favourable for the region's socio-economic development by introducing liberal - adapted to European standards - mechanisms for improving the competitiveness of local products, developing the financial infrastructure, compensating negative factors, and using the region's favourable geopolitical and economic position.

Like the current Law, the new Kaliningrad SEZ regulations stipulate a special legal regime for conducting economic activities which cover the entire territory of the region, except for sites of defence and strategic significance. At the same time, the preparation of the draft new Law on the KR SEZ is an attempt to improve the legal regime in order to enhance efficiency and to provide additional opportunities to the SEZ.

The draft law proposes to significantly simplify the processing of foreign citizens entering the territory of the Kaliningrad Region, which implies the possibility of getting entry visas directly at a cross-border point in the Kaliningrad Region on arrival at the RF State border. This measure would certainly contribute to extending the region's international (including economic) relations.

The new draft Law retains the main features of the free custom zone. The draft law envisages preserving, and even some simplifying, the criteria for determining the origin of goods. However the practice of identifying goods produced in the SEZ can be regarded as indirect subsidisation of local companies.

Another serious problem is the futility of reducing the requirements to the "rate of processing" for adding value to products for future development of the regional economy. Taking into account the expected reduction of import custom duties, in the short-term this measure could improve the internal competitiveness of Kaliningrad products. However, from a longer term perspective, it would result in the progressive "primitivisation" of the Kaliningrad economy and, consequently, strengthen its dependence on SEZ privileges.

Some of the new provisions in the draft Law on the KR SEZ conflict with not only Russian legislation, but also with a number of WTO regulations.

Even though the exact date and specific conditions for Russia's accession to the WTO are uncertain, Russia's entry is a real threat to the future of the Kaliningrad SEZ regime. The Kaliningrad Region is a part of the RF. It would be covered by the same conditions pertaining to Russia's accession to the WTO as per elsewhere in the country. At the same time, some of the most important issues relating to Russia's accession of the WTO may be of different – either greater or lesser - importance for the Kaliningrad Region than for other RF regions. One of the principal - still unsettled – issues is the (in)compatibility of the Special Economic Zone regime with WTO regulations. In particular, problems may arise with regard to the use of the most-favoured-nation regime by the WTO.

The legislation in different countries formally includes free custom zones (FCZ) as it was done in Poland or it excludes them (in China) from the State customs territory. However, in any case, the FCZs actually find themselves outside those territories, and the same law applies to their borders as to the national customs borders, i.e. goods shipped to another part of the country are fully levied with customs duties. The situation in the Kaliningrad Region is quite different. Goods manufactured in the SEZ territory under the special tariff regime, and shipped to the rest of the RF territory, are exempt from normal customs duties. Meanwhile, according to GATT rules, internal taxes and charges must not be used to provide protection to

³ <http://www.economy.gov.ru/MinEc/idex.html>

domestic products. (Item 1, Art. III GATT). Internal taxes and charges, exceeding those applied to domestic products, must not be imposed on imported goods (Item. 2 Art. III GATT). In the GATT and other WTO regulatory acts there are no rules that specially prohibit the existence of a regime like the Kaliningrad SEZ regime but, based on the provisions of Article III, objections to this are possible. In the process of negotiations between Russia and its trade partners the SEZ issue has not been raised, but it can be raised by Poland and Lithuania in connection with Kaliningrad's competitive advantages on Russian markets or for more formal legal reasons in connection with other special zones in the RF territory.

The problem of compatibility of Russian legislation with the world's external-trade regime is ambiguous. It should be understood that international agreements are based on political and economic motives. This means that clear legal answers with regard to certain issues are not always possible. This is especially applicable to the sphere of economic development, in particular, to the assessment of such actions as subsidies provided to an area, including free zones.

3. Main External Factors Which Influence External Trade Conditions in the Kaliningrad Region

3.1. Factors of the External Trade Regime in the Kaliningrad Region: Short-, Medium-, and Long-Term Prospects

By virtue of the well-known geopolitical situation of the Kaliningrad Region, favourable conditions for external economic activities are of particular importance for its successful socio-economic development. This is determined by two main factors: the Russian Federal centre and the expanding European Union.

In the framework of its constitutional powers the Federal centre establishes the external-trade regime in the country and conditions for its operation – as in the case of the Kaliningrad Region. This regime is changing, or can be changed, as a result of negotiations on Russia's accession to the WTO. In turn, Kaliningrad's main external-trade partner – the European Union – establishes its external-trade regime of access for commodities and services from the Kaliningrad Region, and Russia in general, to its markets. Moreover, the EU influences or can influence the RF external-trade regime (and its particularities in the Kaliningrad Region) through negotiations on the accession of Russia to the WTO. In future, negotiations on the formation of the Common European Economic Space (CEES) may become another channel of such influence.

A separate factor in the formation of the region's external economic activities is the EU enlargement process, and primarily the accession of Kaliningrad's neighbours – Poland and Lithuania – to the EU. It should be noted that even today this issue is largely incorporated into the factor of 'European Union policy' and, after accession of the countries to the EU, it will lose its individual significance. However, as soon as the countries become fully-fledged EU members, the mechanism of their influence for EU policy on the Kaliningrad Region issue will change (including the process of negotiations on Russia's accession to the WTO).

The scheme of formation of external economic activities in the Kaliningrad Region is shown in Fig. 4.

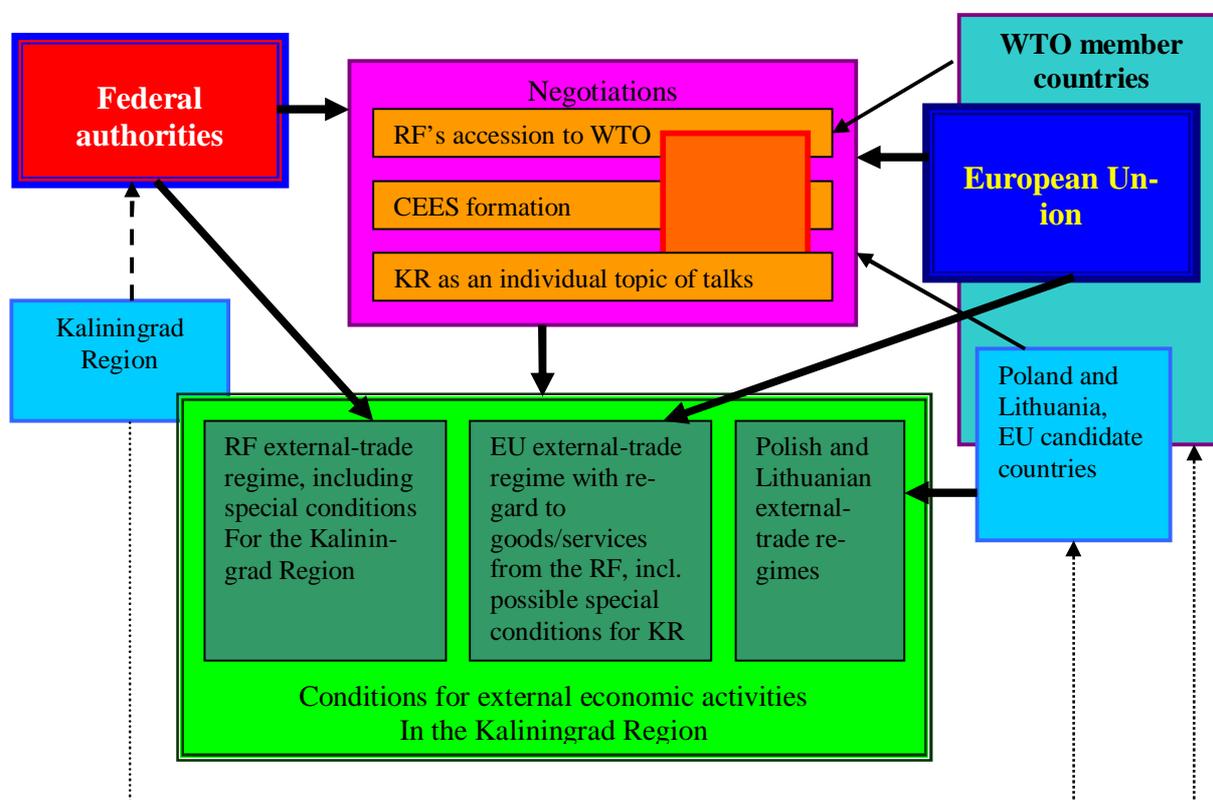


Fig. 4. Main factors and mechanisms of formation of external economic activities in the Kaliningrad Region

