WIDER EUROPE

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Kari Liuhto and Zsuzsanna Vincze

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FOREWORD

In 1989, Eastern Europe was going through a profound political metamorphosis, as the first free elections after the Second World War were held in several East European states. This political momentum enhanced their socio-economic transformation and their re-integration with the western part of Europe. Now, some 15 years later, eight former socialist countries have assessed full-membership in the European Union and several other ones will join the EU during the forthcoming 15 years.

The enlargement of the Union gives new impetus to the effort of drawing closer to some 400 million inhabitants of the countries who find themselves on the external land and sea border, namely Russia, the Western Commonwealth of Independent States, and the Southern Mediterranean.

Probably more than ever before, we need to understand that isolation is not a solution but a condition for turbulence. In order to maintain the stability of Europe, the Union should not look into a mirror but through a window to better comprehend the future realities of Europe as a whole. In building relations with our neighbours, we must never forget that European integration is not about quotas and customs duties. It is about peace, prosperity and stability for our citizens.

The gap in living standard between the EU and its new neighbour-states stresses the importance of the European Neighbourhood Policy. The EU's Northern Dimension and planned Baltic Sea strategy provide functional regional frameworks to co-operate with the Union's largest neighbour, Russia. Actually, the new EU members, the three Baltic States and Poland are very welcomed actors in this framework. Their thorough knowledge and historical experience of Russia means that they may play a key role in establishing relations with Russia as well as with Belarus and Ukraine.

The cross-border enterprise co-operation may be an efficient way to enhance economic development for both the EU and the bordering regions. Thus, cross-border collaboration between the EU-based companies and firms located in the regions bordering the EU should be supported. These, among other important issues, are raised in the book at hand.

Moreover, the selected articles are representatives of the open communication among Europeans during the conference organised by the Pan-European Institute at the Turku School of Economics and Business Administration in August 2004. Opinions of all, e.g. politicians, diplomats, business practitioners, educators and social scientists needs to be listened, in order to create a wiser rather than a wilder Europe. We all have a stake in Europe's future and we ourselves are responsible for the social, technological, economical, environmental and political well-being of Europe, from the Atlantic to the Ural.

We dedicate this book to Professor Emeritus Urpo Kivikari, who constantly reminds us that "*the transformation of old enemies into new friends is going to be expensive and accompanied by serious problems of adjustment*". He, however, never doubts that these efforts are worth to pursue.

Turku, March 2005
Kari Liuhto and Zsuzsanna Vincze

Chapter 1

KEYNOTE ARTICLES

PROFESSOR URPO KIVIKARI

-"THE FATHER OF THE GULF OF FINLAND GROWTH TRIANGLE"

Juho Savo

Professor Urpo Kivikari is also known in Finland as "the father of the Growth Triangle" for he brought this new economic term into Finnish discourse at the end of 1990's. According to Kivikari the Growth Triangle means co-operation between at least three countries or regions located in close geographical proximity to one another. By developing prerequisites for an international division of labour, these countries will improve their competitive ability and welfare. The Growth Triangle is based on improving mutual ties between three economies, which is further based on the differences between their production infrastructures and level of development. Business orientation, political engagement and co-ordination are the basic prerequisites of the Growth Triangle.

Behind Kivikari's Growth Triangle concept is Asia, more accurately East Asia, where several Growth Triangles have already been implemented since the end of 1980's. The most important models for Kivikari have been the Sijori Growth Triangle between Singapore, Malaysia and Indonesia and the South China Growth Triangle consisting of Hong Kong and parts of China and Taiwan. The attained benefits in these Asian Growth Triangles have been for instance the benefits of large-scale and parallel production, technology transfer, new jobs, direct investments and globalization of companies. Of course there have been some difficulties too, for example, the lack of interest on the part of economic life and excessive state influence.

The Gulf of Finland Growth Triangle

Kivikari introduced the idea of the Gulf of Finland Growth Triangle in the first place in a book written in 1999 together with Maarit Lindström "Suomenlahden kasvukolmio – Suomen, Viron ja Pietarin alueen integraation väline", where the applicability and performance of the growth triangle concept were examined. According to Kivikari the business relationships of Finland, Estonia and Russia experienced a complete upheaval in the 1990's and as a result, new instruments are necessary to develop business relations between these countries.

The Gulf of Finland Growth Triangle refers to the economic area formed by the regions of South Finland, Estonia and St. Petersburg (St. Petersburg City and the Leningrad Oblast). When assessing the performance of the growth triangle model in the region of the Gulf of Finland, Kivikari found that it fulfilled well in many respects the fundamental prerequisites of co-operation for the growth triangle, it is important to mention that the economics of Finland, Russia and Estonia differ from each other markedly concerning production, costs and the foreign structure as well as with respect to market areas. In view of geographical proximity and accessability the prerequisites for implementing the growth triangle are indisputable. Kivikari also points out that even if the relations between Finland, the region of St. Petersburg City and Estonia haven't always been smooth in every respect the historical, cultural and economic ties be considered as a unifying factor rather than a divisive factor.

Kivikari also found that more closely linked economic co-operation between these three areas wouldn't be an entirely new development because there are already several existing bilateral and even trilateral co-operation models such as the commercial partnership agreement between Turku and St. Petersburg, co-operation between Lappeenranta and Vyborg and the Helsinki-Tallinn Euregio.

The South Finland Regional Alliance as the implementer of The Gulf of Finland Growth Triangle

The South Finland Regional Alliance is a co-operational organisation for the Regional Councils of South Karelia, Häme, Itä-Uusimaa, Kymenlaakso, Päijät-Häme, Uusimaa and Southwest Finland which has been responsible for the co-ordination and implementation of the Gulf of Finland Growth Triangle since 2000. Why the South Finland Regional Alliance? The most important motive is grounded in the fact that the Alliance seeks to develop the regional and economical relations between South Finland, Estonia and Russia. The growth triangle offers an excellent instrument to realize this aim. The growth triangle concept also supports the vision of the Alliance to make Southern Finland a high-level business centre in the Baltic Sea Region. The Alliance wants to draw attention particularly to developing cooperation between the sector of small and medium-sized enterprises and the public-private sector in the area.

The central co-operation partners for the Regional Alliance have been the Estonia Small Business Association EVEA, the Harju County and Ida-Viru County in Estonia and, the municipal administration of St. Petersburg and the regional government of Leningrad in Russia.

The South Finland Regional Alliance has sought in various ways to promote the development of The Gulf of Finland Growth Triangle. The central instruments have been the preliminary reports, i.e. strategy- and network projects by which the Growth Triangle Co-operation hopes to gradually intensify and develop.

The preliminary report

The Gulf of Finland Growth Triangle Preliminary Report was drawn up in February-August 2000. The objective of the preliminary report was to chart the possible co-operation partners, to outline the contents of the co-operation and to list measures for implementing the Gulf of Finland Growth Triangle. One of the objectives of the preliminary report was also to shed light on the attitudes and interests of the inhabitants of South Finland towards the Growth Triangle. The preliminary report comprised by interviewing a total of approximately 80 representatives from the central ministries, universities, research centres, business life organisations, enterprises and provinces. On the basis of assessing the results from the responses in the preliminary report, the hope was that co-operation between authorities and business life would be intensified in adjoining regions. During the phase of the preliminary report it was already discovered that the Growth Triangle is closely linked to the development of the EU's Northern Dimension.

Strategy

The formation of the co-operation network was based on the theme "The Gulf of Finland Growth Triangle". By adopting The Growth Triangle as an instrument in Finland, Estonia and Russia were thus integrated into the objectives for the project entitled The Gulf of Finland Growth Triangle Strategy financed by the South Finland Coastal Zone Interreg III A programme. Forming national work groups for the Gulf of Finland Growth Triangle in different areas played an important role in creating the network. The aim of the national work groups was not only to function as central liaison groups but also to find new areas of trilateral co-operation and to make project propositions. The work groups consisted of representatives from regional governments, organisations promoting trade, universities, research centres and ministries.

The Gulf of Finland Growth Triangle co-operation project was publicised during the project by participating in the St. Petersburg conference of The Baltic Sea Countries in October 2002 and by organising The Gulf of Finland Growth Triangle Seminar in Brussels in November 2002.

The project resulted in a joint strategy for the Gulf of Finland Growth Triangle that serves as the foundation for continued co-operation. The strategy project was implemented during 2002-2003.

Network
The Gulf of Finland Growth Triangle Network Project was launched at the beginning of 2004 as a continuation of the strategy project. The aim of the project is to extend the cooperation network of the Southern Finland, Estonian and St. Petersburg economic area as well as to intensify cooperation in the area. This presupposes finding new actors and increasing political support for the said cooperation. A central challenge is to expand the integration of the SME sector into the growth triangle cooperation model. During the network project, a Regional Planning Vision 2030 of Southern Finland will be formulated.

The Growth Triangle as a Process
The Gulf of Finland Growth Triangle should be seen as a larger process: its key elements are publicising the concept, promoting the project and coordinating the operations. As in Asia, bilateral and trilateral projects and connections enhance the Gulf of Finland's development into a growth centre in the Baltic Sea region. At the time when Professor Kivikari was launching the growth triangle concept, he stated that the growth triangle would not be complete during the initial stage and the that triangle had to be processed further. One objective has been to increase the number of actors involved in the growth triangle cooperation model. The principal successes so far have been operations in environmental enterprises within the growth triangle. Several companies from both Finland and Estonia are operating in the network of the field.

Political commitment
According to Kivikari, the success of the growth triangle is dependent upon political support and commitment to cooperation in the respective countries. Therefore, from the beginning of the promotion of the growth triangle attention has been paid to gaining extensive political and regional support for cooperation from Finland, Russia and Estonia.

Already in 2000, Prime Minister Paavo Lipponen stated in the Gulf of Finland Growth Triangle seminar that Southern Finland, Estonia and the St. Petersburg area constitute a unitary entity that will become one of the global growth centres of the future where diversified cooperation is generally accepted. Later Estonia's Prime Minister Mart Laar and President Lennart Meri amongst others have supported the growth triangle cooperation model. In Finland, the growth triangle has recently been introduced to Prime Minister Matti Vanhanen and President Tarja Halonen.

Although the growth triangle has been acknowledged as a significant initiative to develop economic relationships in the Gulf of Finland region, considerable work has to be done to improve the political commitment and coordination. Finland's and Estonia's commercial and political relations to Russia are closely linked to the general development of the relationship between the EU and Russia. Finland and Estonia have nevertheless the possibility of paying special attention to the economic relationships with Russia and to the development of the Gulf of Finland area.

Northern dimension

The Gulf of Finland growth triangle directly supports the Northern Dimension Policy of the EU that aims to increase the importance of the northern parts of the EU and to connect Russia more closely to the Western European system of cooperation. As an example of cross-border cooperation, the Gulf of Finland growth triangle is involved in the Northern Dimension Action Plan 2004-2006. In the growth triangle seminar, Prime Minister Paavo Lipponen estimated that the growth triangle concept plays an important role in the development of the Northern Dimension. According to Lipponen, the Gulf of Finland growth triangle focuses on the most promising area of the northern dimension. According to Kivikari, the Baltic Sea region growth triangle (or triangles) can provide a new link to Russia, the expanding EU as well as to the Northern Dimension Policy.

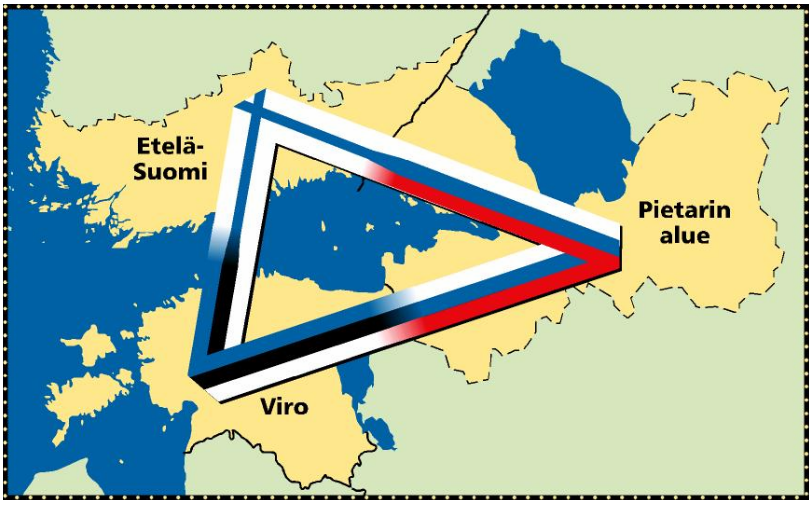
Future of the Growth Triangle

Major changes have taken place in the operational environment of companies in the area of Gulf of Finland since the 1990s. Finnish enterprises have become established in Estonian markets in many ways, Estonia has become a member of the EU and NATO, Russia has been recognised as a market economy country and negotiations concerning its WTO membership have made significant advances. Trade between Finland and Russia has increased steadily and Finnish corporations have gradually started to target their investments to Russia.

The prerequisites for the growth triangle emphasised by Professor Kivikari have not disappeared as a consequence of changes in the operational environment. The economies of Finland, Estonia and Russia will remain different for a long time with respect to their cost structures and differences in their respective development. The growth triangle can also be utilised as an economic model in the future so that the growth of the economies in the area can enhance the common interest in economic cooperation that is related to the environment and transport infrastructure among others.

We thank Professor Urpo Kivikari for his assistance and initiative in developing the economic cooperation in Southern Finland, Russia and Estonia. The work goes on.

Map 1: Gulf of Finland Growth Triangle.



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NEW OPPORTUNITIES AND CHALLENGES FOR ECONOMIC COLLABORATION

Tapio Reponen

Competitive forces are changing our future

In business life there are many interesting trends at the moment. Over the last decade leading companies have moved from multinational to global operations. There is a more recent trend in the increasing demand to link locally customized services with the economies of scale that result from worldwide operations. One management challenge is to cope with this new customer need.

L.G. Thomas (2004) in his recent article titled “Are we all global now?” states that “A great paradox of contemporary economies is that as markets steadily globalize, many firms retain their distinct national identities….a group of scholars has contended that strong national identities are becoming a competitive liability in globalizing markets.” We should take these findings seriously in thinking of future development.

Market orientation and competition shape increasingly our future and we have to face the different competitive forces in our everyday life. Porter (1981) has defined the competitive forces in the following way: suppliers, buyers, potential entrants, substitutes, and industry competition. His recommendation was to analyze firm’s competitive position thoroughly with all these dimensions and then decide the feasible generic strategy.

Porter has suggested three different generic strategies: cost leadership, differentiation and focus on a selected customer group. In the recent development of global competition the role of price has strengthened, and the other elements (quality and service) has less influence. Consequently all the generic strategies are closer each other than ever before.

Price orientation means in the longer run that other strategic alternatives, quality and service, has less room for success. We can notice it in our everyday lives in the way that service is not as good or not similar than earlier.

Grönroos (2000) has stated that efficiency and service has strong relationships. Increasing efficiency may first improve service and quality, but in the longer run it deteriorates them. There are some weak signals on the emerging trend that price orientation has gone too far. End users notice that the service levels are not satisfactory; instead customers have to sacrifice service to get lower prices. This development may have a turning point, and we are hopefully returning to the situation where all the elements of competition are in balance.

In Finland we have been discussing the effects of globalisation for more than ten years. Some of our companies have been at the leading edge of implementing global operating models. Our economy is at the moment strong to meet the challenges of the globalisation, which has both positive and negative effects.

As an example of recent development in our own area we may take the decision to move the manufacturing of huge ships and electric power plants engines from Turku to Italy. Behind this decision there must be logical process of carefully considering different alternatives and factors influencing profitability of the company. Based on them the choice may be well argued and evident.

Results of this move are, however, very different in Turku and in Italy. We have empty factory, wasted competence of the workers, increasing unemployment in the area, lost of income in Finland etc. In Italy the situation is the opposite: more workforce is needed, investments are needed to add capacity and prosperity of the area increases. In this case Finland was suffering and Italy winning, in some other cases Finland is winning and some others suffering. We have to be prepared for both situations also in the future.

Alliances are needed

One of the features of modern competition is to look for strong alliances and other joint agreements. A single company is often too small player to serve global markets and therefore partnerships are created. Airlines are one example on strategic alliances to offer worldwide service to customers.

Cross-border alliances become more important in global networking economy. Jagersma (2005) has analyzed the success factors of these alliances and had pointed out e.g. the following factors:

- Appreciate that business and national cultures are different
- Be prepared to recognize and react to factors beyond the direct control of your partner
- Understand the advantage of cross-border alliance to the partner
- Commitment, courage and capability throughout the participating company's organizations are key to the successful cross-border alliance
- High expectations are common source of problems
- Communication oils the wheels of alliances and nothing is worse than to have two partners in the same bed with different dreams.