Thus, in the foreseeable future, the conditions for external economic activities in the Kaliningrad Region will change due to the influence of four inter-related processes:-

- formation and implementation of the federal strategy towards the Kaliningrad Region;
- Russia's accession to the WTO;
- EU enlargement to the East;
- development of co-operation between the Russian Federation and the European Union, including – in this or any other form – the concept of EU-Russian Common Economic Space.

The intensity of the processes in the Kaliningrad Region will change with time. Table 3 shows the periods when they might exert the greatest influence on conditions for external economic activities.

Table 3

Main factors of changing conditions for external economic activities in the Kaliningrad Region in perspective

Factor (process)	Short-term perspective (1-3 years)	Medium-term perspective (from 3 to 7-8 years)	Long-term perspective (over 7-8 years)
Formation and implementation of the federal strategy towards the Kaliningrad Region	Development of the strategy, adoption of the new Federal Law on the SEZ, implementation and amendment of the Federal Target Programme; other federal measures towards the KR	Correction of the federal policy towards the KR, incl. the effects of negotiations on the accession of the RF to the WTO	Correction of the federal policy towards the KR, incl. the effects of negotiations on the creation of Common RF-EU Economic Space
Russia's accession to the WTO		Russia's accession to the WTO. Correction of the federal policy towards the KR, based on the results of negotiations on the accession of the RF to the WTO.	Completion of the transition period agreed with the WTO

Development of cooperation between the Russian Federation and the European Union, including – in this or another form – the concept of EU-Russian Common Economic Space		Development of the concept of Common RF-EU Economic Space	Beginning of implementation of the concept of Common RF-EU Economic Space, first of all, in the form of a Free Trade Zone
EU enlargement to the East	Accession of Poland and Lithuania to the EU. Reduction of their tariff protection level. Introduction of EU rules and standards.	Enhancement of the new EU members' economic competitiveness	

At present, Kaliningrad Region's influence on the formation of conditions for successful external economic activities in the region is weak and indirect. However, the influence might grow as a result of the synergistic efforts from regional authorities, by political and business interests, and by society. Due to its specific nature, the region has to seriously try and find feedback channels, and to apply aggressive lobbying of its interests by all possible means.

In 2002, when Kaliningrad found itself at the centre of European-Russian dialogue, the efforts of the federal and regional authorities led to formal recognition - by the European Union - of the specificity of the Kaliningrad Region, of the existence of its special problems, and of the necessity to apply a special approach to their solution. However, until now, the main efforts have been focused on solving visa regime issues. The more substantial and complicated problems for forming the proper conditions for external economic activities in the Kaliningrad Region, which will determine the competitiveness of local enterprises on the regional, Russian, and foreign markets, are still to be solved.

3.2. Changes of Import Tariffs in Russia and in her Trade Partners: Influence on the Regional Economy

3.2.1. Export markets

In the opinion of the European Commission⁴, EU enlargement will have beneficial implications for the Kaliningrad Region. This conclusion is founded on the argument that, after joining the European Union, Poland and Lithuania will consider the Agreement on Partnership and Co-operation as a part of their *acquis*; in trading with Russia they will use the common external tariff, whose current average weighted rate is 4.1% and, furthermore, given that protective tariffs in Poland and Lithuania are 15,8 and 5,3%, respectively, after EU enlargement Russian goods will get considerable advantages on the new EU members' markets.

At the same time, a considerable part of Kaliningrad's exports are raw materials and partly processed products which, as a rule, are charged with low import tariffs. Therefore it is most probable that Kaliningrad exporters, likewise its transport sector, will neither receive additional price advantages nor any considerable increase in the trans-shipment volume. One should also take into consideration that, by today, the Central European countries joining the EU have already incorporated a considerable part of general European external-trade tariffs into their customs legislation.

Thus, if the structure of exports remains at the present level, the decrease in protective tariffs used by the neighbouring countries is not expected to provide any advantages to the Kaliningrad Region. Both in theory and in practice, gains from the decrease in tariffs are obtained from the export of industrial products whereas the Kaliningrad Region is currently oriented mainly to Russian markets. This could mean that, in the short-term, EU enlargement and Russia's accession to the WTO will not lead to an increase in regional exports. In the medium- and long-term, the processes can create a certain potential for an increase of industrial exports.

Such conclusions with regard to the Kaliningrad Region are compatible with the conclusions of a study conducted by the Russian Academy of Sciences on the influence of WTO membership on the Russian

⁴ Commission of the European Communities, Report to the Council of Ministers of the EU "EU and Kaliningrad", Brussels, 17.01.2001, KOM 26.

economy⁵. According to this study the expected growth in gross regional product (GRP) for the RF subjects, influenced by the growth of import-substituting production output, will be within 0.6-0.7 percent. However due to the improvement in external (foreign) trade conditions this will, to a certain extent, be beneficial for the region.

3.2.2. Kaliningrad Market

As a result of Russia's accession to the WTO, Russian tariffs for the importation of highly processed goods will gradually decrease. However, under SEZ regulations, imports into the Kaliningrad Region are exempt from import customs duties. Therefore, as long as the SEZ conditions exist in their current form, the general decrease of Russian import duties will not directly affect Kaliningrad producers on the Kaliningrad Regional market.

Even today, consumers in Kaliningrad have the advantage of low prices for imported goods. Thus they will not get any price benefits but, at least, price stability would be guaranteed: there will be a serious barrier in the way of the Russian industrial lobby trying to increase import customs duties, namely the legal international commitments under the WTO requirements.

Due to the SEZ regulations, ***the changes to the Russian import tariffs are not expected to directly influence the Kaliningrad Regional market.*** The reason for this is that it is already widely open. Nevertheless some indirect impacts may take place. For example, the general strengthening in the competitiveness of Polish and Lithuanian producers (e. g. through the scale- economy effect due to their full accessibility to the European Common Market) may also help them achieve a stronger position in the Kaliningrad markets.

The reduction of custom duties will much more seriously affect the position of Kaliningrad goods on the Russian market.

3.2.3. Russian Market

In the forthcoming years, the situation may become a serious test of the competitiveness of Kaliningrad producers on the Russian markets, which are known to be the main consumers of the region's industrial products. The most important marketable sectors of the Kaliningrad economy – machine building (including assembly lines), food industry, and manufacture of furniture – are mainly oriented to Russia.

The strengthening of competitive pressure on regional producers on the Russian market may be caused by the following factors. Firstly, Russian tariff barriers for imported foreign goods and services will be gradually reduced, not only due to the extension of the effect of the Agreement on Partnership and Cooperation between the EU and RF (the APC), but also due to the changes during the transitional period of Russia's accession to the WTO. Secondly, the production costs of enterprises in mainland Russia will also decrease due to the reduction in import tariffs for components, equipment, etc. This will result in the growth of the competitiveness of Central and East European as well as Russian (non-Kaliningrad) enterprises on Russian markets. Thirdly, the enlargement of the Common Agricultural Policy zone to the CEE countries will intensify their agricultural exports to Russian markets. This prospect is a direct threat to Kaliningrad exports to Russia, which - to a considerable extent - consist of processed food products.

However, one should also take into consideration that mechanisms of internal market protection exist which are compatible with WTO rules. Thus, the agricultural sector can be regulated by special agreements and negotiations. In this sphere, higher tariffs are allowed as well as non-tariff protection methods. Furthermore, on joining the WTO, Russia will be granted the right to use a transitional period (from 3 to 7–8 years for different items), which will enable it to react to changes in the external-trade regime and to make relevant corrections in the region's existing economic-development model.

3.3. Non-tariff Trade Barriers

3.3.1. Regional Allocation of Import Quotas within the Framework of SEZ

Despite the uncertainty about the exact date and conditions for the accession of Russia to the World Trade Organisation, one can be sure that this will take place in the nearest few years. The process of ac-

⁵ The Russian Academy of Sciences, National Investment Council. Implications of Russia's accession to the WTO for the national economy, Report. M., 2002, p.p. 9-10.

cession to the WTO may have direct relation to both the future of the Kaliningrad SEZ, as a whole, and to the regional system of import quota allocations in particular. The WTO is a strong advocate for the cancellation of non-tariff trade regulation measures and a supporter of relevant tariffs (Art.XI GATT), so regional quotas will be subjected to particular pressure. At the same time, on the federal level, there are a number of possibilities to use non-tariff barriers. Among the well-founded reasons is the unfavourable balance of payments (Art.XII GATT), for health protection, safety considerations (Art.XI GATT), and so on. WTO rules are definitely opposing *regional* non-tariff barriers.

Thus the process of Russia's accession to the WTO might result in pressure, based on WTO rules, aimed at abolishing regional quotas both in the territory of Russia as a whole and for the Kaliningrad Region in particular.

3.3.2. Anti-dumping Procedures

Anti-dumping legislation is the most frequently used market protection tool by the EU against Russian exporters. (It should be remembered that the EU is the main trade partner of Russia and the Kaliningrad Region). After Russia's joins the WTO, anti-dumping procedures will remain feasible but more complicated. The changes directly concern the Kaliningrad Region as an exporter of raw materials and semi-finished products, and as a transport hub for the exportation of raw materials from Russia. Even though anti-dumping disputes have not involved Kaliningrad export enterprises, the probability of such actions in future cannot be excluded.

<p>According to Article VI GATT, dumping is defined as a method of export sales where the "goods of one country are put up for sale in another country at a price below the normal cost of the goods". Dumping as such is not prohibited. Anti-dumping measures may be taken in certain conditions. They are possible in the following cases:</p> <ul style="list-style-type: none"> • based on a complaint from a subject(s) of industry in the importer-country, an anti-dumping investigation is conducted; • the investigation has proved the fact that dumping is, or can be, detrimental to the material interests of industry or can lead to a slow-down in the development of the respective industry. <p>Carrying out anti-dumping investigations over imports is envisaged by trade legislation of most countries. The legal framework in WTO member-countries is unified The application of anti-dumping measures is regulated by the EC Basic Regulations No. 384/96 on protection against dumping imports from non-EU countries. To take anti-dumping measures against Russian exporters, the investigation body has to prove at least three facts:-</p> <ul style="list-style-type: none"> • the fact that dumping exists;
<p>the fact of material damage to a local (national) industry-</p>
<ul style="list-style-type: none"> • the existence of the cause and effect relations between the dumping and the damage caused to the local industry.

In addition, the formalisation and more advantageous rules for implementing anti-dumping investigations may give a guarantee of more stable Russian exports which will be beneficial for the region in view of its transport specialisation.

3.3.3. Technical Requirements Standards and Certification of Export Production

Technical requirements are one of the most efficient legal mechanisms for market protection against external competition. EU enlargement makes Kaliningrad's existing and potential exporters face the fact that: CE countries, including Kaliningrad's major trade partners - Poland and Lithuania – adopt EU technical standards as their guidelines. Consequently, Kaliningrad exports oriented to Europe have to meet the same stringent criteria and to be certified according to the same strict rules.

It is difficult to overestimate the significance of technical requirements as real barriers to the ingress of outsiders' goods to European markets. Therefore only one third of goods, covered by agreements on free trade between the EU and certain developing countries, can really use the regime and overcome the bar-

rier of technical and documentary requirements⁶. In addition, industrial products, the exports on which Kaliningrad Region's development hopes are based, are the most difficult to certify.

The problems of certifying export products, related to the EU enlargement, may have positive and negative aspects for the Kaliningrad Region. The negative aspect is obvious and real: it is the strengthening of certification procedures for exporting to Central and Eastern Europe. The positive aspect consists in the unification of certification procedures for the entire European Union. Having passed relevant procedures, the Exporter may get access to the whole huge market of the European Community.

The results of studies by working groups and individual researchers contain an assumption⁷, which we fully support. A Centre of Norms and Standards must be established in Kaliningrad which will become an efficient tool for informational and technical assistance to regional economic subjects with export potential.

3.4. Other Changes of External-trade Conditions in the Region

Amongst other spheres where one might forecast changes to the existing situation which may influence regional external trade, one may point out the visa problem, freight transit to mainland Russia, and the problem of electricity and gas supplies. The complexity of forecasting and the uncertainty for settling these problems may be a considerable handicap for the region's economic development. Thus the introduction of the visa regime by Poland and Lithuania increases overhead business costs and deteriorates conditions for tourism and related industries. On the other hand, the Agreement on Partnership and Cooperation (the APC) envisages free freight transit without any customs charges through the territories of new EU member states. This creates the framework for a positive solution to be reached in the process of trilateral negotiations between the EU, Lithuania, and Russia. The 900-MW Combined Heat/Power Generation Plant (TES-2) would meet the region's need of electricity. However, the achievement of this goal is connected with the issue of gas supply and requires the laying of a new gas pipeline through the territory of Lithuania.

Separately, it should be mentioned, that the Polish Republic and Lithuania might toughen their border crossing regimes because their boundaries will become external borders of the European Union. This may, and would, lead to a decrease in black/grey cross-border trading. In principle, this is a positive phenomenon in the long-term but, in the short- and medium term, it will result in a loss of livelihood for 10,000-40,000 families, concentrated mainly in small border towns. This would create a serious structural problem because employment opportunities in these towns are extremely limited. It appears desirable to discuss the possibility of developing a programme of structural assistance to encourage legal business activities (within the framework of European funds for assistance and cooperation) in the border territories.

4. Liberalisation of External Access to the Services Market: Consequences for the Regional Economy

The task of quantifying the implications of Russia's accession to the WTO for the regional services market is much more complicated when compared to commodity markets. This is because of several factors. The nature and regulation methods of services, being the result of economic activities, are much more different. Intangible non-price factors (traditions, producer's reputation, etc.) have qualitatively different significance on the world market.

Exact quantitative appraisal for the implications of liberalising access to the RF market of services seems unfeasible or, in any case, wouldn't be correct. It should be added here that their integrated appraisal is impossible without considering the most important indirect effects (change of business culture, improvement of investment climate, enhancement of the entire business environment etc.), which are difficult to express in quantitative terms. However, the indirect implications of Russia joining the General Agreement on Trade of Services (GATS) may be more important for the economy as a whole than any direct effects of that step.

From the point of view of the implications in joining GATS, another important feature of the services market lies in the essential differences between the federal and regional visions for the situation and interests, which can be seen in the case of the Kaliningrad Region.

⁶ Brenton P., Manchin M. Making EU Trade Agreements Work. The role of the Rules of Origin. CEPS Working Document, 2002, No. 183. Brussels.