In this challenging environment of continuous change we should bring into attention the European tradition and perspective on management, where human centred aspects are heavily emphasized. In this way we might be different from mainstream economies, but we need enough negotiating power to make that model known.

This calls attention to the tradition and perspective of cooperation between countries in different parts of Europe. Regions may hold a stronger position in the future than they do today. A competitive region is, however, cooperation between several countries, not within a single one.

A competitive edge in the present environment demands the integration of research and development activities, ICT deployment and effective global logistics. Pioneering companies have already created integrated management structures to master their internal information flows, but there are still problems linked to customer service. Networking, joint ventures and mergers bring fresh challenges to the development of business cultures.

Information and Communication Technology (ICT) will play an increasing and essential strategic role in the present society of networks. That role comprises coordinating activities and keeping interorganizational groups together. This demands a very high level of service and top quality ICT.

In this development a natural cooperation between Baltic countries has a lot of potential. Finland is a country of early adoption and even pioneering use of technological innovations. We are known for our strong mobile communications industry and the development there. It is, however, just one example of using advances in technology. We hope to continue to be an important technology implementer, but more emphasis will be placed on marketing innovations. In this sense we have the potential to be a good partner in Baltic cooperation.

Commercialization of products and services will in the future have more emphasis than earlier. Business economics and business administration will have a stronger role in this development. Countries and contexts are different, but I am sure that the trend of marketing knowledge is strengthening in most European countries. Thus we have common interests to discuss.

Cooperation in the Baltic Sea region has always been extremely important to Finnish people and to the Finnish economy. E.g. at the moment Russia is the second largest import country and the fifth largest export country of Finland. The total trade is almost eight billion euros.

In the history there have been fluctuations in the trade relationships between Baltic countries. Despite of this fluctuation we have always understood that our economies are heavily dependent on each other. Finland is a small country and we have to understand the trade balance from this perspective, but despite this I think that the trade has always been important to all parties.

From this background it is very interesting to discuss our trade relations in the present world of increased globalisation. In the long term there are several factors influencing on the "profitability" of collaboration between companies and nations. In the present mental atmosphere there is a tendency to think short-sighted, and due to immediate profit orientation long-term opportunities are lost.

Universities' role in competitive economies

Universities are facing several challenges at the moment. Globalization, freer markets for research and education, shifting demographics meaning fewer young people in industrialized countries, diminishing public financing and students' loss of interest in studying for several years are all changing the environment radically (EUA, 2002; Barry et al., 2001). At the same time the quality of research is improving in many developing countries and younger people there are increasingly interested in studying in respected western universities. Consequently there are global structural changes in University markets.

Markets will become more and more fragmented in a way such that there will be global players offering their services worldwide, both through distance learning using a variety of e-learning technologies and through personal customized lecturing. There will also be smaller specialized universities to meet the demands of focused customer groups. These smaller units need cooperation, networking, joint efforts and even some ownership arrangements.

In this new environment the role and importance of strategic thinking are strengthening, as universities have to position themselves in more competitive markets. Research and education has to be on a global level, which calls for collaboration and alliances between them. Unifying knowledge creation among Baltic Sea countries is one of the great opportunities, which we have not yet fully utilized. We have different cooperating organizations, but their practical results are still limited compared to the huge potential.

Generally speaking global competitiveness requires for critical mass, networking, and specialization on core knowledge and focus on selected education areas. If we accept the foresight that market orientation will strengthen in University sector, these requirements should be taken seriously. Collaboration among Baltic countries is one alternative of creating competitive research environments. Our long tradition of University education offers good cultural environment for successful operations.

We are living interesting times in the European research environments. We need more mobility between Universities, large research projects, recruiting best young people into them and financial resources to support them. Baltic countries might be one strong research area in wider Europe. To meet this target we have to overcome the language barriers and create joint educational markets.

In science internationalization is a self-evident starting point. Research contributions are evaluated and classified according to their international novelty. In practice several language, culture, area and contextual factors have, however, influenced the evaluation processes. The situation is changing in the way that openness destroys all such border lines.

Conclusion

Baltic Sea economic and research collaboration has high potential in the present competitive world. We have understood this opportunity, but actions are taken very slowly. Pan-European Institute is one of the key players in Finland and might be one of the coordinating bodies of this cooperation. It is now time to realize professor Kivikari's visions (Kivikari et al., 2004) on Baltic Sea triangle, where the Institute could have a significant role. The Universities in Turku have knowledge and experience in studying the region and building networks there. Joint expertise would offer a solid platform for significant research efforts.

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DEEPER INTEGRATION AND FASTER GROWTH IN WIDER EUROPE

Paavo Okko

Introduction

Europe has a major challenge in global competition. The European Union has started its Lisbon strategy in order to become a competitive information society. The first results have not been promising. The new start of the Lisbon strategy is now required when the eastern enlargement was just completed. After the eastern enlargement of the EU the whole Europe has come into a fundamentally different stage of the integration process. An important question is now, what kind of growth effects will emerge from integrating quite different economies. The European integration has not earlier been widening and deepening so strongly at the same time. If the Euro zone will cover new members as soon as they are hoping for, the currency union will tested in different circumstances compared with its short history until now. The new member countries are mainly transition economies and their income levels are quite low. For that simple reason budget problems have been in the focus of the debate. That is why many citizens of the old member states have been concerned that the accession of low income/low wage countries will have adverse effects. In the long run the budget shares cannot be the crucial issue. The most important economic question is, what is the impact of the eastern enlargement on the economic performance of the large EU and its neighbours. Are we having a stronger Europe with deep and wide integration and better results in the global competition?

Endogenous growth theory offers an adequate approach to these questions. It points out how an economy can enhance its economic progress, and it also points out how economic growth may benefit from the fact that the EU is coming to be a heterogeneous group of economies. There is a potential for poor countries to catch up the rich ones. For the larger EU the hope lies in catching-up process: the average growth rate may be higher when large income differences do exist. Another question is how Europe will develop as a part of the global economy. Endogenous approach can offer advice also for this issue.

This paper briefly describes empirical observations on convergence in the history of the European integration. Expectations about the growth effect of the further integration are drawn from previous experiences of the European integration. There is also new research producing convergence simulations for the future. The role of human capital and institutions are seen important factors of the development both in member countries and in Europe as a whole.

Income convergence is the basic trend

There is a general hope among integrating economies, that the integration enhances economic growth and has a favourable impact on income differences between members. It is good to ask first, what are theoretical expectations on income convergence There is a large literature on growth and income convergence.

The neoclassical growth models are mainly in favour of income convergence via growth. Endogenous growth theory supports the existence of multiple equilibria and divergent behaviour of different economies. The catching-up and convergence are possible under certain circumstances. The countries with sufficient human capital, infrastructure and institutional settings are capable to adopt and use new technologies successfully. Investment in physical capital is a necessary but not a sufficient condition for convergence (see e.g. Kejak et al. 2004 and Okko 2004). Member countries belong to the same single market. They have no technical restrictions to adopt same technologies but their capacity to absorb may be different. That is why there is no ultimate guarantee for convergence.

According an unconditional beta-convergence measurement about EU14 (Luxemburg excluded) the speed of convergence has not been constant but income levels have been converting in the history of the EU (Wagner – Hlouskova 2002, 21-22). The speed of catching up in 1961-98 was on average 2,05 % per year. It was slowest in the 1980`s (0,83 %) and fastest in the 1990`s (3,59 %). The result shows that even if some studies have been indicating decreasing rate of convergence in Europe, it still seems to work.

In addition to above-mentioned β-convergence research (conditional or unconditional) there is a large empirical literature on measuring income differences by different kinds of inequality measures. So-called σ-convergence concept is based on the standard deviation of incomes. Even if poor countries are growing faster in relative terms, the income distribution may be changing adversely if original differences are large enough. Those calculations show that income inequality between the member states of the EU has been decreasing with variable speed over time (see e.g. Puga 2001 and Wagner – Hlouskova 2002).

Expected income convergence in the large EU with the single currency

The eastern enlargement of the EU created a union with large income differences. Countries have access to the same technology, but many of them are lagging behind. This means that the steady state income levels are near to each other but actual levels are far from each other. The crucial thing is how soon these differences will be narrowing. That will also determine the growth rate of the larger EU. There is now a large potential to catch-up. The R&D-input has crucial role to create an absorptive capacity of an economy (Griffith et al. 2003). The economy must be capable to create innovations but it must have also capacity to learn from others – using the main strategy to learn new things. A special way for that is offered by foreign direct investments (FDI).

If these predictions hold also for the new members of the EU, it would mean that the income gap will be narrowing but it will be an issue for long time in the future. E.g., the current gap in the per capita GDP between Poland and the EU15 average is about 60%. If the convergence rate would be only 2 % per year, the difference would be still about 15 % after 70 years! It is reasonable to think that members of a single market are capable for faster convergence. Actually, the latest observations show that the new member countries have a higher growth rate than the EU-15. So it is supposed to be also in the future, if we are going to see income convergence.

According Armstrong (1994) the convergence rate in Europe is lower if more peripheral regions are included into the analysis. This is in accordance with the original results by Paul Romer that in the global sample including countries of very different income levels no clear over all convergence is found. The catching-up - hypothesis works only in certain circumstances. Cumulative causation may work into the both directions; there are both convergence and divergence going on. In this respect it is important to notice that according to Barro (1991, 437) those poor countries tend to catch-up the rich countries, which have high human capital per person (in relation to their level of per capita GDP), but not otherwise. The debate continues but it reveals that the accumulation of human capital has a crucial role in the process of growth and convergence.

It is possible to demonstrate how fast or slow the catching up process will be in the large EU by assuming certain growth rates and convergence speed. Calculations made by Wagner and Hlouskova (2002) are interesting, but their content depends heavily on assumptions made. In an optimistic case it will take 26 years from the ten Central and Eastern European accession countries to catch up to the level of 70 % of the EU25 (Wagner - Hlouskova 2002, 42). The variation is large: Slovenia is already about at that level and for Latvia it will take 51 years. A comparison to the EU15 shows that, it will take 30 year to come to the level of 70 % of the EU15. Even if the tendency of convergence is in existence, income differences will remain forever in practice.

The prediction is that those low-income countries having the access to the same technology and investing strongly into human capital are capable to catch up high income countries. The new members of the EU are supposed to be that kind of economies. This will mean that the eastern enlargement is going to be growth-enhancing from the point of view of the EU. The low-income entrants are often considered to be a burden to the EU budget, but the main impact is on the real side of the economy. The fact that the EU is coming to be a heterogeneous group opens up new opportunities for growth. If new members are capable to catch up, the average growth rate will increase. Transition economies entering into the EU market have urgent needs for investments and they offer new possibilities to combine new ideas and new production.

FDIs mean an effective way of absorbing knowledge capital into a low income country. It is not only the question of comparative advantages of a country but also competitive edges of firms located in a country. The last ones are changes very rapidly via FDIs. That is why FDIs have also an important role in convergence process. According the simulations made by Alho et al. (2004) the speed of convergence is faster if FDI flows between members are larger. According the same results adverse effects of a relocation of EU-15 manufacturing to the new members will not be large.

Integration is a long-term process, which tends to abolish income differences, but they will never disappear entirely. According Charles Kindleberger (1968, 194) factor price equalisation is the ultimate measure of integration, but it is like the absolute zero point in low-temperature physics: it will be never reached! Income differences are fuel of economic growth, and an integration process has not yet come to the end as long as differences still exist. This all means that regional integration – as well as global integration – is actually an ingredient of economic growth.

Integration means also rearrangement of institutional setup of a country. That is one important background factor for the growth (see e.g. Easterly – Levine 2003). Actually, membership of the EU is sometimes considered from a very narrow viewpoint of membership related budget expenditures and revenues. The main consequence of joining to the EU is the change of institutional environment into which a country is committing itself in the future. For accession countries even the commitment to membership negotiations has meant a strong motivation factor.

There are also nominal convergence criteria of the EMU process. Those requirements deal with monetary and nominal conditions on economies entering into the EMU. The real convergence considered earlier means different growth rates, and different growth rates tend to mean different inflation rates. Inflation rates in traded goods sector and nontraded goods sector will differ, too. It will create the so-called Balassa-Samuelson effect. Faster growth is bound to affect the exchange rate (see e.g. Halpern – Wyplosz 2001). There will be a tendency towards real appreciation of the currency. The Balassa-Samuelson effect is potentially problematic both in the convergence process before the third stage of the EMU and during the single currency. In the first case it is difficult to keep the required exchange rate band and in the second one inflation difference is causing adjustment problems to a sub region of a currency area. The EMU may mean problems to fast growing low-income countries showing real convergence but having problems with nominal convergence. That means a challenge to the EMU, which was established actually for a final stage of a very deep integration. Now at least some transitions economies are entering into it perhaps too early.

It is lucky enough that there is also a tendency that the membership of a currency area makes a country to develop faster into the direction, which makes a member to be more suitable for an optimal currency area (Brada et al. 2005). Experiences from the Euro period are supporting this. Finland is a good example of restructuring in this way.

The market-driven integration is benefiting from large income differences. There is a strong tendency towards factor price equalisation and towards income convergence. The large EU and especially new entrants are in front of a challenge. They must be capable to create an endogenous growth process by investing into physical and into human capital and maintain high growth rate even if there are strong pressures of new competition and adjustment. The endogenous growth theory points out that it requires effective transformation towards innovation-driven economy. The new member countries have also high marginal returns of physical investment. That requires capital flows within the large EU, too. It will normally mean also migration of labour. By this way the investment rate both into physical and human capital can remain high. That is the ultimate guarantee of a high growth rate. This will also contribute positively to the competitiveness of the large EU.

The speed of convergence will be quite slow even if growth rates will differ clearly. This ends up to adjustment process requiring both sectoral and regional restructuring. It is quite natural that in these circumstances regional policies of the union is required to take care of observed regional disparities. Even if the average income differences between member countries are narrowing regional inequalities will remain, but he regional policy strategy is better to be in line with long term adjustment requirements than against the basic trends.

The European double challenge

Europe as a whole has a challenge in the global competition. A new investment-driven development in Asia and a new technological competition from the USA and some other countries outside Europe mean a strong adjustment requirement. Within the large EU we have the same kind of situation. The incumbent members have adjustment requirements because of competition from lower cost level entrants. It may seem paradoxical that the internal restructuring problem can help Europe in solving a simultaneous external problem of adjustment for the global competition. But that is a real option for Europe.

Successful catching-up process of the new members means possibilities for the old members. The crucial condition is that the new members invest enough both in physical and human capital. FDI is a good way of mutual adjustment. High income level member countries must be capable in increasing their productivity in accordance with their cost level. The fact that the old members are loosing some production to new areas within the union is their possibility to allocate more into more productive sectors. The capacity to transform is required both from the old and the new members. That is also the crucial issue for Europe as a whole.

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VISIONS AND STRATEGIES FOR WIDER EUROPE

Paula Lehtomäki

EU is the incomparably biggest foreign trading partner of Russia. When dealing with the future prospects of EU-Russia economic interaction, through the very nature of things, EU and Russia must be using big letters. In their very much own interest they are doomed to succeed, too.

By creating the view of four common spaces within the framework of the existing Partnership and Co-operation Agreement the European Union and Russia, at the St. Petersburg summit in May 2003, confirmed their commitment to further strengthen their strategic partnership. As we know these common spaces cover economic relations and environment; issues of freedom, security and justice; external security, as well as research and education.

In general terms, the aim of the Common Economic Space is to put in place the necessary conditions for increased and diversified trading by the way of pursuing economic integration and regulatory convergence, market opening, trade facilitation and infrastructure development.

Together with the main sectors such as trade, investments, industrial cooperation, competition and enterprise policies and so on, the essence of the Common Economic Space will be covering a wide range of more specific areas from intellectual property rights to satellite navigation, just to name some. Co-operation on environmental issues forms a central part of the work. In the beginning Finland proposed the environment to be dealt with as a space of its own.

One of the ultimate benefits of the Common Economic Space should be diversification of the Russian economy. For Russia pursuing an economic widening is very important because a sustainable growth of her national economy cannot be based on energy supplies only. As voluminous as the existing or foreseeable oil or gas reserves in Russia ever might be, in relation to the amount of population and the enormous geographical size of the country, I am afraid, they would not be sufficient as the only generators of income for prosperity and economic growth.

EU needs a fruitful co-operation with a dynamic Russian market corresponding to world standards and committed to a WTO guided integration. For Russia, the path to a sustainable economic growth must be laid down with investments, both domestic and foreign. So far, Russia seems not to have been very successful in solicitation for foreign placements, for example when compared with countries like China or India. One of the implicit tasks of the Common Economic Space, therefore, should be connected with the creation of an inviting investment climate in Russia.

The Northern Dimension became a part of EU policies in 1999 as a response to the challenges and opportunities in the Union's North European neighbouring areas. Finland was one of the main initiators of the project. After the EU enlargement in 2004, the main focus is on North-West Russia representing, as a matter of fact, both socially and economically one of the most promising regions in Russia.

Because of the importance of North-West Russia, the Northern Dimension policy should play a correspondingly visible role in each of the Four Common Spaces, not least in the Economic one.

The Northern Dimension Environmental Partnership together with the Northern Dimension Partnership in Public Health and Social Well-being have made a very promising start. I would like to call them real success stories. As a matter of fact, with the partnership concept, as I believe, we have found the form we need for carrying out the very idea of Northern Dimension with the active support of Russia.

It is also very important that the cooperation be further strengthened between European Union and the Regional Councils like the Barents Euro-Arctic Council and the Council of the Baltic Sea States. There are huge reserves of experience in each of these Councils.

Traditionally, the Northern Dimension Policy of the EU has been conducted through biennial Action Plans. The actual one will expire at the end of 2006. Thanks to these Action Plans the Northern Dimension has established itself as an integral part of the Union's overall foreign relations policy delivering for EU a great amount of valuable experience for a comprehensive vision on the future.

Now EU needs to express that vision with clear objectives and put it down in a long term strategy paper. For that EU needs the participation of her member states as well as the support of the international financial institutions. As much there is a need of Russian engagement.

Finland has given her special contribution to the EU Northern Dimension policy in the form of the bilateral neighbourhood area co-operation with Russia. In the future this traditional form of cooperation, at least to some extent, will be included in the framework of the planned by the EU Neighbourhood Policy Instrument covering cross border cooperation type of activities.

Thus, with the help of the forthcoming instrument EU will be taking up a very important form of practical cooperation with Russia carried out by Finland with success already for more than a decade. By that we Finns can be good advisors.

The Finnish EU-presidency will take place during the latter half of 2006, at a very decisive moment for the EU relations with Russia. That is because in 2007 the Partnership and Cooperation Agreement, forming already for years the contractual basis for the relations between EU and Russia, will partially expire. From 2007 onwards the Agreement could continue being in force one year at a time only. That would be living from hand to mouth.

The European Union and Russia, of course, have changed in many ways since the days the Agreement was negotiated. Consequently, we need some kind of an updating. Finland should be ready to give a substantial contribution to that work. Not only because of our EU-presidency in the eve of 2007 but according to our experience of Eastern Europe that has been gained through decades. Finland, I believe, has a lot to offer in the relations of European Union and our eastern neighbour.

THE EU AND ITS NEIGHBOURS IN A WIDER EUROPE

Kristiina Ojuland

The enlargement of the European Union on 1 May 2004 was the biggest in the Union's history. Instead of fifteen Member States, the European Union now consists of twenty-five countries. The population of the European Union grew by nearly eighty million. Its territory increased by more than twenty percent. The borders of the Union were redrawn.

But the enlargement was not a simple arithmetic sum of countries, people, and square kilometres. It was much more than that, since it actually extended the models of stability and prosperity that have worked so well for Western Europe, further to the east. The enlargement created an added value of security and prosperity that a divided Europe had never been able to provide.

It goes without saying, however, that security and prosperity in Europe are also dependent on the stability of the countries in the immediate vicinity of the European Union. Hence, we have to continue working not merely towards further integration within the enlarged Union, but also towards more active cooperation between the Union and its neighbours. This means aiming for the potential membership of the remaining candidate countries. It also applies to actively developing relations and cooperation projects with the European Union's eastern and southern next-door neighbours.

Estonia, as a European Union border state, realizes especially clearly, the need for creating and strengthening a zone of social and economic welfare, as well as of stability, in the immediate vicinity of the Union's external borders. The priority role of the Neighbourhood Policy is also reflected in the document <u>The Government's</u> <u>European Union Policy 2004 – 2006</u>. Due to Estonia's geographical location, our attention is mainly concentrated upon cooperation with the European Union's eastern neighbours, but we also support the development of the Union's relations with the neighbours to the south.

Helping to stabilise Ukraine, Belarus, Moldova, the South Caucasus, as well the Western Balkans and the Middle East and North Africa regions, contributes to the security and prosperity of all of Europe. Tighter cooperation with these vast areas contributes to the competitiveness of the European Union as a whole. It is, thus, essential to create the means for economic integration, as well as the intensification of political and cultural interrelations, to promote cross-border and regional cooperation, and also to prevent any possible development of economic and political conflicts between the European Union and its new neighbours.

We are glad to note, that the formulation of concrete action plans has been based upon a differentiated approach towards each and every state. Estonia welcomes the European Union's cooperation with neighbours on the basis of individual action plans. With several partners - Ukraine, Moldova, Morocco, Tunisia, Jordan, as well as the Palestinian Authority and Israel the European Union has already reached a common understanding concerning their individual action plans. It is praiseworthy that the countries of the Southern Caucasus have also been encompassed in the European Neighbourhood Policy, and that preparations are being made for the formulation of individualized action plans. We welcome the Commission's plan for a new European Neighbourhood Instrument, and the fact that Agenda 2007 comprises the European Neighbourhood Policy.

Developing relations with new neighbours is the endeavour in which the historical experiences and the know-how of new members are particularly useful. Estonia already has substantial experience with carrying out bilateral development cooperation with several countries. The Estonian contribution to the Neighbourhood Policy could be particularly valuable in the information and communication technology sector, as well as in the sphere of e-government. This is where Estonia has been quite successful in adopting new technologies and introducing reforms. We are happy to share this experience with other countries undergoing reform processes.

But active involvement is also expected from the countries that these policies are aimed at. Ukraine and Moldova, as well as the South Caucasus countries have expressed a clear wish for a more intensive level of partnership with the European Union.

For the sake of the future of Europe as a whole, it is important, that, in a country as large as Ukraine, a functioning democracy, a developed civil society, and an effective economy are established. We welcome the results of the Ukrainian presidential elections. This victory for democracy is, in our opinion, opening up new prospects for Ukraine to cooperate with the countries of the European Union, including Estonia. The European Union's more extensive cooperation with Ukraine should be taken into consideration upon the implementation of democratic and market economy reforms in that country. Ultimately, in the more distant future, the prospects for Ukraine's EU membership should be discussed on the EU level, if the reforms in that country succeed. And Estonia is actively contributing to Ukraine's European oriented development as a democratic state. This takes place, primarily, through development cooperation projects, and by participating in the formulation of the European Neighbourhood Policy directed towards Ukraine.

As Moldova has demonstrated its clear will to integrate itself in Europe, cooperation between Estonia and Moldova has intensified, and will continue to do so in the future. It is especially heartening to note, that the role of non-governmental organizations in cooperation is noticeable. At the same time, of primary importance, from the point of view of Moldovan development and international cooperation, is the solving of the Transnistrian conflict, which is both a stumbling block for Moldovan development, and a serious problem for all of Europe.

Estonia continues to support the unconditional withdrawal of Russian troops from Transnistria. The EU should increase its efforts for finding a sustainable solution to the Transnistrian problem, and should call upon Russia to fulfil its Istanbul commitments.

The situation in Belarus continues to be problematic. The European Union's future relations with Belarus should be based upon a pragmatic and selective approach when it comes to developing both the spheres of activity and contacts, with the yardstick being the promotion of democracy, as well as of human rights and freedoms.

Of particular importance are the relations and cooperation between the European Union and Russia. Therefore, relations with Russia should be based on the sharing of common values. At the Hague summit, on 25 November 2004, the Union's determination to build a balanced and reciprocal partnership with Russia based on the rule of law, democracy, human rights and fundamental freedoms, as well as a market economy was reaffirmed. The European Union plans to develop a partnership with Russia on the basis of the Four Common Spaces, which include the economic space; the freedom, internal security, and justice space; the external security space; as well as the scientific, educational, and cultural space. The Hague Summit also confirmed that both sides want to achieve an agreement concerning the Four Common Spaces Action Plans by the summit of May 2005.

But the adoption of documents as essential as the Four Common Spaces Roadmaps cannot be rushed, as this agreement must express the principles and interests of both parties. For instance, it is important to clearly establish how this new framework of relations with Russia influences the European Union members' cross-border cooperation with Russia and it's financing from the EU budget.

The European Union and Russian Partnership and Cooperation Agreement's (PCA) Enlargement Protocol, just as the ratification of the Kyoto Protocol by the Duma on 22 October 2004, must definitely be viewed as positive steps. Another welcome development is the agreement achieved at the Hague summit between the European Union and Russia regarding the starting of consultations in the field of human rights, concerning questions that are of interest to both parties.

As Russia's immediate neighbour, Estonia follows, especially attentively, the effects that developments there are having on foreign policy. In this context we have to remember, that some recent political developments in Russia have been of a dubious nature, and are giving an indication of the slowing down of the democratisation process there. Thus, more than ever, the European Union's Russian policy must be unified and consistent. Its cornerstone must be the observance of long-term common values, not the furthering of narrow momentary economic interests or other short-term considerations.

We have to bear in mind, that while tighter economic relations between the European Union and Russia are useful and beneficial for both, common values and democratic standards should not be sacrificed for economic gains. Already now, more than 50 percent of Russia's trade is with the European Union. The enlargement has created entirely new opportunities for both the European Union and Russian businesses. But so far, the European Union has not been very successful in convincing Russia that the completion of its democratic and market economy reforms is a precondition for more successful economic integration with the European Union. A more concerted approach by the Member States of the Union is needed. As an important development towards this goal, the European Union and Russia signed a bilateral protocol on 21 May 2004 concerning the terms for Russia's entry into the World Trade Organisation.

Also, we hope that the border treaties between Russia and Estonia as well as Latvia will be signed in the near future. These border treaties were actually ready to be signed several years ago, and Estonia has, since then, been prepared to sign them. Russia has now indicated that it is also ready to take this step forward and we hope that no additional stumbling blocks will hinder this development.

Russia's ending, on 1st of May 2004, the double customs tariffs, which had been levied against goods of Estonian origin, has undoubtedly had a positive effect upon Estonian-Russian trade. At the same time, Russia has unfortunately continued to implement measures, which have hindered the development of economic relations with both Estonia and other states. Therefore, we have, for some time already, had to deal with problems relating to the phytosanitary barriers for organic goods and also railroad tariffs. In both matters, the European Commission, which represents the interests of Member States, has an essential role to play.

Successful cooperation can and should also be promoted at the non-governmental level. One way to develop democracy and civil society in Russia is to intensify cross-border cooperation locally. We hope that the new European Neighbourhood Instrument will increase the possibilities for more actively engaging our Russian partners in mutually beneficial cross-border cooperation. Already existing structures and initiatives also provide a useful framework for such cooperation. Among these, particularly emphasize should be placed upon the European Union's Northern Dimension and the Council of Baltic Sea States. There is also ample evidence that contacts between local authorities, business communities, and non-governmental organizations can produce positive results.

The enlargement of the European Union has contributed to making Europe more secure and more prosperous. The European Neighbourhood Policy should be aimed at widening, even further, the zone of stability based upon democratic principles and economic welfare. And this can be achieved only through the combined and determined efforts of all countries involved.

RUSSIA — NEW EUROPE: PROSPECTS AND DIRECTIONS

Andrey Sharonov

First of all, I would like to thank the editorial board of your publication for the opportunity to share my views on the issue of economic transformations in the Russian Federation and development of trade and economic relations with the European countries.

In the beginning I would like to draw your attention to the main goals of social and economic development of the country identified by the President of the Russian Federation, which comprise growth of citizens' well-being, strengthening of democracy and development of civil society, consolidation of Russia's position in the world.

The state, while setting such goals for itself, must provide comfortable and safe living conditions for the citizens, create proper environment for production of world-competitive goods and services, exercise effective control over social and economic processes by way of applying the regulation system, which is flexible and low-cost for economic agents. The most important factor of state efficiency in the modern world is receptivity to changes in environment, flexibility, ability to adapt all state components: citizens, business, state administration system.

The state should confine itself to the limits permitting it only to create conditions for effective development of economy. Such conditions are to be provided through formation of high-quality institutes, primarily those of state administration, judicial system, law-enforcement authorities, financial markets, bank system, as well as through development of infrastructure and assistance in implementation of large investment projects. One of the instruments for pursuing the social and economic policy is active introduction of private-public partnership both, in social sphere and in setting-up of material infrastructure projects.

It is important to stress that objective prerequisites has emerged in Russia for stable economic development of the country and hence for cooperation with foreign partners. Above all - it provides the possibility to work on a long-term basis and to work with confidence and calm.

The Russian economy has registered stable economic growth for five years already. By economic growth rates Russia in recent years has been ahead of most countries of the world community. Over that time the GDP has grown by 40%, industrial and agricultural output has increased, as well as real incomes of population. Financial system remains stable. Inflation rates have come down. Situation in foreign-exchange market is predictable.

The indicators characterizing investment activity of the economy and its high potential continue to show positive trends. All these facilitate growth of confidence and interest among domestic, as well as foreign investors. Positive changes in the attitude of foreign investors towards Russia indicate the formation of favorable image of Russia in the world community. Foreign investors have become considerably more active in Russia. The total volume of foreign investments in the Russian economy has increased by 50% and reached about $30 bn. Significant growth of foreign investments reflects stability of the political, economic and social situation in Russia and is caused by the revival of business activity and raising of credit rating of the country. Russia has been transferred to the fourth group by credit rating. For the first time since the commencement of the reforms the international rating agency "Moody's" has raised Russia's rating up to investment level.

Dynamic growth of the Russian economy continues in 2004. Over the year the GDP is estimated to increase by 6.8-6.9%, industrial output - by 6.5-6.7%. High growth rates are expected for other basic macroeconomic indicators as well: investments in fixed capital, real cash incomes of population, retail trade turnover etc.

The existing potential of Russia, the accumulated mass of the changes accomplished since the commencement of the reforms, the geopolitical position of the country, the development of the processes of Russian economy integration into the world community enable us to give a positive assessment of the country's development prospects in medium and long terms.

The macroeconomic situation in 2005 and subsequent years will facilitate the growth of investment attractiveness of Russia. The growth rates of the economy will be high and stable. According to forecasts, the GDP in 2005 will increase by 6.3%, inflation will come down to 7.5-8.5%.

At the present time the economy development scenarios up to 2012 are being worked out, which provide for implementation of innovation projects ensuring enhancement of Russian industry competitiveness. Significant increase in economic growth quality will take place in 2005-2008.

While in the previous period external factors of growth prevailed in the economy, now we forecast considerable growth of internal factors for both main components - investments, as well as population incomes. Thus, while in the previous years the growth of exports was higher than the growth of domestic demand, in 2005 the economy will grow first of all due to the increased domestic demand. Upon the whole in 2004-2007 industrial output growth is estimated at 26-27%. In the forecast period the investment component of economic growth will become stronger. Investments are expected to grow faster than GDP - about 11% in the current year and about 10% in 2005.

The structure of production and investments will change in favor of manufacturing industries. The leading positions will be held by investment industries: average annual growth rates in machine-building and metal processing will be 8.5-10%, in building materials industry -6%. In consumer complex we forecast growth in food industry - up to 6% in 2006-2007. Rather fast reduction of inflation is forecast: consumer price growth will decrease from 10% in 2004 to 8-9% in 2005 and 5.5-6.5% in 2007.

Population incomes will continue to grow faster than production and will increase by 9.4% in the current year and 9% in the following year. Population incomes growth will be provided primarily by the growth in real wages. At that, the Government is taking certain measures, which will contribute to weakening of structural barriers of poverty - this means development of the system of targeted support for low-income categories of population (pensioners, disabled persons, large families).

Stable increase in household incomes will provide further dynamic rise of consumer demand, which will continue to be one the leading factors of economic growth. Retail trade growth is forecast at 7.5-8.5% in 2006 - 2007.

The presented picture of economic growth for 2005-2007 shows that serious qualitative changes should take place in the Russian economy, which will allow to enhance significantly investment attractiveness of the country, to raise living standards of Russian people and to improve the position of Russia in the world.

The administrative reform resulted in the reduction of state regulation of and interference in the economy, prevention of repeated functions of different organizations, division of functions and powers of executive authorities, development of self-regulating organizations in the field of economy, reduction of inspections, simplification of registration and licensing.

In medium term we are planning to carry out massive accelerated privatization of state-owned enterprises. The state will retain only such property, which is required to perform state functions. Such a move will not only increase state budget revenues, but in the long run will facilitate the enhancement of operation efficiency of economic agents and economic system as a whole.

Another important direction in the reforms is improvement of financial intermediary institutions - renovation of bank system and development of stock market.

The pressing task on the agenda is to use high-quality human capital for the purposes of accelerated development of non-raw-material industries. The reform of scientific sphere will be aimed at reinforcing the innovative orientation of applied scientific research and development, enhancing their contribution to economic growth and creating the institutes, which will facilitate transfer of innovations to production sector. Here it should be mentioned that state support for fundamental science must be undoubtedly preserved. In this direction we set a task of creating infrastructure of venture investment funds with a view to finance competitive innovations and to promote new products in the world market.