⁷ Kiel international ad-hoc group of experts on Kaliningrad (2002).

As is known, one of the most complicated problems in the WTO accession process is liberalising access to the **financial services** market. However this is more of a problem for Moscow because over 85% of national financial operations are traditionally effected in the Russian capital, and Moscow banks are holding leading or even monopoly positions in many regions. The inflow of foreign bank capital would mean intensification of competition for major Russian banks. For regions the aggregate effect would be, at least, not negative. In the majority of regions, including Kaliningrad, no substantial or indirect effect on the market or the revenue of local budgets could be expected. On the other hand, credits might become more accessible and cheaper for local producers and the general investment environment might improve. Such beneficial effects might manifest themselves earlier than in other regions, but even here it would take time.

The problem is not that foreign banks would come to the region but that they would not want to come, the main reasons being not only legislative restrictions but the unpredictability of the market situation and, therefore, high risk. Furthermore, one should keep in mind that, until now, foreign banks (like most foreign providers in the sphere of financial and other services) have predominantly specialised in servicing foreign companies and, partly, major Russian businesses. Such specialisation is likely to remain in place for a very long time. In reality, this means that no 'invasion' of the regional financial market would take place.

Similarly, one can assess the eventual implications of Russian commitments to the WTO and insurance services sector. Serious insurance investments have not yet come to the insurance market, despite the cancellation of restrictions on foreign participation in Russian companies' capital. Meanwhile, economic actors in the region are objectively interested in extending the possibilities of insuring their economic risks.

The massive inflow of foreign capital to some sectors of the Russian services market has already assisted in the development and positioning of domestic service providers. This can be proved by changes to the situation for a wide range of **market support services** (audit, consulting, publicity, management), where the presence of foreign business is more visible. Many Russian companies have assimilated western experience and offer an adequately wide range of high-quality services, whilst using to their benefit a number of substantial advantages of foreign providers (correlation of the price and quality, better knowledge of Russian reality, etc.). In the opinion of experts, in recent years, the share of foreign companies in this sector of the market has started to decrease.

Foreign presence on the market of **telecommunication services** is almost similarly visible. The inflow of foreign investment has partly compensated Russia's technical lag in this field. The accession to GATS might intensify the process. Given that the Kaliningrad Region risks finding itself 'telecommunicatively' isolated in the centre of Europe, the benefits of the process would be evident.

The situation is more ambiguous in the transport services sector, which is of special importance for the Kaliningrad Region. Even though the share of transport of GRP is only 7%, which is slightly below the average Russian value, its role in the region's viability cannot be overestimated. In general, complete or partial liberalization of the transport services market may have a beneficial effect on the region. It should contribute to the increase in land transit traffic, a decrease in transport costs for Russian cargo consignors and consignees, and improvement of transport service quality. However if the current preferential regime (artificial underrating of tariffs for railway and air transportation) is preserved, it is hardly possible to expect participation of foreign competitors in this sector. The cancellation of tariff preferences without replacing them with adequate compensatory alternatives may cause problems for transport enterprises and, mainly, ports in the Kaliningrad Region. It should be noted that Russia has been insisting on the preservation of substantial restrictions in the marine and air transport sector.

In the **trade services** sector, the accession to GATS may lead to foreign expansion, primarily in the retail part of the sector. Amongst expected positive effects would be the spread of new technologies and methods for their distribution, and a decrease in general distribution costs. The benefits for consumers would be evident. It should be noted that local companies in the Kaliningrad Region would remain remote from competition for massive consumer for a long time, partly due to their specific advantages (involvement in the cross-border trade, etc.).

In the **tourist services** sector, Kaliningrad firms are already strong enough and hold certain niches on the market. However, they do not have a sufficient volume of resources to develop the rather weak logistical framework in the territory of Kaliningrad Region itself. Like anywhere in Russia, one of the bottlenecks is the shortage of medium-standard European-type hotels which are to accommodate foreign tourists. An inflow of foreign investments, to which GATS accession might contribute, would be quite suitable.

In general, the threat of foreign competition on the Russian market, related to GATS accession, is obviously exaggerated. In Kaliningrad's case, the beneficial effects are more apparent, especially if one takes into account the region's further development as a pilot region for Russian-European economic cooperation. The opening of the market for services would contribute to solving several basic tasks: adaptation of Russian legislation to international rules and standards, creation of modern market infrastructure - indispensable for improvement of the region's attractiveness for investors, the more so for overcoming the region's self isolation in common European economic space. However rank-and-file consumers of the various services will benefit most of all.

The General Agreement on Trade of Services (Art. II. Item 3) stipulates that "It shall not prevent any member to grant or provide privileges to adjacent countries within border areas in order to facilitate the exchange of services, which are produced and used within those territories". Thus, Kaliningrad Region has some additional opportunities for opening up access to the services market.

Meanwhile, the possibility of staged cancellation of restrictions should not be overlooked. This would decrease eventual losses, and allow some time for domestic producers to improve their competitiveness and to adapt to new conditions.

5. Scenarios, Experience, Results

5.1. Development Scenarios based on Changes of Import Duties and Quantitative Restrictions

Within the framework of this bulletin we will examine and briefly describe four development scenarios which will consequently result in different trade orders.

- The first (conservative) scenario envisages: (a) preservation of the current SEZ conditions (b) Russia's rejection from WTO membership.
- The second scenario implies the preservation of the SEZ status (probably changed by the new Law) for a few years after Russia's accession to the WTO. It can be assumed that this scenario is the most probable.
- The third scenario: the abolishment or radical change to SEZ regulations as a consequence of Russian WTO-membership or as a result of federal policy changes towards the Kaliningrad region.
- The fourth scenario is based on the assumption that, in the long run, Russia will sign the agreement on establishing a European-Russian Free Trade Zone.

The description of the scenarios, and their brief analysis outlined below, is not aimed at presenting a final conclusion on what awaits the regional economy in the context of changing conditions for external economic activities. However, in our view, they allow for the better understanding of the nature, the character of development, and eventual implications of the processes, in which the Kaliningrad Region is involved. An in-depth study of this process in terms of its possible influence on economic actors in the region will be carried out in the framework of future bulletins.

5.1.1. Scenario I – Business as usual

The first scenario is the status-quo scenario. It implies that the present conditions will be retained: SEZ regulations will be used without significant alteration to their content until Russia becomes a WTO member.

The conservative scenario allows for the possibility of extrapolating modern trends in regional development policy: further increase of regional imports accompanied by the growth of exports to other Russian regional markets. Thus the orientation of Kaliningrad manufacturers to the Russian market, based on preferential custom tariffs in the SEZ, will be enhanced and, consequently, the one-way traffic of processed goods (including goods processed in the SEZ territory) through the region - from the EU to Russia and from Russia to the EU - will increase. In the situation where Russia is not a WTO member, the existing tariffs and other barriers to the Russian market will continue thus ensuring advantages for Kaliningrad manufacturers. However, it should be noted that the competitiveness of Central and East-European countries (the main competitors of Kaliningrad producers) will slightly increase, with respect to Russian regional markets, because of their entry into the sphere of the Russian-European Agreement on Partnership and Co-operation.

The negative impact of this scenario is that the instability to the regional economy will remain, and even become stronger, due to the inherent threat of changes to the SEZ regime under the pressure of 'internal' or 'external' forces.

This scenario is quite possible in the short-term but hardly possible in the long run. As no radical changes are foreseen in Russian foreign and external economic policies, which could stop the process of Russia's integration into the world trade system, it is expected that Russia will become a WTO member within the next three or four years.