Major decisions have already been taken in the field of health care, the reforms of which should improve drastically quality and availability of medical services by way of transferring them onto insurance principles. Russia is striving to enhance openness of its economy. Work is going on in several directions at the same time. First of all, it is aimed at Russia's accession to the WTO and OECD, establishment of effective support system for Russian exports, improvement of customs administration and tariff system. It is important to note that the WTO accession process itself even now, though it is not yet completed, enables our country to use better its competitive advantages. The fact is that we have carried out serious work on bringing our legislation in conformity with the rules and regulations of the WTO. This creates favorable legal environment based on transparency for the activities of our economic operators and their partners, as well as consumers - our citizens.

In medium term we expect that the Russian economy will operate in the conditions of Russia's membership in the WTO. Russia will start to realize in practice the advantages of its participation in the WTO in connection with provision of equal rights for the Russian exporters in the world market. Accession to the WTO will be a necessary prerequisite for attraction of foreign investments to renovation and modernization of domestic production facilities, enhancement of competitiveness of Russian goods and acceleration of rates of structural reorganization of the Russian economy.

On January 1, 2004 new Customs Code of the Russian Federation came into effect. The Code stipulates reduction of customs clearance time, simplification of customs procedures and contains the provisions granting the right to appeal the decisions of customs authorities. We are striving for openness. And we also expect the same from our trading partners. Integration of Russia into the world economy expands the borders of accessible market not only for our companies, but of the Russian market for foreign companies as well. This is a two-way process. And for all participants of this process it is very important to have guarantees that measures taken by countries to restore fair competition would not be used for purely protectionist purposes. Otherwise the domino effect might bring to nothing all efforts of the world community on liberalization of world trade, enhancement of efficiency and transparency of instruments applied.

Increasing competitiveness of our economy, creating more favorable conditions for access of Russian goods and services to the foreign market and of our consumers to high-quality foreign goods and services - this is undoubtedly one of the factors of stable economic growth in Russia. However, it is not the main thing. The main thing is the man himself. He is the most valuable of all resources, which we possess. It is him, who should become the main object for application of our reforms in all directions. Enhancement of competitiveness of our citizens - this is, in our view, the source for improving quality of economic growth. That is why we speak today about social orientation, humanization of our economic policy, inter alia, in the context of Russia's integration into the world economy.

The current economic situation in Russia is rather favorable for business activity.

Over the last year the number of enterprises has increased by 10% and products (works, services) output - by 30%. This was facilitated by the goal-oriented policy comprising, in particular, reduction of administrative barriers and introduction of preferential tax regimes.

I shall tell you in brief about the Russian tax regime, which is one of the most favourable in Europe. See by yourself: profit tax is 24%, from this year VAT tax rate was reduced to 18%, sales tax was abolished, starting from next year single social tax will be cut from 35.6% to 26%. For small enterprises the situation is even more favorable. They may use three preferential (special) taxation regimes: simplified taxation system, single imputed income tax and single agricultural tax for related companies.

The simplified taxation system grants businessmen the right to choose taxation object: difference between receipts and expenses is taxed at 15% rate, gross proceeds - at 6%. At that, the

Government does not consider that it is possible just to confine itself to creation of favorable conditions for small businesses. Sometimes they still need major assistance from the state. Small enterprises have to solve the problems, which are no problems at all for big business - production areas, obtaining of loans, and access to foreign markets.

Consequently, the Government has to provide the required support for small businesses. The Programme of Financial and Credit Support for Small Businesses is now under preparation. Our proposals are based on the necessity to develop market mechanisms for crediting small enterprises and that means repudiation of direct crediting out of budget funds. In the nearest future the main focus will be on the establishment of mechanisms for dividing the risks between the state, businessmen and banks.

The foreign trade turnover of the Russian Federation has a tendency to grow. In 2003 it exceeded $191 bn (exports - $133.7 bn, imports - $57.4). Exports have increased by more than 33.7% and imports – by 24.3% compared with the previous year. By the results of 2003 positive foreign trade balance amounted to $76.3 bn against $60.5 in 2002 that caused substantial rise in the gold and foreign exchange reserves of the Bank of Russia. In the current year growth of foreign trade turnover of Russia continues.

The European Union is our biggest economic partner. While in 2002 the turnover with the EU constituted $56.2 bn, in 2003 it increased by $69 bn or 36.1% of the total volume of Russian turnover. After the expansion of the EU its share will rise up to 50%.

Among our major trade and economic European partners are Germany (in 2003 turnover was $18.5 bn), Italy ($10.9 bn), Netherlands ($10.3 bn), United Kingdom ($6.3 bn), Switzerland ($6.3 bn), Finland ($6.2 bn), Poland ($6.2 bn), France ($5.8 bn).

It is necessary to note that basically the same countries are the biggest investors in the Russian economy. The investments received from these and some other European countries allowed to implement a number of joint projects of major importance for the Russian economy.

Thus, for example, large-scale cooperation is developing in energy sector. In particular, in July this year in Moscow the President of Russia V.V.Putin and the Federal Chancellor of Germany G.Schroder signed the Declaration on expansion of business relations between the two countries in energy sector. "Gazprom" and "E.ON" are developing joint cooperation in the field of natural gas production, electric power generation, construction of major gas pipeline across the Baltic Sea, expansion of infrastructure for sale of Russian natural gas in Germany and Europe. The British, Italian, French and Dutch companies assist in the development of Kovytka gas condensate deposit, Astrakhan oil and gas deposit and Kharyaginsk oil deposit, the pipeline for supply of natural gas from Russia to Turkey was commissioned ("Blue Stream" project). Besides, practical results were achieved with Italy in setting-up industrial districts in Russia, and first of all in manufacture of household electric goods (Leningrad and Lipetsk regions), machine-building and metallurgy (Sverdlovsk region), manufacture and processing of polypropylene (Tatarstan), milk processing (Chuvashia), agricultural machinery (Perm region), agricultural products processing (Moscow region), manufacture of railway rolling stock (Mordovia).

The German companies "KNAUF" and "Siemens" have invested considerable funds into the establishment in Russia of enterprises for manufacture of building materials and into IT and medical projects.

The Italian and French companies are participating in the manufacture of training aircraft and helicopters.

The French company "Renault" is planning to start manufacture in Moscow of a car adapted to the Russian conditions. The Italian company "Fiat" is taking part in the organization of manufacture of diesel engines for trucks.

The British companies "British American Tobacco" and "Gallaher" are modernizing tobacco factories in Moscow, Saint Petersburg and Saratov. The company "Rolls-Royce" is taking part in the modernization of aircraft engines.

We have traditional trade and economic ties with the countries of Central and Eastern Europe. Numerous projects in various industries were put into operation in these countries with our participation - in energy sector, including nuclear, metallurgy, chemical and petrochemical industry, agro-industrial complex. We are going to continue developing these ties.

The largest in Russia manufacturer of railway freight cars "Uralvagonzavod" has opened in Estonia assembly production of railway tank cars on the base of the Estonian transport company.

In Bulgaria we are assisting in the renovation and modernization of the Kozlodui nuclear power station and Burgas petrochemical plant. We are also rendering assistance in the renovation of the Dukovany nuclear power station in Czechia, Budapest metro lines and Paks nuclear power station in Hungary.

Russian companies are interested to take part in the privatization of metallurgical, fuel-and-energy and chemical facilities, to develop cooperation in chemical and petrochemical industry, including construction in the Russian ports of export-oriented chemical and petrochemical plants. The effect of interaction in the field of advanced technologies might have been more substantial.

Russia possesses significant scientific potential. It is no secret that our country has high quality level of human capital, low compared with other countries production costs, high-capacity sales market, comparatively cheap energy resources and labour. Considerable reserve of economic interaction is the development of production cooperation, establishment of joint ventures, using, inter alia, latest technologies and designs. It seems to us promising to develop cooperation in innovation sphere through joint venture funds, as well as cooperation in tourism infrastructure.

Regional cooperation with the European countries has been growing with participation of Moscow, Saint Petersburg, Kaluga, Yaroslavl and Perm regions, Krasnodar territory, Tatarstan, Komi Republic and many other regions of Russia.

Strengthening of economic relations with all EU countries is the pressing task of the foreign economic policy of the present-day Russia. The vector of general European integration is extremely important to us.

There are close interconnection and complementarity between the economies of Russia and the EU, therefore we expect that both sides will get considerable advantages out of the deepening economic integration.

The EU expansion, taking into account the existing intensive trade and economic relations of Russia with the "group of ten" countries, creates new conditions for economic partnership between Russia and the EU which must be used in order to bring our relations to a qualitatively new level.

Our task is to provide comfortable conditions for the development of business, growth of goods and investments flows by way of creating favorable economic and legal environment. Russia regards the EU expansion not as a formal increase in the number of its members, but as a qualitatively new stage in the development of trade and economic ties with the EU-25. The accumulated potential of traditional trade and economic cooperation with the countries, which have joined the EU, will introduce new quality into our relations with the EU-15 and, in its turn, it should get additional impetus for development on the basis of the Agreement on Partnership and Cooperation.

We share the point of view of our colleagues from the European Commission that in medium term and especially in long term the effect of the EU expansion will be positive for Russia. In the course of the talks we have managed to make serious progress in working out pragmatic solutions to complicated trade and economic aspects of our cooperation, which are recorded in the Joint Declaration on EU Expansion and Russia-EU Relations. That permitted to sign timely and painlessly for both sides the Protocol on Extending the Agreement on Partnership and Cooperation to the Joined Countries, thus enabling us to avoid unnecessary complications and to create reliable and predictable conditions for further building-up of our economic relations with the "group often".

Now priority is given to the implementation of the agreements recorded in the Joint Declaration. And in this context our further joint work on the construction of the Common Economic Space is acquiring special importance.

The concept of the Common European Economic Space prepared by a high-level joint group has been approved and the action plan for practical implementation of this concept is being worked out.

The process of rapprochement between Russia and the EU in the area of economic regulation will make an effective contribution to the harmonization of other integration processes in Europe and, in particular, integration within the CIS, provided both these processes are based on the same principles.

Positive and perhaps decisive effect could be made by the agreements related to the implementation of certain investment and other commercial projects, which would facilitate more active movement of production factors - first of all, capitals and technologies between Russia and the EU. Implementation of concrete projects of investment, scientific, technical, technological and innovation cooperation should become the guarantee of filling up the integration process.

It is expedient to arrange cooperation, determine priority areas of interaction and examine specific projects with full-fledged participation of the business communities of both sides. There are adequate forums for such interaction - "European Round Table of Industrialists", "Round Table of Industrialists of Russia and EU", as well as national business associations. At that, it is worthwhile to pay more attention to the assistance in the establishment of direct and effective contacts between them with a view to identify the areas of mutual interest and to work out concerted approach to integration. Then their contribution to the building of the Common European Economic Space would be most effective. Objectively the level of compatibility between the economic regulation systems of Russia and the EU is quite higher, than the level of technological compatibility of their production facilities. One of the ways to overcome such gap could be the steps directed at the establishment through joint efforts of innovation infrastructure, venture funds, implementation of joint projects in the field of high technologies with the understanding that new technologies and goods will be used in the economies of both, Russia and European countries.

In parallel with the work on the creation of the Common European Economic Space energy dialogue is being actively pursued. We consider it to be one of the main directions in the establishment of the Common European Economic Space, which determines mutual complementarity of our economies. It is intended to incorporate subsequently the results of the on-going Russia-EU energy dialogue into the concept of the Common European Economic Space.

One of the most important concrete results is the Protocol signed between Russia and the EU on completion of bilateral negotiations concerning access to the markets of goods and services within the framework of the process of Russia's accession to the WTO. This is a long awaited balanced agreement having positive effect. It took more than six years for the Russian and European negotiators to finalize mutually acceptable terms and conditions for Russia's accession to this international economic organization. We estimate positively the signing of the Protocol and consider it as an impetus that will advance significantly the completion of the dialogue with other member-states of the Working Group on Russia's Accession to the WTO.

Thus, it is possible to state that Russia and the European Union intend to continue the trust-based dialogue and are capable to find mutually acceptable solutions to any, even the most complicated problems. I am convinced that this is the guarantee of our successful partnership.

STRATEGIES AND VISIONS FOR WIDER EUROPE; HUNGARY'S CONTRIBUTION TO THE EUROPEAN UNIONS' NEW NEIGHBOURHOOD POLICY

Gábor Zupkó

Having become a member of the EU, the Hungarian foreign policy, as a whole, entered into a new era. Without having changed the three main priorities - namely enhancing the Euro-Atlantic integration, regional co-operation and the issue of ethnic Hungarians living outside the borders of Hungary - they acquired a new interpretation, a new reading: being a full and active member of the Euro-Atlantic integration, the emphasis is being placed on reinforcing our double commitment to the EU and to the transatlantic cooperation. As a result of its regional and neighbourhood policy, Hungary has become a factor in strengthening stability in the region.

The abovementioned priorities are deeply rooted in the history, in the geopolitical and geographical position of Hungary. Due to her geographical location and considering the fact that Hungary is a member of the European Union, the country has a special responsibility promoting the European orientation of the countries in the region. This is a primary political interest of Hungary and, it may also serves the interests of the overall security and stability in Europe.

Several countries of Central and Eastern Europe have joined the Union together with Hungary in the group of ten countries, and hopefully Romania, Bulgaria and Croatia will follow soon. However Hungary considers it important to deepen the cooperation between the EU and other countries in the neighbourhood, as well.

Without committing an error of exaggerating Hungary's performance during its preparations for membership in the EU, adjustment of the Hungarian foreign policy, alignment to that of the Union has been smooth. The European Union in 2003 has outlined an orientation within the Common Foreign and Security Policy (CFSP), which has been extremely important for Hungary. This has been the concept of "New Neighbourhood Policy". Hungarian neighbourhood policy perfectly fits into this framework. The objectives of the European Neighbourhood Policy (ENP) correspond quite well to the neighbourhood policy of the Hungarian foreign policy. (If we have a look – for example - at the key objectives for future (EU – non-EU) cross border co-operation, one can find that these are the ones identified – earlier - by the Hungarian government, too. Just to mention a few: promoting economic and social development in the border areas; working together to address common challenges, in fields such as environment, public health, and the fight against organised crime; ensuring efficient and secure borders; promoting local, "people-to-people" type actions.)

Enlargement has opened up new opportunities for the EU to enhance co-operation with its neighbours, promoting stability, prosperity and security beyond the new borders of the EU. Experience gained by the new Member States can now be shared with their neighbours across the external borders of the Union.

And here comes into the picture the – today widely known and recognized – "Szeged Process", initiated by Hungary in 1999, which is giving assistance to the Southeast European states in their democratic reforms.[1] Since 1999 the Process has provided support to Serbia-Montenegro, Albania, Macedonia and Bosnia-Herzegovina in the fields of democratisation, strengthening the rule of law, the local governments and the civil society.

Some words about the recently renewed and broadened Szeged process. Its main focus is to promote the idea of European integration as an attractive perspective for the nations concerned and also to strengthen the democratic values. Its main goal is to support those forces and actors in the region who are dedicated to follow on strengthening democracy, democratic institutions, reforms, EU integration and market economy. Main practical instruments of the Process are organising seminars, trainings, twinning, sending experts etc.

It has been recognised also by the EU partners of Hungary, that because the Szeged Process is able to create the basis for long-term perspectives, it fits well into other Community programmes and initiatives. Hungary strives to reach that the member states of the Union take a role together with her in strengthening the stability of the region. These endeavours have already brought some results. Hungary would like to engage them within institutional frames in a dialogue on different questions of mutual interest, making more visible the perspective of integration for the states of the region, and to encourage government agencies, as well as non-governmental organizations to strengthen their relationships. This could be an important contribution to the success of the EU-policy towards the Balkans. It is similarly important to build up regional cooperation between the countries of Central Europe and the Western Balkans.

Yet another possible area for the Hungarian foreign policy to add value to ENP would be the EU-Ukraine cooperation. After the historic EU enlargement on 1 May 2004 through which the EU and Ukraine became direct neighbours, and after the recent Ukrainian Presidential elections where the pro-European nominee and his EU-integration oriented policy won majority, one can only agree on the importance of a further reinforced relationship between the EU and Ukraine and to confirm the need to work together to contribute to

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[1] *Szeged: the 4th largest city of Hungary on the south of the country, few kilometres only from the Hungary – Serbia-Montenegro border.)*

increased stability, security and prosperity on the European continent, and to avoid the emergence of new dividing lines.