5.1.2. Scenario II – Preservation of the SEZ status and Russia's accession to the WTO

It is expected that, under this scenario, Russian custom tariffs will be reduced due to Russia's accession to the WTO. In the year 2002, the National Investment Council of the Russian Academy of Sciences conducted a detailed study dedicated to the effect of Russian WTO-membership on the national economy. On making calculations, two tariff change scenarios were examined. The first, a more probable one, implies smooth transition of import tariffs towards an agreed final binding level. The second, a more 'optimistic' version, is based on the assumption that Russia will be able to increase import tariffs significantly, and afterwards, during a seven-year period and then reduce them to an agreed final binding level. The figures given in Table 4 are the results of the aggregate amount of import tariffs on a wide range of commodities, which are under discussion at the negotiations concerning the accession of Russia to the WTO.

Table 4

Comparison of the version of smooth modification of import duties with regard to their current level (version 1) and of the version involving a substantial increase of import duties in the year 2003 (version 2)

	2003		2005		2007		2010	
	Version 1	Version 2						
Oil processing industry	5.0%	13.9%	5.0%	11.4%	5.0%	8.8%	5.0%	5.0%
Coal mining	5.0%	5.9%	5.0%	5.6%	5.0%	5.4%	5.0%	5.0%
Ferrous metallurgy	14.9%	19.0%	13.7%	16.6%	12.5%	14.3%	10.7%	10.7%
Non-ferrous metallurgy	7.0%	12.0%	7.2%	10.7%	7.3%	9.4%	7.5%	7.5%
Chemical industry	7.8%	18.1%	7.5%	14.8%	7.2%	11.6%	6.8%	6.8%
Machine building industry	19.2%	35.9%	19.8%	31.7%	20.4%	27.6%	21.2%	21.2%
Wood-pulp and paper industry	15.5%	18.4%	14.9%	17.0%	14.4%	15.7%	13.6%	13.6%
Building materials industry	5.0%	5.9%	5.0%	5.6%	5.0%	5.4%	5.0%	5.0%
Light industry	21.3%	32.1%	20.6%	28.3%	19.8%	24.5%	18.7%	18.7%
Food industry	34.0%	42.2%	32.6%	38.4%	31.1%	34.6%	29.0%	29.0%
Other branches of industry	20.3%	35.0%	19.7%	30.2%	19.0%	25.4%	18.1%	18.1%
Agricultural and forestry	17.9%	43.7%	21.6%	40.1%	25.4%	36.5%	31.1%	31.1%

Source: Report, published by the Russian Academy of Sciences: National Investment Council. Implications of Russia's accession to the WTO for the national economy, M., 2002. p. 23-24.

According to the above analysis, changes in import tariffs will have only a minor effect⁸. However, due to the specific features for the functioning of the Kaliningrad economy, the results of the general analysis of the Russian economy cannot be fully applicable to the region (see Section 3 of this Bulletin).

⁸ "The effects of the modification of customs policy on the economy appears to be minor, both in respect of the general dynamics of the economic processes, and in respect to individual branches of national economy... The second scenario is characteristic of relatively higher rates of economic growth during the forecast period. This is connected with the effect of import-substitution after introduction of higher duties on the level of 'initial binding'. Later on, as the duties will be lowered to the 'final binding level', the economic growth rates under both scenario versions come closer to the same values. ... A sharp increase of import duties to the 'initial binding' level in the year 2003 in the second version of the appraisal, according to the obtained results, would lead to a 2.73% drop of the aggregate volume of imports, and to an increase of the aggregate national production output by 0.565%, compared to the 'zero' version. In that case, the GDP will grow by 0.586%. These insignificant changes prove the assumption of low sensitivity of the economy to changes of custom duties... It is obvious that in the sectors where serious protective measures are planned to be introduced (agriculture and machine-building) the dynamics is higher than in other sectors. A more detailed picture might be obtained from analyses of intra-sectoral structures, because, as is known, protective measures are applied to concrete goods, and not to the entire sector production". (Russian Academy of Sciences, Na-

It should be noted, that the economy of the Kaliningrad Region is highly sensitive to changes in custom tariffs. The development of the regional economy in the 1990s resulted in the formation of its import-substitutive character (70-80% of the regional industrial enterprises belong to the import-substituting production sector), and its orientation to taking advantage of duty-free importation of raw materials and components (spare parts) into the region for processing and subsequent exportation of finished products to mainland Russia. The model of import-substituting economic activities, based on tariff- and non-tariff barriers, being formed in the Kaliningrad region, in the long run will lead to the region's non-competitiveness both in the national and international division of labour. It is obvious that the general reduction of import customs duties in the Russian Federation will lead to a fatal decrease in the profitability of the import-substituting sector. In new conditions, its production will be non-competitive on the domestic Russian market due to high transportation costs and, because of its technical and technological backwardness, it will hardly be in demand in the majority of foreign markets. An obvious, and probably only, way out of this situation is to intensify the search for new kinds of businesses aimed at producing export goods, as well as to accelerate the modernisation of existing production enterprises with the goal to bring them to international standards combined with export orientation.

It is of certain interest to compare these arguments with the opinion of Tatar experts regarding perspectives for the Free Economic Zone "Elabuga" in Tatarstan. The research foresees negative results of Russian membership in the WTO for the FEZ "Elabuga". The rationale is as follows: "joining the WTO will mainly encourage the development of export-oriented production, whereas production by enterprises, located in the territory of the FEZ, is aimed at the domestic market (production of motor-car components, buses, oil-extraction equipment, etc.). A large part of the investment projects, being implemented, are also directed at substitution of imports. The reduction of customs duties in accordance with the WTO requirements may lead to the inexpediency of implementing some of the projects due to an unexpected increase of imports in the same goods. («About the effects of accession of the Russian Federation to the WTO on the production economic sector in the Republic of Tatarstan", RT Informational Materials, 24 September, 2002).

In spite of a high potential threat, which is hidden in the perspective of normalising Russian custom tariffs, the region's economy has certain chances for successful development. The adaptation of customs legislation of the Russian Federation to WTO norms will take rather a long period of time (the duration of the transitional period, most likely, will not be less than 5-7 years), during which a reduction of bound (initial) customs rates is to take place. Moreover, the level of bound rates (it is expected that initially not all tariffs will be bound, but just 60-70% of the commodities nomenclature) can be set even higher than the effective ones at present. Such a long transitional period, in the presence of the existing basic strategy for regional development and a will to implement it, will give time to adapt the region's economy to the new conditions.

An in-depth analysis of the prospects of the external-trade regime in the Kaliningrad Region by economic sectors will be presented in future bulletins.

We can briefly quote the rather authoritative assumptions by Mr. Maxim Medvedkov, Deputy Minister for Economic Development and Trade, the main Russian "negotiator" with the WTO. In his opinion, joining the WTO will lead to the following effects on particular sectors of the Russian economy:

- *High-tech branches.* Alternatives are possible depending on the level of encouragement for technological progress in the country.
- *Food processing.* Not possible to state even now the effect of import competition on the market
- *Furniture.* Every percent of the protective tariff is important.
- *Pharmaceutics.* Exacerbation of competition, but the consumer can gain on the quality of import.
- *Metallurgy.* Competitiveness will depend on the prices of goods and services from these natural monopolies.
- *Chemistry.* The exacerbation of competition on small-tonnage chemicals, motor oils and cosmetics.
- *Motor road and air transport.* Will be able to survive only if supported by the State.
- *Transport.* Competitive situation will be preserved.
- *Communications and computer technologies* The exacerbation of competition, leading to a partial gain by consumers.

- *Trade.* Situation in the wholesale link will be preserved. In the retail trade – invasion of foreign supermarkets.
- *Sciences.* The WTO will bring little changes. The main issues – lack of financing, brain drain.
- *Financial sector* will be able to survive if supported by the State, but the consumer will gain from competition.