There is no doubt that strengthening our relations with the Ukraine under the ENP is a must. The ENP aims at strengthening the bilateral relationship by deepening trade and economic relations, strengthening co-operation in conflict prevention and crisis management, integrating transport, energy and telecommunications networks, and expanding participation in EU policies and programmes. It also aims at fostering joint efforts to promote human rights, dialogue between cultures, and people-to-people contacts. Other fields of assistance include support for institutional, legal and administrative reform, support for the private sector and assistance for economic development, for justice and home affairs (including border management and migration questions); for civil society development through partnership and exchange programmes with EU institutions; for the alleviation of the social impact of reforms.

In the Action Plan of the Common Strategy of the EU on Ukraine special attention is given to Ukraine's specific position in the context of the European Neighbourhood Policy and to further ways to develop an enhanced partnership in the next three years. The Action Plan is based on the following principal objectives: support for the democratic and economic transition process; ensuring stability and security and meeting common challenges on the European continent; support for strengthened cooperation between the EU and Ukraine.

The Hungarian "Nyíregyháza Initiative" is in line with the mentioned objectives[2]. Having started the Initiative in October 2003 the main objective to be attained has been the strengthening of the relationship and cooperation between local and regional authorities on both sides of the borders with special emphasis on the EU's Eastern borders. The first results immediately became visible when the participants had the opportunity to take stock of the future chances of cross-border cooperation having in focus that the Western regions of Ukraine are to get as close to the enlarged Union as possible, in the sense of being directly involved in different types of cooperation.

When starting the Initiative, the Hungarian organisers kept in mind their intention to dispel any kind of fear or reservations originating from countries outside of the Union that strengthening the external borders of the Union would mean to create new dividing lines in Europe. On the contrary, the aim of the new members, including Hungary has been to eliminate artificial barriers on the road to genuine cooperation between countries across the EU borders, to ease visa-restrictions, to facilitate people-to-people contacts. The Initiative intends to promote intensive working contacts in the field of education, environment protection, pupils and student exchange programmes – applying for additional Community resources and involving other partners. Another feature of further broadening the existing relations will be the specific training and re-training of local municipality officials, transfer of experience and know-how gained during our preparation for EU membership.

The target groups are the representatives of local governments, civil organisations, border management, academic sphere, chambers of commerce, and competent specialised officers of

[2] *Nyíregyháza is a city in Eastern Hungary close to the Hungarian-Ukrainian border*

the concerned ministries from Ukraine. The Initiative is being run through training programs, workshops, forums and other forms of co-operation. The programme is carried out mostly on the basis of the Nyíregyháza Training Centre, with active participation of the EuroClip-EuroKapocs Public Foundation (managing the process, tendering the training blocks, workshops etc.), and by relying on the experience of the international organisations and other interested countries.

To sum it up: Hungary's interests lie deeply in contributing to the process of *rapprochement*: it is in Hungary's interest for things to develop in a way of giving additional impetus to stabilizing democratic institutions in the region. There is one important factor for Hungary in this regard: we have never kept it a secret that we have additional interest in the development in the region since Hungarian minorities live in the area of our neighbours. For us it is important to know whether the Hungarian communities living in the neighbouring countries may dispose of their due rights.

Hungarian foreign policy, diplomacy and external economic policy may represent an important value for the European Union in the course of the implementation of the European Neighbourhood Policy. Therefore, Hungary strives to play an initiative role in the European Union, not to be only one of the countries strengthening the stability of the region, but to be initiator of this process.

IN SEARCH OF A NEW POLITICAL ORDER FOR EUROPE

Hanns Schumacher

On 1 May 2004 old and new member states together celebrated the enlargement of the European Union in Dublin. The ceremony in Dublin has marked the formal commencement of something which has become a matter of course during the last months in the institutions of the European Union: namely that the new members will be helping to shape a larger Europe. The division of Europe in East and West has been overcome once and for all.

The new member states lent the European Union a new face and they themselves will be influenced by the Union. Both these factors are evident already.

And the enlargement process has not come to an end on 1 May 2004. The negotiations with Bulgaria and Romania were concluded. Both countries are preparing intensively for their accession to the Union in 2007. The German Government will keep on doing everything in its power to support them.

Croatia has also applied to join the European Union, so has Macedonia. The countries who emerged from the rubble of the former Yugoslavia are looking towards Brussels as their final political target.

Turkey already has the status of a candidate country and is linked to the European Union by close ties. The German Government considers leading Turkey towards the structures of united Europe to be a key task. However, a long and difficult negotiation process, which is to begin on 3rd October 2005, lies ahead.

The Turkish Government has made remarkable progress with its resolute reform policies, particularly towards establishing structures which enhance the rule of law. If we are honest, many of us would have regarded this as unrealistic only a short time ago.

However, much remains to be done, particularly in implementing rule-of-law standards. Turkey must therefore continue its reform course with the same determination with which it began. The European Union cannot release the Turkish Government from its obligations and responsibilities here.

Allow me to outline a possible future scenario: perhaps Turkey can succeed in developing into a European state – in keeping with the Copenhagen criteria – with a largely Moslem population, in which the human rights of the majority and of the minorities are respected and rule-of-law and democratic principles prevail.

This would have an inestimable influence on stability in the entire region and on the prospects for reform in the Islamic world, especially in our neighbouring region, the Middle East.

This democratic Turkey would send a clear message that an Islamic culture and an enlightened, modern society in one state do not have to be a contradiction in terms.

Europe has been promising Turkey full membership since 1963. In December 2004, the European Council has finally made the decision to begin accession negotiations with the Turkish Government.

If we fail to keep the promise which Europe has been making to Turkey for forty years due to reservations about allowing an Islamic country to join the Union, we will pay a very high price.

We believe that there was and still is no alternative to the enlargement of the European Union. However, it presents the accession countries and the new candidates with considerable challenges.

With the new members and candidates lining up, Europe is shaping a new political order in the 21st century.

Both the old and new member states will benefit from the enlargement of the European Union. However, the positive effects will not come about of their own accord.

Quantity must not kill the quality of integrations: a Union which increases the number of its member states so dramatically needs effective structures if it is to make efficient use of its increased economic power and its greater influence in foreign and security policy and to live up to its greater responsibility. The “acquis communautaire” is our most precious asset to be defended and preserved.

Therefore, the following still holds true: enlargement must go hand in hand with a radical reform of the European Union and its institutions.

Immediately after the accession of the ten new member states from eastern and south eastern Europe to the European Union, a very important signal was sent: in spite of the great differences of opinion, an enlarged Europe is still able to find a way to achieve cooperation while continuing to grow together. The process of agreeing on a constitution has served to underscore this fact. We are creating the foundations that will enable a larger Europe to maintain its ability to make decisions and, in this way, remain politically manageable. This is another aspect of the discussion on the constitution that must not be played down – as is sure to become evident in the years ahead. This aspect is of vital importance, for the issue here is not only the fact that a united Europe has increased in size, but also that it should be possible to work within it in a way that is politically efficient.

Everyone in the European Union – large and small, old and new member states – is dependent – and in future will be much more dependent – on a Union of 25 and more not only retaining its effectiveness but on further enhancing its effectiveness, its capability to take action, its acceptance among citizens and its democratic transparency.

Every member state must realize that in the world of the 21st century, even legitimate national interests can only be safeguarded in a European context.

Before it can enter into effect, the constitution must now be ratified by all member states. In some member states, there will be a referendum.

The vote – whether held in parliament or carried out through direct democracy – is an opportunity to see where the common ground lies in Europe. In Germany, the constitution treaty will be ratified in a parliamentary process as stipulated by the German Basic Law. After the treaty is signed, the federal government will quickly take the necessary steps.

Europe needs this constitution in order to live up to the expectations of its citizens: to preserve peace, ensure safety, promote prosperity and demonstrate solidarity.

We need a constitution which will endure for a long time. For under no circumstances do we want to be forced to hold intergovernmental conferences every three to five years. And the larger the European Union becomes, the more difficult it will be to produce satisfactory results.

This is the one major task ahead.

The consultations on the next financial perspective, which will determine the European Union's budget until 2013, are well under way and are the second challenge.

The fact that we are negotiating this second key issue simultaneously with the ratification process will certainly not make the process any easier.

We consider it important that the new financial framework sets clear priorities. This includes strengthening the competitiveness of European industry, as well as the Common Foreign and Security Policy and the joint protection of our external borders.

Secondly, we are convinced that the new member states urgently need financial resources in order to enhance their competitiveness as quickly as possible. One could also say that it is in our interests to make the new members net contributors as quickly as possible. We will do all we can to achieve that.

European solidarity and our mutual interests require us to make these resources available to the new member states as quickly and efficiently as possible. The joint commitment to solidarity in a widening EU and to the maintenance of the political "acquis communautaire" in the ratification process should go hand in hand.

I would like to take this opportunity to once more point out Germany's special situation. We are happy that we were able to bring about German unification. However, the efforts which we now have to undertake in order to master the challenges of unification are still considerable. We are not being selfish when we call attention to our limited capacities.

It would be impossible to convince our citizens that all budgets, whether local, national or at federal state level, must be cut and that the EU budget is the only one in which no savings have to be made.

Reconciling the interests of large and small member states will influence all decisions made in the enlarged Union. More than ever before, the decision-making processes in Europe will be marked by compromise.

It is therefore all the more important that we reach these compromises in a fair and transparent manner, which does not put at risk the achieved level of integration.

Many are concerned about what the consequences would be if the constitutional and financial process could not be brought to a successful conclusion within the envisaged time-tables.

We must realize one thing: we in Europe cannot and must not ignore the numerous challenges facing us as Europeans in the 21st century. Conversely, however, the world will not wait until Europe has solved its problems.

The threat posed by international terrorism, smouldering regional conflicts in our immediate or extended vicinity, the proliferation of weapons of mass destruction, as well as the fight against hunger, poverty and disease or the task of shaping globalization positively – all of these challenges must be tackled and mastered. However, I am firmly convinced that no individual state, not even the largest European nation-state, is able to do this alone in the 21st century.

No-one wants to see a new division of our continent into a Europe of two speeds. The great achievement of the Convention, which consisted of 28 states with equal rights – the old and the new member states, as well as Bulgaria, Romania and Turkey – was that it succeeded in reading a consensus on a draft.

The final Constitution provides us now with an opportunity as an enlarged Union to create effective institutions. If we do not succeed in doing so, we will either end up with a Europe of different speeds or with a less of the specific supranational European character of the Union as a body out of its own right.

This runs counter to our aim to become an effective political entity on the international stage at a time, when the traditional areas of national sovereignty, Foreign, Security and Defence Policy, are in a continuous process of integration.

The "Old World" of the national state, which had emerged from the Westphalian Peace more than 350 years ago, is being replaced by something new – a historical process.

It was Jean Monnet who introduced the idea of an European constitution back in the 1950s. As many things in Europe, this was achieved by moving forward slowly and resolutely over a long period of time. Unification of Europe and the deepening of its integration cannot be dictated, as it were, from above. The European constitution is a workable and also necessary basis for a Europe that now can and will grow closer together.

This is the strong and united Europe we want, also in order to be able to further develop our European social model of solidarity and participation to include the greatest number of people having their say and sharing the benefits of prosperity in Europe.

A Europe strengthened and united in this way will also be partner for others in the world: for a world in which justice and shared prosperity prevail, for a world in which, above all, great efforts are made for achieving peaceful coexistence among the different nations.

DID PUTIN'S REFORMS CATAPULT RUSSIA INTO DURABLE GROWTH?

Pekka Sutela[1]

Abstract

Since 1999 – the year Vladimir Putin became Russia's prime minister – the Russian economy has recorded a statistically measured average growth rate of 6.5% a year. This places Russia among the fastest growing large countries of the world, along with China, India, Kazakhstan and Ukraine. The fact that none of these economies, according to received economic doctrine, can be considered an efficiently operating economy reminds us that growth is always measured relative to a preceding period. Growth alone does not indicate a good performance. It simply means that the economy has functioned better than in the previous year. Ceteris paribus, the most efficient – richest - economies generally grow more slowly than others, partly because wealth-accumulation is already a fait accompli. They operate at the cutting edge of technology and so do not have the opportunity to 'catch up'. Moreover, wealth seems to be related to demographic changes – populations ageing and then shrinking. This has been Japan's course, and many European countries are now following suit, albeit at varying speeds. Although Japan has not grown in the last 15 years the Japanese are among the world's wealthiest people.

Though countries with lower income and efficiency levels have the potential to catch up, convergence is not guaranteed. Both willingness and capability is needed for the potential to be realised.

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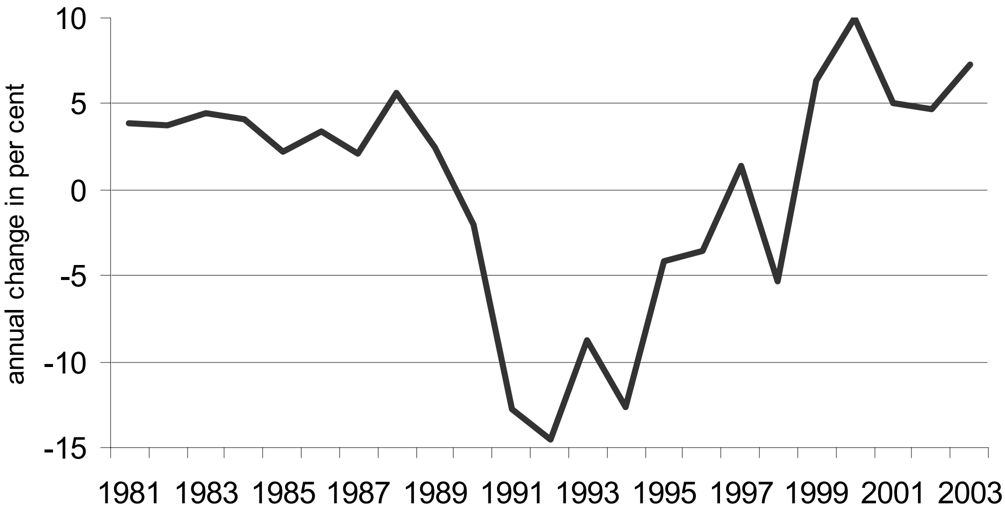
Introduction

Figure 1: Russian GDP

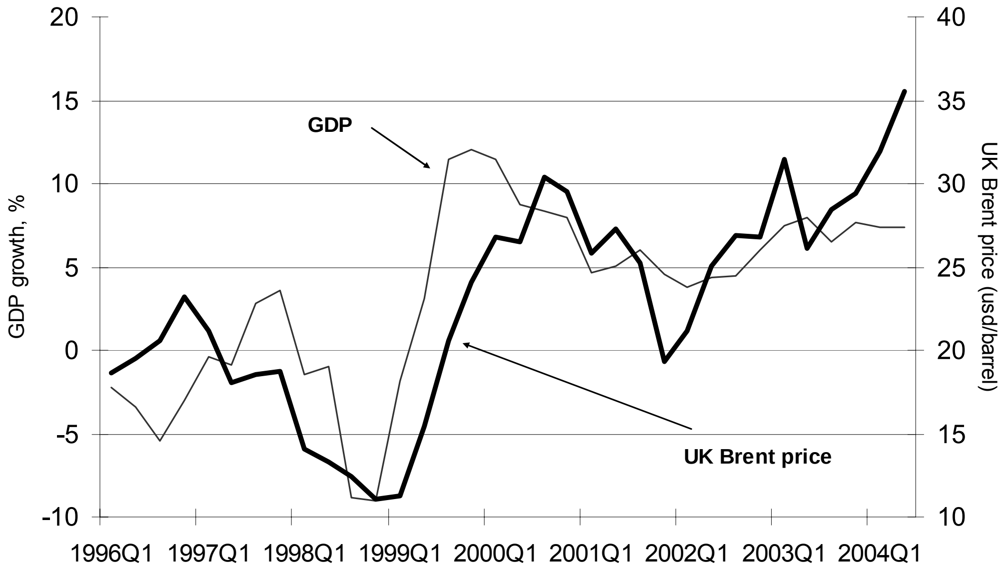


Explanations of Russia's growth performance (Figure 1) of recent years include a number of alternative, possibly complementary, scenarios. One candidate is that growth is solely or primarily a recovery from earlier crisis, a return to normalcy. Here, one might single out the financial crisis of 1998 or the crisis of the decade as a whole, during which time statistically-measured output declined by just over 40%.

Another possibility is that we are at last witnessing the results of economic liberalisation, which began in the latter part of the 1980s and then became a transition from central management to market economy. A market economy is more efficient, and even though the Russian transition deviated - in many ways to its own disadvantage - from those of the eastern block of Central European countries (Sutela 2003), its effects had to be felt at some point. The OECD (2004), for example, stresses the fact that Russian output growth has in recent years been fastest in sectors that have been relatively free from state ownership and control. As regards oil production, where there are both privatised and still-state-owned companies, the former have proven more efficient and have increased their output fastest. But it is also possible that the latter companies have invested more for the long term, in the development of new oil fields.

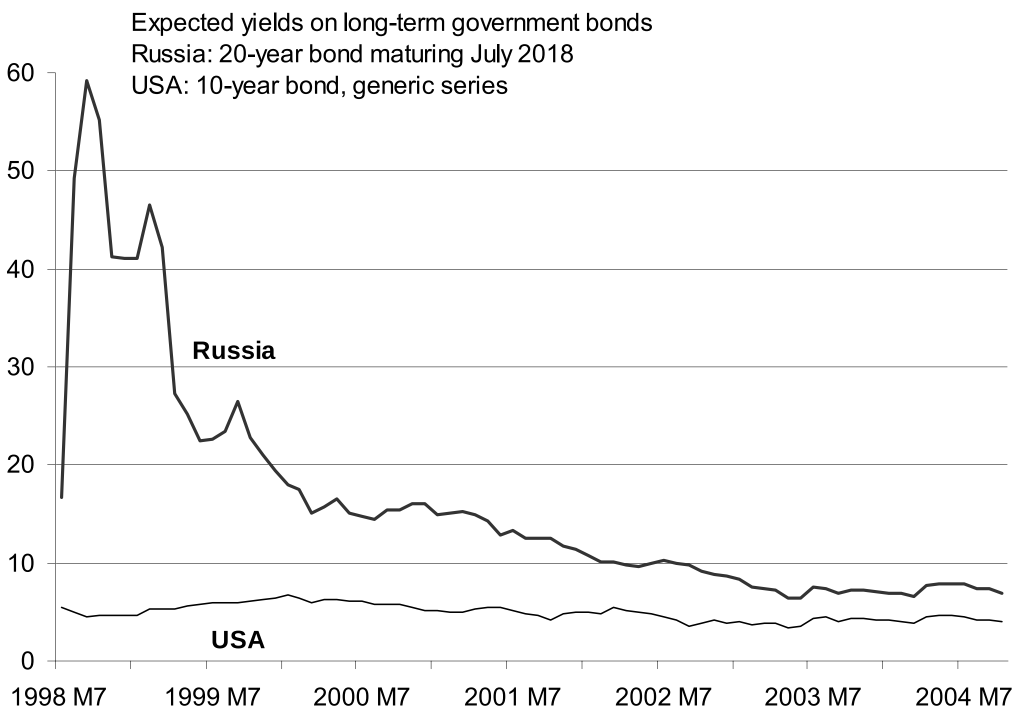
The third suggested scenario focuses on external changes. In spring 1998 the world market price of oil (Figure 2), Russia's key export product, was having trouble breeching USD 10 per barrel. During the final stages of 2004, the price rose by a factor of four or five. The price of natural gas, Russia's other key export product, follows the oil price with a lag. According to numerous evaluations, the energy sector is currently generating about a fourth of Russia's GDP, 40% of its public sector revenue, and substantially over half of its export income. Russia exports other raw materials besides energy, but only a small amount of processed commodities. The overall price level for raw materials tends to move in the same direction as energy prices, reflecting both world economic conditions and the strength of demand in major consumer countries such as China.

Figure 2: Russian GDP vs oil prices



The fourth scenario stresses the fact that the external environment, which had turned in Russia's favour, laid a firm foundation for better macroeconomic policy. In contrast to the 1990s, public finances have been in the black and monetary policy has been moderate. Due to a gigantic current account surplus, inflation has remained at a fairly high level (but under control) while the economy's monetisation and de-dollarisation have boosted the demand for roubles. The exchange rate, tightly controlled by the central bank, has been eminently predictable, and interest rates have declined. All this has created a much more predictable environment for business, as compared to the 1990s. Economic doctrine suggests that this should promote growth, productivity, investment, and a rising standard of living. And the same can be said for the predictability of policy since autumn 1999. Figure 3 shows how the risk premium entailed in long-term interest rates has declined steeply, reflecting strengthened confidence in the predictability of Russian developments.

Figure 3: Russian and US long-term interest rates, 1998-2004



Fifth, it has been asked if Putin's first-term reform policies are not another major factor (Åslund 2004). Particularly in 2001-2002, the economic legislation programme was broader, deeper, and better aimed than many – surely most, including this author - Russia-watchers had thought possible. It is clearly too early to attempt a summary evaluation of the impact of that legislation. Opposing the idea that the reforms would have had nearly immediate effects is the fact changes come slowly and are long-lasting, particularly where the purpose is to revamp institutions, structures and operational models. But the economics literature does admit of the possibility of more immediate effects also. In the 1990s, economic agents' expectations pointed to economic and political instability. In fact, for the long run, one might well anticipate a continual shrinking of the economy. For the short run, the focus was on quick financial returns, often via price arbitrage or privileged legal rights. Now in the early years of the century, it is quite possible that economic agents' expectations have changed. Stabilisation of the macroeconomic environment has reduced the opportunities for arbitrage, and tighter governmental supervision has reduced the opportunities for major economic decision-makers to obtain political favours. High export prices have made investments in the real economy highly lucrative. Russia could even be entering a self-fulfilling cycle of meeting optimistic expectations. If such a change occurs in the balance of expectations, we could well see a jump in the rate of economic growth (Hausmann et al 2004).

All of the above scenarios have believability, and the rationales are informed by both economic theory and history. Even in the best of circumstances, a statistical sorting of their effects would be difficult. As regards Russia, what makes this impossible is the shortness of the time period involved as well as the exceptionally large number of changes that Russia has undergone in the last two decades. It would be rash to discount the importance of any of the above five scenarios. The fact that this article probes specifically the importance of the reforms does not mean that other factors are pushed aside. On the contrary, the argumentation presented here involves several simultaneous and parallel factors impacting the society. One certainly cannot credit all of the recent years' economic growth to the Putin era. The growth actually began earlier. Moreover, some of the factors clearly date from immediately after the crisis of 1998 and its aftermath.

Putin's first-term macroeconomic policy

When Vladimir Putin became Russia's prime minister in 1999, few foresaw a longer term than that of the previous prime minister, hardly a year at most. When Boris Yeltsin gave up the reigns of power and named Putin his successor, little was known of Putin's views. Most analysts saw him as a mediocrity without convictions, a bureaucrat who had slogged his way up the hierarchy, better at listening than making decisions. This portrait seemed to gain credence while Putin was spending his first year in office solidifying his own position while shedding little light on how he would use that power. In spring 2000 he did go so far as to accept as a basis for economic policy the 'Gref programme', which however seemed so grand in scope and detailed as to have little practical significance. Nonetheless, approval of the Gref programme, after other options had been considered, did demonstrate that the economic liberals of the 1990s were still playing a key role in the formulation of economic policy.

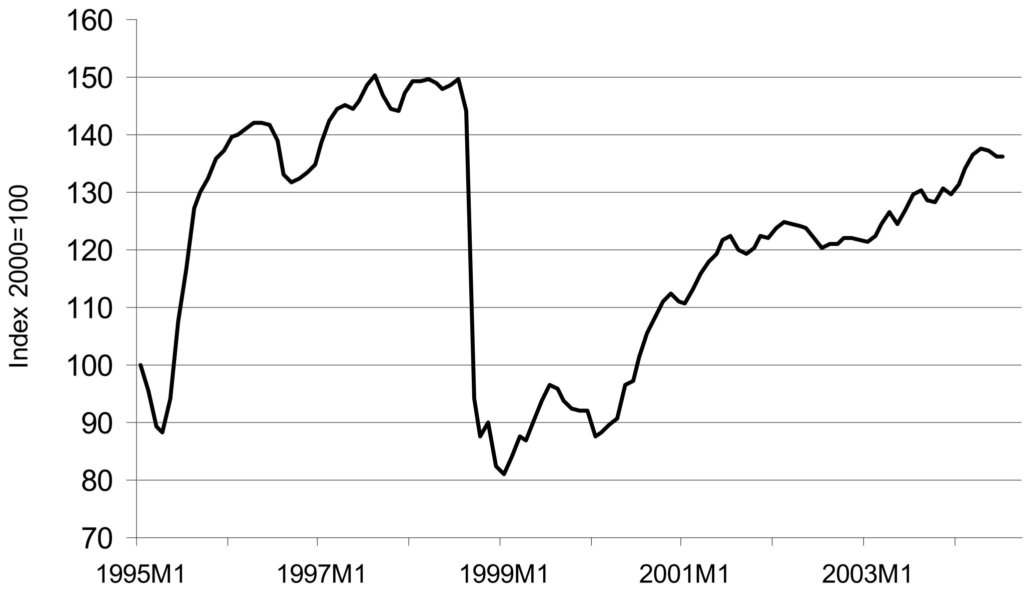
From a macroeconomic perspective, the real turning-point occurred already at the turn of 1998-1999. The need for balance in the economy was agreed already in the mid-1990s. But stabilisation could not be achieved as long as there was a huge public sector deficit, and the will and capability to boost revenues and cut expenditures were missing. Primakov's government, which came to power in autumn 1998, was finally forced to put macroeconomic policy in order, primarily due to a lack of policy options, as emphasised by Åslund (2004). The main reason for the crisis of 1998 was the swift ballooning of the government's short-term debt: instead of trending downward, the budget deficits fluctuated between 5 and 10% of GDP. Since Russia's 1998 declaration of its inability to service debt, this situation became impossible to continue. Borrowing to cover the deficit was no longer an option, nor was there great enthusiasm for a return to note-issue finance after the experience of the early 1990s. With no escape, the ratio of public sector expenditures to GDP was pushed down by 11 percentage points in three years, from 45% in 1997 to 34% in 2000 (Owen and Robinson 2003, p.101). It was also understood that the threat of post-devaluation high inflation had to be alleviated with tight monetary policy. The lessons of the 1990s, also in this regard, have not been forgotten. Thus a huge post-devaluation loss of competitiveness was averted. At the same time, Russia avoided a spiral of instability of economic and political systems and society as a whole. Obviously, the default and currency depreciation of 1998 were not anything to be welcomed, but once they took place, Russia has earned the credit for not spoiling the improved competitiveness they brought about.

Good policies were key to the improving state of affairs, but Russia also enjoyed a good dose of good luck at the same time. Export earnings began to soar due to price developments in world markets. This eased the balancing of public expenditures and revenues - as well as the clearing up of payment arrears and reduction of bartering. The state no longer accepted anything but money in payment of taxes, while the current account surplus, and its attendant effects, enabled companies to pay. Bartering, which had reached 54% of industrial production during the crisis, dropped to 13% in the autumn of 2001 (Russian Economic Barometer 2004). Because the financial base and political influence of big investors (oligarchs) had faltered during the crisis, it was now possible to shift the tax burden to the export sector, especially the oil companies, at an earlier stage (Kwon 2003). This rendered public finances dangerously exposed to gyrations in energy prices, but not to worry - oil prices kept climbing for several years. At the same time, the federal share of tax revenues was notably raised. There were many reasons for doing this, but above all it was a way of putting fiscal management on a more rational foundation. By 2004 public finances had been comfortably in the black for five years running. Part of the public debt has been repaid ahead of schedule, and Russia has indeed started to resemble a country with a very small debt. Its international reserves now rank among the world's largest. The rapidly growing, albeit still relatively small, stabilisation fund is slated to help in rapidly shrinking the country's external debt.

Nearly all of Russia's large banks ran aground during the crisis. This led to increased central bank powers in supervision of the money and foreign exchange markets, especially as the state-owned banks strengthened their position. Because the markets were small and underdeveloped, monetary policy was conducted largely via administrative edicts and other similar measures. Although the instruments were unsophisticated, monetary policy proved successful, as witnessed by the decline in inflation (albeit to many, too slow), the improved predictability of the exchange rate, and the decline in interest rates. Yet a crisis of confidence in the banking sector in summer 2004 showed how difficult it would be to normalise the financial system. Following the experiences of the 1990s, the financial system participants simply did not trust each other. Restoring confidence in the financial system, and elsewhere, requires careful, transparent and long-range policies.

There is no clear evidence that the rouble was overvalued prior to the crisis, despite the many strong opinions that it was. But it is clear that since the crisis the rouble has been undervalued. Using current exchange rates in comparing economy sizes, puts Russia on a par with the Netherlands – or with Sweden and Finland combined. The rouble's real exchange rate has, since the crisis, risen nearly to the level of spring 1998. But if one takes into account productivity growth, unit labour costs have not risen at all (Figure 4). Thus the price-competitiveness of Russian companies, at least in the domestic market, remains excellent. The appreciation of the rouble's real exchange rate in 2004 appears to have come to a halt. But for the long term further strengthening is inevitable, at least if Russia continues to liberalise its market economy.

Figure 4: Real effective real exchange rate



Among all of its dimensions and details, the keynote message of the Gref programme was that the 'first-wave tasks' of economic transition - liberalisation, stabilisation and privatisation – had in essence already been accomplished. It was now time to shift the focus to such second wave reforms as taxation, banking institutions, social security, labour markets, education, judicial system and the public sector. Russia's goal was WTO membership, and the literally hundreds of planned reforms were set to boost the growth rate to 8%. The role of small enterprises would expand, as various requirements affecting them were eased.

Tax reform provides a good sampling of Putin's first-term legislative programme. The general view is that the tax programme developed in the 1990s was complicated and arbitrary. There were a couple hundred different laws involved and, while the nominal tax rates were often high, these could be avoided by finesse. Reforms affected in 1999-2002 sharply reduced taxes. Rates were lowered while the tax base was broadened by reducing exemptions that had become instruments of administrative arbitrariness and corruption. For taxing income, a flat tax was chosen; in company taxation, the adopted system was based largely on turnover taxes, en route to a more purely profit-based system; finally, the turnover tax rate was reduced. According to Åslund (2003), Russia's tax system is now a reasonable system that could even serve as a model for some western countries.

Tax reform has received special attention. In 2001 Russia dramatically lowered its highest tax rates on income and adopted a flat 13% marginal rate. In the following year, income tax revenue jumped by about 25%. What was really behind this has hardly been studied at all. In particular, we do not have evidence of any strong supply-side incentive factors. Most likely, much of the credit should go to a simultaneous transformation of the macroeconomic environment, probably along with better tax collection.[2]

A listing of Putin's first-term reforms would stretch over many pages (Åslund 2004, Owen and Robinson 2003, OECD 2004). The next section will describe just a few of the most important ones. One should keep especially in mind the primary goals of the reforms: formation of a more normal market economy, a more diversified structure of production, more competitiveness at the international level; and as a result of all this, a doubling of total output in a decade. These considerations are entailed in certain indicators used in the sections that follow to evaluate the practical effects of the economic reforms.

Putin's first-term structural reforms

Since the 1980s Russia has breached many limits widely deemed not to be breachable. Perhaps the most significant was the taboo against private ownership of land. Because Russia did not have a real tradition of private ownership of land, the approval of it for the population centres in 2001 - after protracted discussions - was indeed an important turn. In the following year the parliament extended private ownership rights to agricultural land. Private ownership of land is still not highly significant in a practical sense; ownership is generally limited to the enterprise sector. The regional administrations have decision-making power regarding land sales, so that differences across regions can be great. Regarding the much-discussed private ownership of forest lands, no decision was reached in Putin's second term. Instead, long-term leasing and utilisation rights were approved.

The year 2001 also saw a start in the building of a western-type judicial system. A civil law, a law on an arbitration court, and a law on company activities were approved, as was a law defining the status of judges. The formerly strong position of prosecutors was downgraded while the courts were strengthened. These reforms amount to a significant revamping of the Russian judicial system. The system, however, is still marred by serious defects. Close relations between officials, courts and companies, especially at the local level, often preclude impartial treatment. Low salaries make the courts subject to bribery.

As noted above, the Russian tax system was fundamentally revised, and further changes are in progress. During Putin's first term, company-specific tax benefits were dismantled and deductions for expenses were increased. Moreover, the tax rate on corporate income was reduced at the start of 2002, from 35% to 24%. Income taxation was changed to a low-rate flat tax at the start of 2001. It was intended to decide other possible changes before the end of 2004. The aim is to have in effect the whole revised tax system in 2006. The government does not foresee any further big changes in taxation after that. The planning and preparatory work

[2] Several studies relevant to this topic can be found at www.iet.ru. These conclusions receive support from a yet-unpublished IMF study.

on the tax system per se amount to a huge leap forward in stabilising companies' operating environment.

One aspect of structural change that would be important for companies' operability but in which Russia has been slow to make progress is reform of the financial sector. Although the banking sector has recovered from the collapse in the context of the 1998 financial crisis and failure of several big banks, the banks have not managed to win back customers' confidence. An important institutional problem of the banking sector is the lack of effective banking supervision. There are still some 1200 banks that are very difficult to supervise in a practical sense. Moscow's hundreds of small banks are at the top of the list.

The banking sector is dominated by the savings bank Sberbank, which still has some 62% of households' deposit money. The central bank is still Sberbank's dominant shareholder. The bank's strong position as a deposit bank derives largely from complete deposit protection and an extensive regional network of branches. Last year the parliament approved extension of deposit protection to other banks that meet the central bank's requirements. Following a transition period, ending not later than 2007, Sberbank will have to be satisfied sharing a level playing field with the other banks as regards deposit protection.