5.1.3. Scenario III – Cancellation of the SEZ regime or its radical modification

The third scenario assumes the abolition of the SEZ regime. This could be the result of Russia's accession to the WTO as well as changes in Federal policy towards the Kaliningrad region.

Consensus can be noted from the speeches of experts in different spheres of activities, civil servants, and elected persons and businessmen. The common opinion is that abolishing the Special Economic Zone will have an extremely negative impact on the regional economy and may lead to its complete collapse. In the course of the transitional decade of the 1990s, the economy of the Kaliningrad region was restructured on the basis of SEZ custom privileges. It has resulted in the situation whereby, according to expert estimations, up to 80% of the regional economy is based on the SEZ's tariff regime. In case of its abolition, the larger part of these enterprises will close or relocate to other regions of Russia.

One may assume that some industries and enterprises will be able to survive the abolition of SEZ regulations, particularly where objective factors of competitive advantage exist or cluster formation takes place. The furniture industry may serve as an example. It was formed thanks to SEZ privileges but it has chances to survive if SEZ privileges are abolished, and to retain the position it has gained on the Russian market or to try and win markets in old and new EU-member countries. Nevertheless, one may surely assume that the abolishment of the SEZ regime will immediately lead to a deep and long crisis in the regional economy.

The radical changes to the SEZ regime mean, first of all, abolishment of duty-free exportation of products manufactured in the SEZ territory to mainland Russia. The probability of such an outcome exists in relation to commitments which the RF can make in the course of WTO accession. In this case the Kaliningrad Region, devoid of the right of duty-free exports but retaining the right of tax-free imports, will become a typical free customs zone. In the short-term period, this will result in the same kind of economic crisis as per the full cancellation of SEZ regulations because Kaliningrad producers would lose their competitiveness on the Russian market.

If the abolishment of the right to duty-free export to Russian territory becomes a necessity, it should be introduced extremely carefully over a long, probably 10-year, transitional period which will allow for mitigating any impacts on the established economic mechanism. The duty-free exports mechanism must be replaced with other mechanisms of economic stimulation, in full compliance with Russia's future international commitments in the framework of the WTO. The question outstanding is what tax and investment benefits could make the Kaliningrad Region economically attractive in case it becomes a typical FTZ. However, even with regard to the transition period and introduction of considerable tax and investment benefits, the cancellation of the right to duty-free export of Kaliningrad products to other Russian regions is likely to result in several difficult years for the region. As to whether radical changes in the SEZ regime would, in the long run, be beneficial for the Kaliningrad Region, then this question requires additional analysis.

5.1.5 Scenario IV – Setting up of a European-Russian Free-Trade Zone within the Framework of the CEES (long-term)

The most natural element of the Common European Economic Space (CEES) and its main component may become the Free Trade Zone (FTZ), which will unite the trade spaces of the European Union and Russia. The political will to create a Common Economic Space was demonstrated, but practical development and implementation will take a long time. Experts (scientists, EU and Russian civil servants, diplomats) estimate the setting up of the FTZ in terms of a long-term, 10-20 year, perspective. Nonetheless it is necessary to start thinking now as to how the FTZ can affect the specific economy of the Kaliningrad region, since its impact can be very significant.

How does the CEES look like if applied to the Kaliningrad issue? First of all, we should take into account the long-term duration of perspectives of multitude of aspects of the EU-Russian Federation FTZ. Another aspect is more important. The EU-RF FTZ may not necessarily produce a favourable impact on the economy of Kaliningrad, a reverse effect is possible. Of course, a positive effect on trade growth may turn out to be profitable for the region, due to its functioning as a transportation hub. Nevertheless, the benefit of the effect on production can be questioned. It is necessary to take into account that, at the current moment, the central place in the regional industrial structure belongs to import-substituting production. The development of these industries is based on customs privileges, provided for in the Kaliningrad Special Economic Zone. In implementing an EU-Russian FTZ, the real volume of privileges for Kaliningrad (compared with the rest of Russia) would be significantly reduced and would be equal to the imports from those countries which are not EU members. The reason is simple: setting up the FTZ pre-supposes a zero tariff for foreign trade in respect to the partner in the free trade zone. Considering the fact that about 50% of the Russian imports are supplied by countries from the expanding European Union, we arrive to the conclusion that the Kaliningrad region will lose a substantial part of its competitiveness in Russian markets as a possible result of the European-Russian FTZ. In fact, setting-up an EU-Russia FTZ would emasculate the content of Kaliningrad SEZ regime's customs privileges.

This observation provides us with an additional argument for finding special solutions for Kaliningrad. Special strategies and solutions for Kaliningrad are already necessary in the short- and mid-term perspectives. There is a need for the special attention and approach to the problems of Kaliningrad region, both from the Russian Federal centre and the EU. First of all, a package of measures aimed at increasing the effectiveness of the functioning and application of norms for the CEES/FTZ appears to be necessary (for example, the above-mentioned Centre for EU Norms and Standards and corresponding technical support). Secondly, measures to improve the economic infrastructure (in the framework of the Kaliningrad Development Fund, European programmes of TACIS and INTERREG). Thirdly, a freer movement of people and usage of corresponding potential economic opportunities. Fourthly, it makes sense to assume an extension of standard CEES EU-Russia norms to the Kaliningrad region in additional spheres and sectors, for example, service sectors and agricultural trade. It is also possible to apply specific rules on the origin of goods.

It appears advisable to give the Kaliningrad region a certain time privilege during the introduction of the FTZ norms and to start with the Kaliningrad Free Trade Zone. The regional economy, being placed in especially difficult conditions, would then be capable of adapting to the new conditions within a certain time lag. This would help to avoid the eventual negative impact of the EU-Russia FTZ on Kaliningrad. It is also of no lesser importance that the Kaliningrad region can play a positive role as a site for modelling new procedures and rules, particularly those on the origin of goods and technical requirements.

5.2. Experience in Adapting Special Economic Zones (Free Custom Zones) to International Requirements in EU Candidate-Member Countries

The experience of the EU candidate-member countries in adapting their special and free economic zones to international requirements is of great interest, mainly for appraising the prospects of Kaliningrad's regional development should the concept of Common European Economic Space be implemented.

For EU candidate member countries, the determining external checkpoints in their foreign economic policy are the requirements of the integrating body. The matter is not only that accession to the EU is their strategic goal, but also that the requirements related to the freedom of competition and liberalisation of access to internal markets, implied by the EU membership, are much more stringent and often exceed requirements of the WTO and Organisation of Economic Cooperation and Development⁹. Meantime, the observance of EU rules, normally ensures freer access to the EU market not only by Union members but also for non-EU countries. Thus, acceding to the EU, some of the EU candidate countries have not joined the WTO GPA. However, after acceding to the European Union they will have to commit themselves to all EU international obligations, including the above Agreement. The European Union is also much more exigent in opposing all sorts of tax and other privileges relating to the existence of special economic zones.

The countries, neighbouring the Kaliningrad Region, which are joining the EU, have short, but rather illustrative, experience for the creation and consequent improvement of mechanisms of SEZ functioning. Amongst the key distinctive features of that experience, compared with Russian SEZ, one can point out the fairly stringent and systematic observance of tried and tested foreign models. As a result, and in con-

⁹ All ten EU candidate member countries have joined the WTO. Czechia, Hungary, Poland and Slovakia have been admitted to the OECD.

trast to Russian analogues including the SEZ in the Kaliningrad Region, the mechanisms of currently effective special economic zones in EU candidate-countries mostly manifest relative stability and correspond to initially set objectives.

The main directions in the modification of the SEZ's management mechanism in EU candidate-members were determined by the fact that, in the 1990s, the European Union was fighting against individual and regional quotas that prevented efficient competition. SEZ related benefits were included in the list of the privileges "in question". They were considered to be a form of so-called public (State or municipal) assistance to private entrepreneurs, which the European Union was trying to limit and to bind with the volume of funds invested by the entrepreneur himself.

The EU prefers to provide grants, subsidies, and assistance for the development of infrastructure instead of tax benefits. The permanently effective tax benefits contradict EU policy, particularly the benefits covering not only investments in fixed assets but also those costs of procuring raw materials, consumables, and spare parts. Such benefits were considered to be indirect subsidisation of exports, which was absolutely unacceptable for the European Union.

Meanwhile, in most post-communist countries, due to the limited capacity of public funding at both national and municipal levels, tax benefits and other privileges were considered to be more appropriate tools for regional policy than either grants and/or subsidies.

The least number of problems was related to adapting free economic zones (FTZ) to the new requirements. The general downward trend of customs duties made these privileges increasingly less attractive. In such countries where the level of protection of the market meant that tariffs were very low (e. g. in Estonia), there was no question of creating an FTZ at all. In other EU candidate-member countries, free economic zones were created - from the very beginning – according to a classical scheme in accordance with the WTO requirements which stipulate that the boundaries of a customs zone are the national border with all relevant implications. In addition, the schemes of combining free customs zones with free economic zones in different countries are constructed in different ways. In Poland the SEZs and free customs zones (FCZs) exist severally. In Lithuania, FCZs can be separate parts of free economic zones. In Latvia, two free ports are functioning under a regime of free customs zone. In addition, there are two complex SEZs, where the FCZ regime is combined with tax benefits. However in all cases, the customs border regime is functioning without exception.

Even though the legislation in most of these countries envisages the possibility of limited production activities in custom zones (processing and improvement of goods, repairs, etc.), these functions have not noticeably developed.

The most substantial experience with the functioning of special economic zones and their adaptation to international requirements has been accumulated in **Poland**. The first of the currently functioning FCZs emerged in 1989 in the port complex of Szczecin-Svinouisce (re-organised in 1994), and the special economic zone "Euro-Park" in Melets city, created with the assistance of experts from Irish Shannon SEZ in 1995.

Almost at the very start, Poland declined the idea of setting up free custom zones with developed production functions. In fact, the main objective of a FCZ is to form efficient logistical schemes. Therefore, by today, out of a score of FCZ projects only those dealing with the servicing of principal transport flows have been implemented. Out of seven currently functioning free customs zones, three are located in the marine ports of Gdansk, Szczecin, and Svinouisce). FCZs are also functioning at the largest river port in the country (Glivice), near the railway and road cross-border points at the Polish-Belorussian border (Terespol), at the crossing of meridian- and latitude-oriented motor roads in the centre of the country (Msconuv), and at the Warsaw international Okence airport. In addition to free customs zones, five free custom storehouses are functioning in Poland (4 in the biggest airports and one at the sea port of Gdynia).

A more substantial role has been given to special economic zones. In Poland, the SEZ was considered to be an important regional policy implementation tool. The main objective for creating the SEZs was to intensify economic activities in depressed areas with a high unemployment level. Some European models were used. However at the time when the Polish law on special economic zones was adopted (20 October 1994), they became obsolete because of new EU policy in this field. The inevitability of conflict with the new EU regulations became evident, more so because at that time Poland was intensively preparing to join the EU (the Agreement on Associated Membership was signed in December 1991).

As a result, special economic zones became one of the main issues of negotiations for the country's accession to the EU. The European Commission was unhappy about the large number of special economic zones in Poland and their territorial fragmentation (the latter comment was later withdrawn and enclave sub-zones of existing SEZs are still created in the country). However the most substantial EU claims concerned the system of tax benefits, which the EC found to be not transparent enough and difficult for calculations. The EC also criticized the long-term nature of the benefits, while the initial version of the Law on special economic zones focused on the importance of such provisions. According to that version of the law, SEZ economic actors, who observed certain conditions (minimum volume of investments, export orientation, specialisation in certain sectors, etc.) would be exempted from taxes on legal-persons' incomes for 10 years. In the next 10 years they could pay up to 50% of the tax. Local self-government bodies were also granted benefits within their competence: they could lower the land tax, real estate tax, rents on production and storage premises rates, and other charges¹⁰.

Another important claim by the European Union was against the regime of benefits provided to so-called sensitive industries (production of cars, textile industry, metallurgy, ship-building), the more so because SEZ regulations encouraged the orientation of such enterprises to exports.

The Polish side found itself in a complicated situation. On the one hand, accession to the EU was an absolute priority of Polish national policy. On the other hand, the harmonisation of national legislation with EU regulations would mean a substantial worsening of conditions for the activities of the economic subjects, stipulated by government directives. Such a development of events was dampened by including the provision on the priority of European legislation over Polish legislation into the regulations of the 10 special economic zones.

Nevertheless, as a result of negotiations with the EU, the Polish parliament had to modify the principles of privileged taxation of economic subjects, operating in special economic zones, in order to significantly reduce the benefits. Amendments to the Law on Special Economic Zones were made and came into force on 1 January 2001, as well as the Law on provision and control over public support provided to entrepreneurs by the State and municipal authorities. As a result, the benefits related to the tax on legal persons' incomes, granted to businessmen, who obtained a license for economic activities in a SEZ, before the new provisions of the Law became effective (before 1 January, 2001), based on the national Government directives, were reduced. The rate of benefits is directly bound to the size of investments. The greatest cuts concerned automobile industry enterprises, and the maximum size of State or municipal support to them was established at the rate of 30% of investments made in the zone before the end of the year 2006.

Lesser changes were made in the legislation for medium-size and small enterprises. These will be using benefits in accordance with the previously issued permits for economic activities in a SEZ. The marginal size of the income tax exemption for them is 15% higher than large enterprises (i. e. it is 65%). The previously set period of the SEZ regime validity is also preserved at the level of 20 years.

If the changes had not been made in the Polish legislation, much tougher EU regulations on the State and municipal support to economic entities in SEZ would become effective in Poland from the day of its accession.

The specific location of special economic zones in **Lithuania** and **Latvia** – in contrast to Polish SEZs – relates to transport hubs and main lines. In Lithuania, the SEZ is situated in the port of Klaipeda and in the area of Kaunas on the crossing of the Via Baltica with the highway leading from the Klaipeda Sea Port towards Russia. At the same time the 'peripheral' project of the SEZ in Shaulai turned out to be unviable. In Latvia, special economic zones are represented by the free ports in Riga and Ventspils, the SEZs in Liepaia and Rezekne (on the highway, not far from the Latvian-Russian border).

In these two countries the process of adapting SEZ regulations to EU legislation did not proceed as painlessly as in Poland. This was primarily due to the fact that SEZs in these countries were not considered to be important regional policy tools, and also because the zones with their legal framework started developing later than in Poland. Nevertheless, in orienting themselves to the European Union, both Lithuania and Latvia had to reduce the benefits for SEZ economic actors and to bind them with the volumes of their own funds invested. As a result the maximum rate of tax benefits (like that in Poland) cannot exceed 50% of the initial investments for large companies and 65% of funds invested by medium-size and small enterprises. Similarly, as in Poland, the 20-year period of validity for the special economic zone regulations has been retained.

¹⁰ See «Polskie specjalne strefy ekonomiczne». Red. Elżbieta Kryńska, Warszawa, «Scholar», 2000.

The experience of the EU candidate-member countries in adapting their special and free economic zones to international requirements allows one to make two important conclusions for appraising the prospects of the Kaliningrad Region's development, should the concept of Common European Economic Space be implemented:-

- such a scenario will lead to a gradual but inevitable levelling, and subsequent complete abolishment of regional quotas and preferences, preventing the natural development of competition;
- in the process of negotiations between the EU and EU candidate countries, the need for an adequately long adaptation period was recognised for facilitating the more or less painless discontinuation of the use of SEZ as a regional policy implementation tool.