The vast majority of companies, especially small and medium-sized companies, have difficulty obtaining finance because their credit ratings entail too much risk for the banks. Companies do not have long credit histories, nor is the lender's position sufficiently secure in the event of insolvency. Thus a large share of companies' investments are financed with retained earnings; bank loans account for only about 6% of such financing. The large and well-known companies are in a better position, being able to borrow from abroad or from their own banks.

The Russian financial sector is however developing all the time, as evidenced by steady growth of credit granting and banks' balance sheets. Foreign banks can operate in Russia, albeit they are still not a major force in deposit-taking or credit extension. Looking ahead, however, they assume more importance as an upgrade to interbank competition and an addition to the overall level of banking activity.

The modest role of small companies in the Russian economy is recognised as a problem even at government level. One reason for this situation is well known: bureaucracy and excessive controls hinder small companies' operations and the birth of new entrepreneurship. Since 2002 company registration has been simplified and official inspections have been limited via legislation. Despite some improvement in the situation, the bureaucracy is still heavy.

Russia remains totally devoid of real corporate governance, which would provide direction for company management. In this regard, the small shareholders in particular have suffered from the trampling of rights. Things have improved in the last couple years with the entry into force of legislation on stock companies and bankruptcy. Guidelines on good company management issued by a commission on securities markets in 2002 provide detailed norms for company operations. Since the new legislation became effective, companies' voluntary bankruptcies have decreased and small shareholders' rights have been upgraded. The change nonetheless affects mainly the larger companies, which depend on a good reputation, inter alia for purposes of exchange quoting and borrowing from abroad.

Reform of state-owned monopolies continues, at varying effectiveness and speed. In 2003 a railway company for handling transport was split off from the Railways Ministry. The company is still state owned. The intention is to privatise some of its operations. The energy producer EES has been reorganised and regional production units are being sold as separate companies. On the other hand, the natural gas monopoly Gazprom has not been restructured despite several years of effort. It now appears that Gazprom will remain in state ownership.

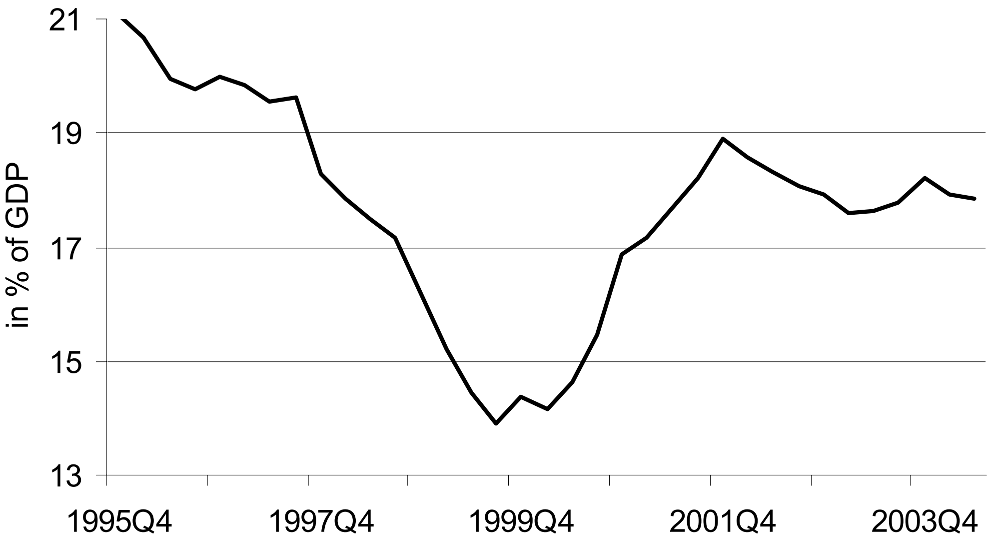
New laws on customs and foreign exchange could prove to be significant improvements for companies doing business with Russia. A new law on the customs system, which entered into force at the start of 2004, observes western customs standards and provides a basis for simpler procedures. The law requires customs officials to inform clearly on new rules and to complete the clearance process within three days instead of ten. Only time will tell how well the new law is implemented.

A new law on foreign exchange, which entered into force in summer 2004, virtually ends the control of currency movements. The underlying principle is that the central bank will monitor currency operations but normally will not restrict them. A phase of step-by-step liberalisation of currency operations runs until end-2006. The law empowers the central bank to set restrictions in times of crisis. As from the summer of 2005, Russian companies will be free to open accounts in foreign banks. One consequence of the new law is that the bureaucracy associated with foreign trade-related payments should be reduced.

What do the statistics tell?

Simple calculations show that for Russia, like other countries, long-term growth forecasts depend very much on assumptions about the investment ratio. If its investment-to-GDP ratio stays below 20%, as it has since the start of the 1990s, one can predict that Russia's growth will remain at 2-3% a year, assuming the absence of a continuing improvement in the external environment (Sutela 2003). Such an improvement might be a continuing rise in the price of oil (Rautava 2004). On the other hand, if its investment ratio should climb to around 30%, on a par with many rapidly growing economies, the Russian economy could track an annual growth trend of 5%.

Figure 5: Investment ratio

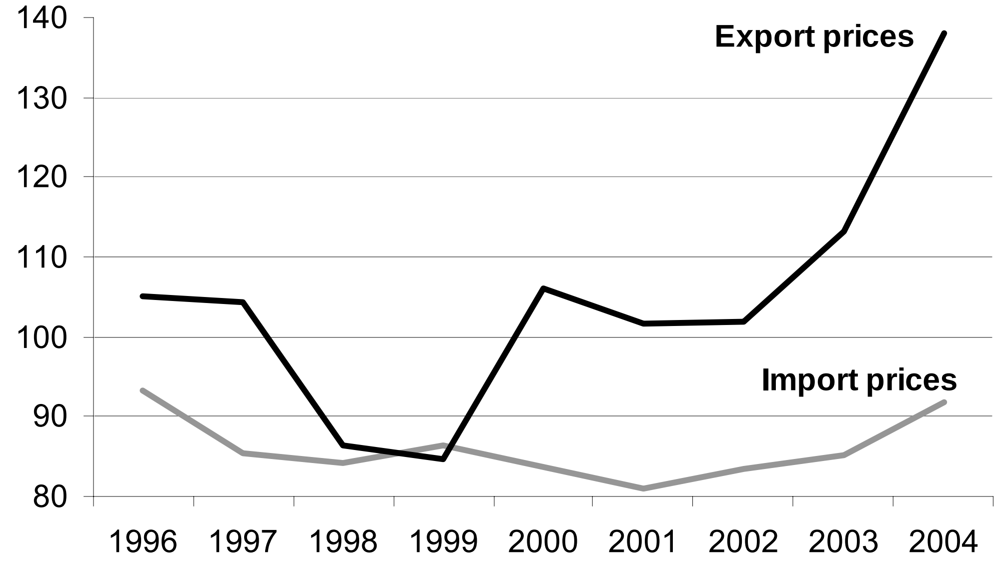


These calculations assume that nothing has altered Russia's potential growth trend since the 1998 crisis. The shortness of the period obviates the possibility of drawing specific conclusions. However, Figure 5 above shows that the productivity growth of the open sector would caution against writing off such an optimistic scenario.

It is possible that market prices of oil and raw materials will stay at a high level if world economic conditions improve and particularly if demand for raw materials remains strong in the major industrial economies. This could enable Russia to join the club of nations with persistently strong terms of trade (Figure 6). Such a policy result would obtain only to the extent that the strong terms of trade derive from good monetary and fiscal policies that keep inflation low and the exchange rate stable. Another possibility is that the terms of trade would strengthen in the context of an increase in Russia's output of products that are more competitive and high in value added, and hence highly priced in world markets. For the most part, the terms of trade of Russian-type raw materials producers depend on factors that are exogenous to policy. By contrast, there is reason to assume that pressures for more reforms that are in many ways technically demanding and that often directly lower the standard of living are the less, the more Russia benefits from externally determined strengthening of the terms of trade. This applies above all to activities not directly benefiting from growth of export income.

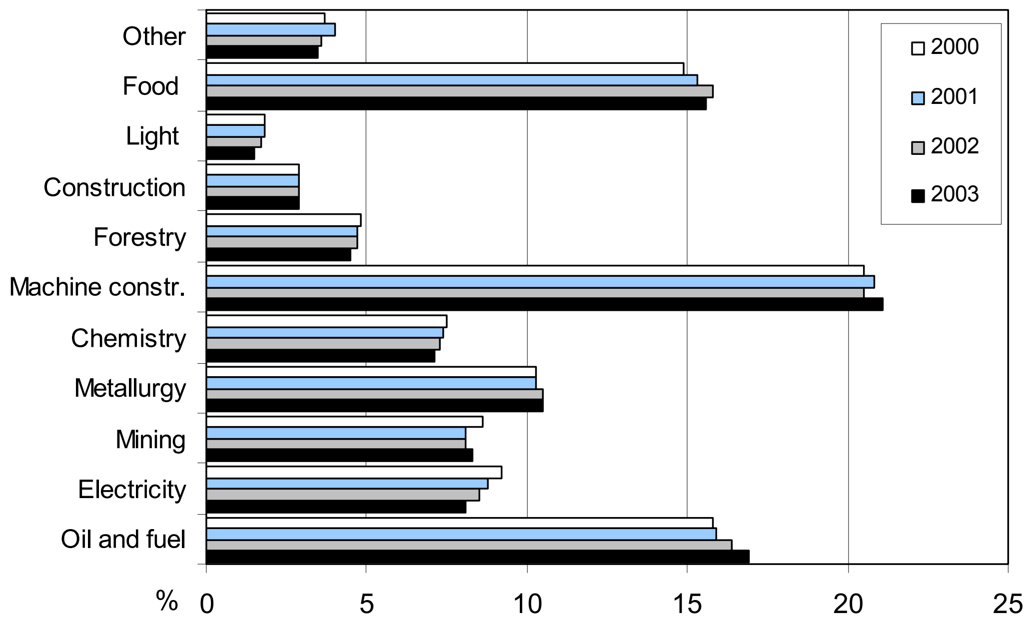
But even here there could be a problem. Several forecasts predict that Russia will have sever problems in maintaining growth of energy production after about 2010, at least if very major investment needed to open new fields in difficult to access places like Eastern Siberia is not forthcoming in very near future. Here, the recent increased emphasis on the energy sector as a strategic filed that should be more closely controlled by the state is probably not conducive to foreign or private domestic capital inflows.

Figure 6: Terms of trade



Besides boosting economic growth, another primary objective of Russian economic policy is to diversify the structure of production. The possibility of becoming an oil state is considered a huge threat. The available data indicate (Figure 7) that essentially there was no change in the structure of industrial sectors during the period 1997-2003. Production of energy and raw materials has grown, but this has happened also in other industrial sectors. Only the light industry sector has recorded a clear downward trend in share of total industrial output. The textiles and clothing sectors have been pushed aside by strengthened foreign producers.

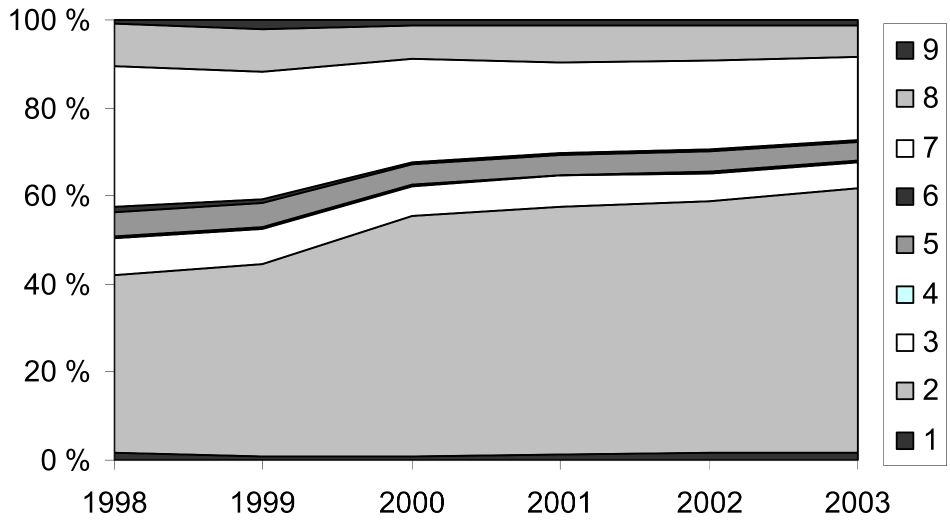
Figure 7: Industrial production by sector, 1997-2003, % of total



In 2003-2004 the government approved changes in taxation that tighten taxation of the energy sector, especially with the high price of oil, while easing taxation in the rest of the economy. This applies at least to VAT and social security taxes. On the other hand, it is apparent that direct subsidies are not being given for diversifying output, as eg the proposed use of international reserves or the stabilisation fund for such public sector investments or for extending credit for related private sector investments. This demonstrates that the ideas of economic liberalism are still very important for the economic policies of Putin's government.

In an open economy, the success criterion for structural change is the ability to produce high-value-added industrial products or services that are internationally competitive. Such products have not come out of Russia, at least not in statistically significant amounts. Nor do foreign trade statistics indicate diversification of the export structure (Figure 8). More to the contrary; even the country's military industry has not proved to be highly competitive, especially outside of China and India, its two major markets.

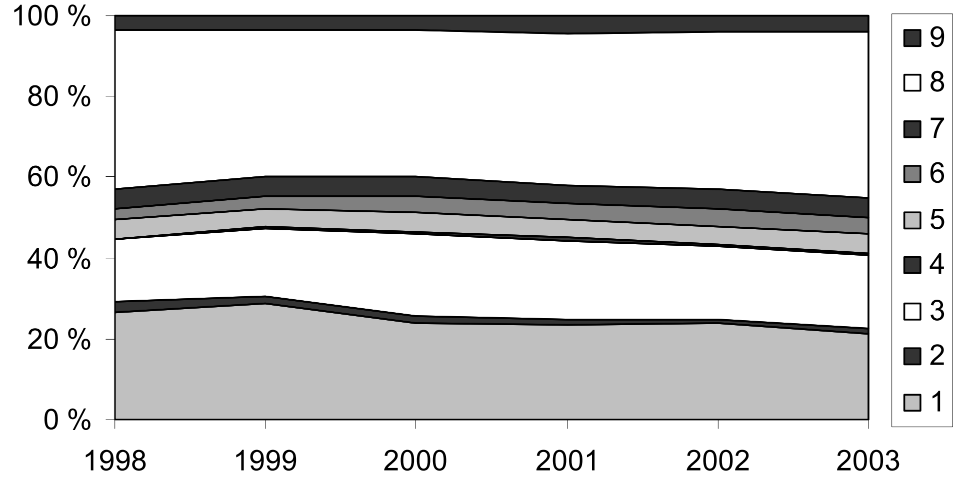
Figure 8: Structure of exports



1 foodstuffs and agricultural raw materials
2 mineral products
3 chemical products, rubber
4 leather raw materials, fur and their articles
5 wood, pulp-and-paper products
6 textiles, textile articles and footwear
7 metals, precious stones and their products
8 machinery, equipment and transport means
9 others

One can also learn something from the structure of imports. If the country is in a phase of rapid development, one might expect to see an increasing share of investment goods in total imports. As the level of income rises, one should see growth in the share of durables in total imports of consumption goods. In the case of Russia, little of this can be detected in statistics, especially remembering that import statistics include items like cars and mobile phones among investment goods.