5.3. Results and Recommendations

The situation around the Kaliningrad Region is such that, even in the medium-term, radical changes of external-trade conditions may take place. The changes would influence not only external trade in the region but also its inter-regional trade relations. This would certainly affect the regional economy where trade flows have played a special role. Thanks to the significant trade flows, the regional economic system is maintained and the population's welfare is supported.

The economy and trade relation of the Kaliningrad Region have a character, unique in many respects and different from other Russian regions. A specific feature of the region's trade flow dynamics is that the volumes of shipments to mainland Russia are growing, whilst exports to other countries are stagnant. This position of the region in European and Russian trade is determined by two key factors: the geographical location of the region and the tax benefits provided by the SEZ regulations. Under the influence of these two factors the trade structure of the Kaliningrad Region has been established, based on the development of import-substituting industries. At present over 2/3 of the region's enterprises are, in one way or another, using the SEZ mechanism in their activities. This economic model is characterized by a high dependence on the benefits granted to the region, thereby determining its especially high sensitivity to changes in conditions for external economic activities.

In the nearest few years, the conditions for external trade in the Kaliningrad Region (and in a wider sense: the conditions for all economic activities in the region) will be effected by the interaction of four key factors:-

- federal policy towards the Kaliningrad Region and the SEZ;
- the EU enlargement process;
- the accession of Russia to the WTO;
- implementing the concept of Common European/Russian Economic Space.

The influence of these factors might be ambiguous and lead to different results in the short-, medium-, and long term perspectives.

In order to assess these or other development options, four contrasting scenarios have been considered whose qualitative characteristics allow one to draw conclusions on the eventual future of the Kaliningrad Region, and to recommend measures accordingly, which would mitigate the threat of unfavourable impacts should any of these scenarios be realised.

Conservative (business as usual) scenario implies the preservation of the currently effective SEZ regulations in the Kaliningrad Region and Russia's exclusion from the WTO. This would mainly result in further strengthening the orientation of Kaliningrad's production enterprises, based on SEZ customs benefits, to the Russian market. This scenario is quite probable for the short term, but hardly probable in the medium-term perspective, so it can be used as the option for the next 1.5-2 years. However, one should clearly understand the time limits for the existing SEZ and the inherent uncertainty in the development of the Kaliningrad economy in such circumstances.

Preservation of the SEZ regulations scenario after Russia's accession to the WTO presumes that Russian custom tariffs would gradually decrease. In this case, the products of Kaliningrad producers, using imported materials and components, would become less competitive on the Russian market and thus lead to a decrease in profitability and closure of some of them. Taking into account the significant weight of import-substituting enterprises in the Kaliningrad economy, such a development variant could result, at least, in a substantial decrease of the region's economic growth rate.

The abolition or radical changes to the SEZ regulations scenario, as a consequence of Russia's membership in the WTO, or in case of radical changes in federal policy towards the Kaliningrad Region, the realisation of this scenario would have an extreme impact on the regional economy and might lead to its complete collapse. Today's regional economy is based on SEZ customs preferences, therefore instantaneous abolishment of the SEZ regime would result in a deep and long crisis in the regional economy.

The implementation of this scenario is extremely undesirable (and hopefully unlikely), because it would result in severe consequences not only for Kaliningrad's economy but also for Russia. If radical changes to the SEZ regime become a necessity, then they should be made very carefully, during an adequately long transition period, which would allow for mitigating the transformation of the established economic mechanism. In this case, all possible efforts should be made, to achieve the prolongation of the existing SEZ regime for at least the 3-5 years required for adapting the regional economy to the new conditions.

Scenario, based on the establishment of an EU-Russian Free-Trade Zone is probable in the long-term and promises ambiguous consequences to the region. A beneficial effect will arise from the growth of Russian external trade and the increase of transit trade flows through the region. However, on the other hand, the creation of the EU-Russian Free-Trade Zone may actually emasculate the content of Kaliningrad SEZ customs privileges, which would thus undermine the foundation of the regional economy's development.

A measure to compensate the impacts from such developments might mean making specific decisions on the Kaliningrad Region, actually turning it into a site for testing and introducing new standards, procedures, and rules to the Russian economy.

The analysis of the proposed scenarios shows that, in the medium term perspective, it is quite probable that conditions for the access of foreign goods to the Russian market will be gradually liberalised (primarily due to the accession of Russia to the WTO). This will "erode" Kaliningrad's customs benefits, provided under the Law on the SEZ, even if the provisions of the Law remain in force. Accordingly the price advantages currently enjoyed by Kaliningrad enterprises (over other Russian companies), in purchasing imported goods and components on privileged customs conditions, would decrease. Considering today's specialisation of the Kaliningrad Region as an economy built on import-substitution, a worsening of Kaliningrad enterprises' competitiveness on the Russian market might lead to serious problems for the regional economy.

In our opinion, the long-term strategy for the region's development must be oriented towards a greater integration of the economy into European economic space with the development of a sound export sector. This bulletin is not designed to present detailed recommendations for the implementation of such a strategy: this will be the subject of future bulletins and other project components. Meanwhile we can pinpoint a number of steps which might mitigate the regional economy's losses from the perceived impacts under the above scenarios.

1. Preservation of the SEZ in the short-term and medium-term future. The establishment of the SEZ in the Kaliningrad Region would allow for the creation of a large number of new production enterprises. At present, over half of the enterprises in the region are actively using SEZ privileges. Radical alterations to the main provisions of the Law on SEZ could result in a serious crisis to the regional economy. Therefore, any changes in the SEZ regime should be made gradually and enough time should be given to the bulk of enterprises for adaptation.

2. Increase the level of value added in the criteria of origin of goods in the SEZ. This measure would, to a certain extent, decrease the dependence of the regional economy on import-substitution. Furthermore, this step would create incentives for orienting new investments towards increasing the processing rate of imported, unfinished, products. This would allow for the upgrade of the industries' technical equipment and to improve their disposition in the region's territory. At the same time, in the short run, this measure might reduce the inflow of investments into the region.

3. Integration of the region into European economic space. The geographical setting of the region and its enclave situation makes the region dependent on EU decisions and policy in different economic spheres: custom tariffs and requirements, transit, environment, transport policy, fisheries, etc. These conditions necessitate the gradual adaptation of the economic activities in the region to the EU legislation. The approximation of European and Russian legislation is stipulated in the Agreement on Partnership and Co-operation signed in 1994 and by the recently approved CEES concept. In these conditions, the Kaliningrad Region might act as a pilot region in the partial adaptation of EU regulations. In particular, the crea-

tion of a European Quality Centre in Kaliningrad, where Russian enterprises could get their products and processes certified for compliance with European rules and standards, would be an important step forward in this direction

4. Facilitation of contacts between the region's inhabitants and those of neighbouring countries.

In order to implement this task, it will be necessary to open a number of European countries' consulates in Kaliningrad, and to introduce a simplified visa regime (using Polish and Lithuanian experience) followed by a gradual transition to a visa-free regime. Russia might make the first step in this direction by allowing visa-free visits to the Kaliningrad Region (and perhaps to "mainland" Russia) by EU citizens.

5. Support to exports. The WTO regulations prohibit direct tax support to export activities. Nevertheless Russia as a whole, and the Kaliningrad Region in particular, do not fully use the widely adopted export support mechanisms. Similar measures may include insurance of political risks, public funding of export contracts, information and consultations on the main export markets, organising trade missions, exhibitions, and fairs. In co-operation with the Regional Development Agency, the project intends to carry out a number of trade promotion events and to create the basis for providing information and consulting services to Kaliningrad enterprises for developing their export potential.