Figure 9: Structure of imports

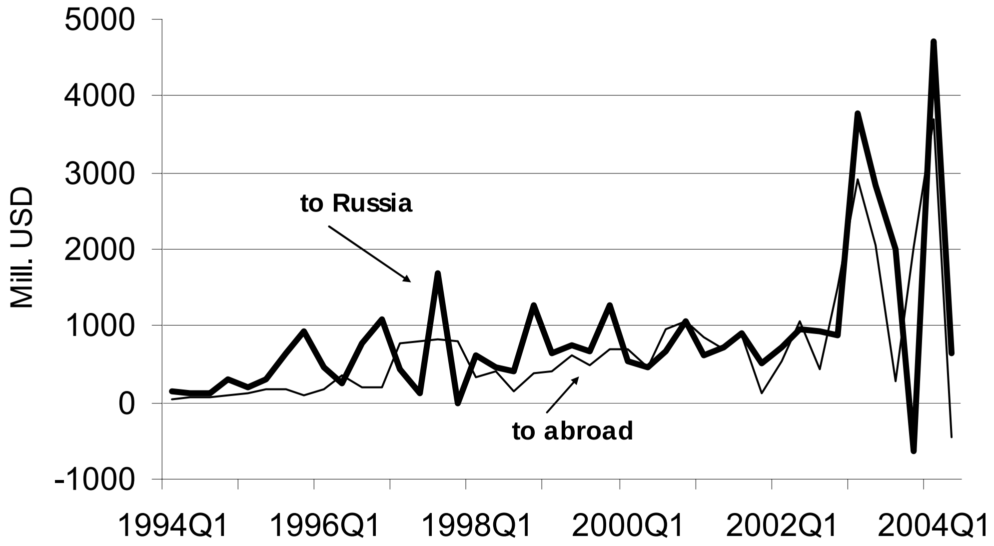


1 foodstuffs and agricultural raw materials
2 mineral products
3 chemical products, rubber
4 leather raw materials, fur and their articles
5 wood, pulp-and-paper products
6 textiles, textile articles and footwear
7 metals, precious stones and their products
8 machinery, equipment and transport means
9 others

The statistics classify Russia as a high-savings country. With domestic investment remaining at a very low level, the inevitable consequence is the exportation of capital. From another perspective, the deficit on the capital account is the result of the current account surplus. Hence Russia does not need foreign investment as a source of financing. Still, foreign direct investment in particular has often proven to be useful in taking advantageous of being a lagging country. FDI is associated with technology and other know-how, useful applications, readily marketed brand names, and other means of gaining access to markets.

The bulk of FDI goes to industrial countries. Economies in transition have never been leading receivers of FDI. Although the latter may in the early stage offer advantageous privatisation targets, they generally are not able to offer more highly developed technology or (permanently) cheap labour. This is a particular problem for Russia. The domestic market is certainly large in terms of population, but so modest in terms of buying power that its needs can be met by foreign production. The matter is different eg in terms of its many difficult-to-transport food products, in which domestic brands are also strong. It is clear that foreign investors are also interested in Russia's non-energy natural resources. However, during Putin's second term, it has become obvious that the state intends to keep a tight reign on natural resources.

Figure 10: Russia's inflows and outflows of direct investment



Statistics (Figure 10) tell that although the amount of FDI has increased, the level is still very modest and there have not been upward turn. It is noteworthy that the data are not comprehensive. The biggest foreign investment, the BP-TNK deal, is not included in Russia's capital account at all, because technically it involved two companies with foreign registration.

For many transition economies, growth has been driven by a rapidly growing small and medium-sized business sector. This is not the case for Russia. Because it was not until the final stage of the Soviet Union that there were liberalising reforms of the economy, Russia inherited a tiny sector of small and medium-sized businesses. Whether measured by workforce or share of output, the sector has not gained in importance since the millennium change. While the statistics are neither comprehensive nor fully comparative with other countries, it is clear that for Russia the sector's relative importance is only a fraction of its importance for both the old and new EU countries.

Figure 11: Numbers of small and medium-sized companies

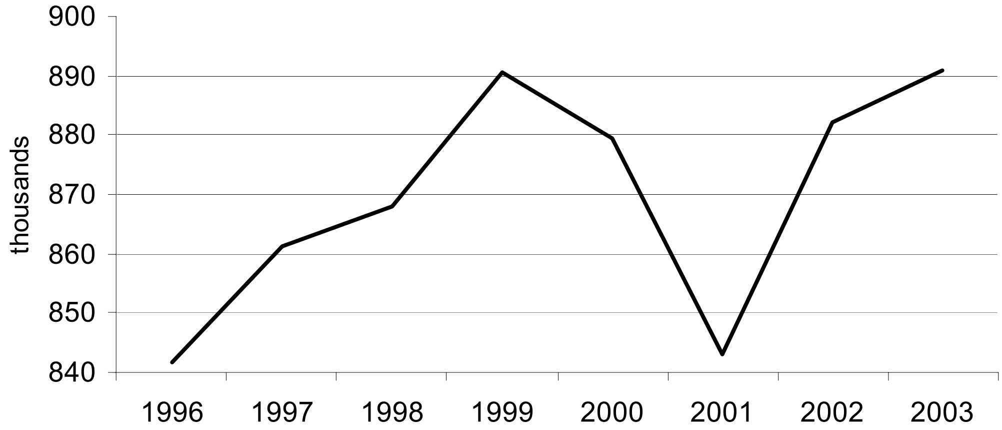
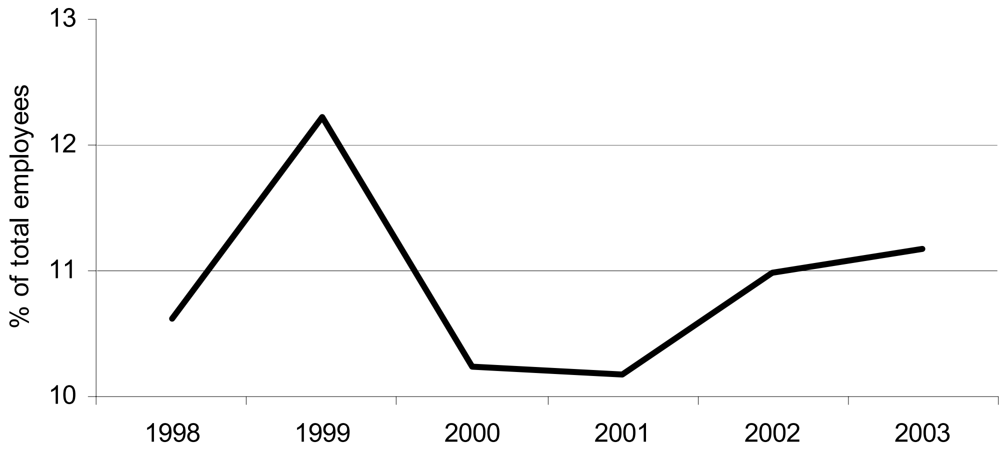


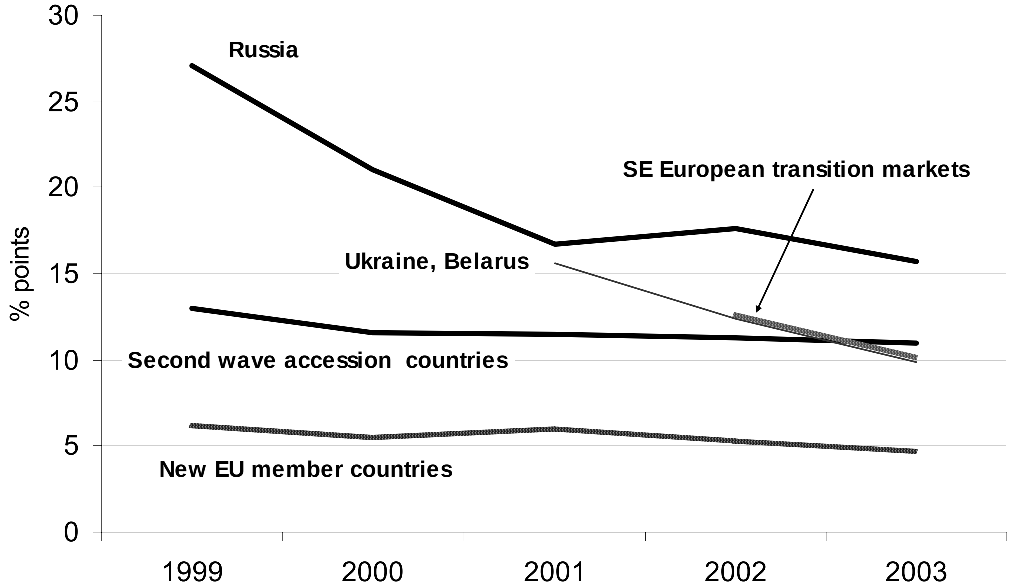
Figure 12: Numbers of employees in small and medium-sized companies



In study after study, entrepreneurs list the well-known problems (see below). The arbitrariness of public sector behaviour, high taxes, time and trouble in registering a company, dearth of orders and financing, and tight competition top the list. The problems are also known to the authorities and, while much legislation is aimed at alleviating them, the statistics do not yet reveal noteworthy results.

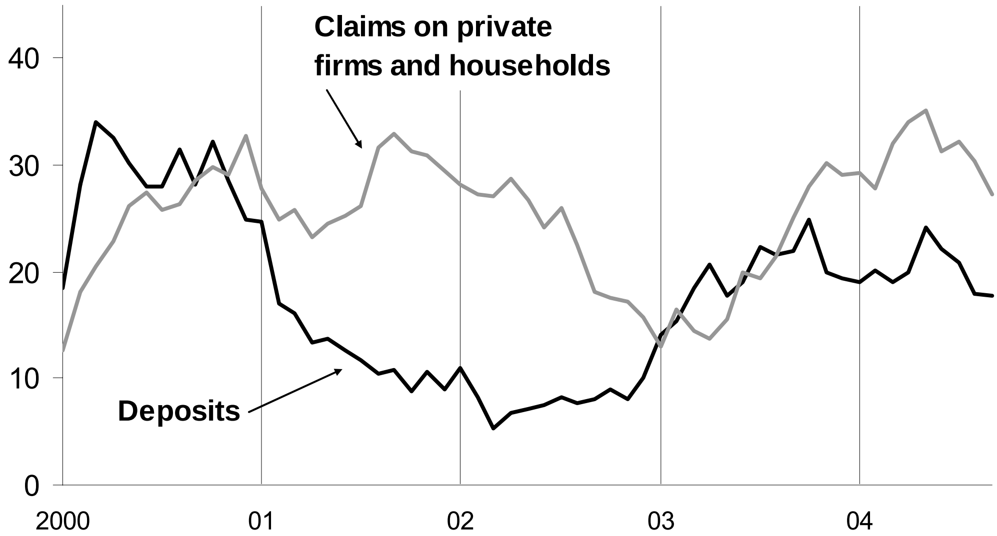
One of Russia's economic problem areas is the financial system. A vast literature on development economics indicates that, for many reasons, a highly developed financial system promotes growth. The relationship, however, does not appear to hold for the transition economies, where rapid growth of the financial sector has typically led to a banking crisis that is very costly in terms of lost output (Koivu 2002). Russia has gone through three serious banking crises (1991, 1994, 1998); and more recently (summer 2004), market participants' loss of confidence signalled some uneasiness. There are other reasons for the small size of the financial system and small number of markets.

Figure 13: Interest rate margins, Russia and other countries (Average lending rate minus average deposit rate)



There have been positive developments. While the margin between funding and lending rates (Figure 13) has narrowed, it remains considerably wider than in the countries compared. In recent years, banks' deposits and lending (Figure 14) have also increased - so rapidly that the monetary authorities have become concerned about a possible expansion of problem loans. Also positive from Russia's perspective is that the deposit growth has been specifically in rouble deposits. This is reflected in increased confidence in the rouble as the dollar has weakened.

Figure 14: Growth of funding and lending



What do opinions tell us?

The state of the economy and development possibilities cannot be measured by statistics alone, especially if one wants to assess the effects of very recent changes. These often impact the economic agents' behaviour via expectations. Hence it makes sense to make use of subjective evaluations also.

The first standard question is about how Russian companies view their operating environment. A periodic extensive opinion survey of Russian companies is conducted by the World Bank and the CEFIR research institute in Moscow. It covers 2000 (most recently 1600)small companies in 20 geographic areas and asks companies about the extent to which the selected widely-considered-serious problems hinder their operations. The small-company view of the seriousness of different problems differs from that of the media. Corruption and organised crime are not serious problems, or at least companies have adjusted to them. On the other hand, the manner in which the public sector operates is a problem. Taxes are considered high, as one might presume is the case for small companies in other countries.

The survey results also show how the business climate has changed over time. In almost all included aspects, the situation has improved over the course of the first three surveys, albeit the pace of improvement has clearly slowed. The fourth survey shows that the improvement of perceived business environment has continued at least until the end of 2003, though possibly at a declining rate.

Since 1999, the Finnish Chamber of Commerce has conducted annual surveys of CEOs of companies in northwest Russia (Central Chamber of Commerce 2000), the latest in September 2004. The answer-options were qualitative, but numerical balances can be calculated for these. Interestingly, the survey asks directly for the responder's opinion of how president Putin's policies have affected both their operating possibilities in the last twelve months and foreign companies' investment possibilities.

All through the surveys, more responders have viewed Putin's policies as positive than as negative. This makes the balance positive. Between 2000 and 2003, the balance for both questions rose. But in 2004 the balances dropped abruptly. For the question about foreign companies' investment possibilities, the drop was the most precipitous in the short history of the barometer. At the same time, responder uncertainty has increased. In September 2004 a full 36% left unanswered the question about the effect of Putin's policies on foreign companies' investment possibilities.

Corruption is widely seen as a big problem in Russia. Transparency International has for several years collected information on how businessmen view corruption in different countries. Since 1999 Russia's ranking has deteriorated among a growing group of countries, but according to the present evaluation, corruption has actually receded somewhat. This is somewhat contrary to a widely-shared sentiment that corruption may actually have increased during the Putin years. It is argued that the demand for corruption has strengthened, as there is more liquidity in the economy. At the same time its supply might also have increased, as a stronger state apparatus gives more potential corrupt practices to offer.

Creation of a normal market economy vs Putin's system

For any rapidly changing society such as Russia, trying to reduce things to a few basic elements is risky, if not doomed to fail. But if one is to at least attempt to sort out the permanent elements from the random bubbles, it is necessary to simplify. Apparently if one is willing to simplify shamelessly, to close the mind to possible counter-arguments, and refuse to listen to a conscience that would speak of the actual complexity involved, it may be possible to get a glimpse of what is called, for want of a better name, the Putin system. It is a poor name because the system is not a creation of Vladimir Putin but, on the other hand, his name will mark the decade in Russia's history. Mr Putin may not like the system, and may try to junk it, but success is not at all a sure thing. Even the liberals are split; some see the system as a danger, others as a lesser of evils.

Putin's system is a combination of two elements - two reactions to the 1990s - and only in this light can one come to grips with it. The first element is an attempt to build an authoritarian state. It is only an attempt, not an accomplished fact, nor is Russia about to become a totally authoritarian state. During the 1990s, the years of Yeltsin, policy-making was in many ways chaotic and unpredictable, but it was based partly on competition, among politicians, regions, enterprises, and even political parties. Society developed and the mass media were free of state control but also instruments of private interests. Income differences and other economic inequalities increased sharply. Russia's international reputation and influence diminished at least as fast as its statistical GDP. The country acquired a serious poverty problem, and a host of other possibly-grave social problems surfaced, from a deteriorating educational system to the decaying health of the populace.

In a recurring theme of the history of Russia and other countries, the pendulum shifted. The building of an authoritarian state became based on stability, identified with a yearning for predictability. Power had to be vertically organised. The lower – regional – level could not appear to excessively influence the central power in deliberations and decision-making. A special arrangement would be needed to ensure that decisions were actually implemented. But power was also to be based on division of tasks. Businessmen were not to interfere in political decision-making. But yet it was desired that they should represent the state's political interests also abroad. The judicial system has its own tasks, not the least of which is promoting the interests of the state. Democracy per se is not the goal but rather restoration of the might and repute of the state. But might and repute could be at odds with each other.

Striving for an authoritarian state is not an attempted return to the past. Even though nostalgia might be commonplace, there is no real yearning for an official ideology, state ownership, one-party politics, and a closed society. The country's leadership is sincere in considering Russia a part of Europe; a firm belief in a mythical Eurasia does not exist. Being part of Europe is the only means of achieving modernisation, a more competitive economy, and hence might. Moreover, the leadership wants the country to be a valued and respected member of the international community. The elite want to be free to travel, do business, and buy foreign football teams. The youth hope to use the Internet and to travel by Interrail as well – not to attend a youth camp in Kazakhstan.

In order to be accorded equal status by the international community it is necessary to hold elections that meet the minimal requirement of democracy: more than one candidate and reasonably accurate vote counting. The courts must also be independent at least in that defence lawyers can have their say. Nor can freedom of the press be stifled. Free speech must apply at least to the media of the elite – those that we too follow. For these and other reasons, the authoritarianism of Putin's system can never be total.

In fact, the Putin system's goal of building an authoritarian state is not only not total but also not stable. Elections are indeed held, but the results must be 'right'. In this regard, there is a readiness to resort to means of influencing politics that are considered off-limits in a democracy. Businessman, who strive for independence should - and can - be ousted, but it must be done through the judicial system. And the world's best defence lawyers must be given a seat at the table. The Khodorkovsky case says a lot: above all, the process is not under anyone's control.

The manner in which the 2008 presidential election is conducted will set a precedent. Putin's system calls for a guarantee of its own survival via the choice of a suitable successor. And yet elections are mandatory. Therein lies the need for adequate preparations, which have been in progress already for about a year.

The system's unstable political base stays upright so long as the president's popularity remains inviolate. This is fortified by a number of factors: firm support of the common people and the elite, oversight of the politically important media, a controlled parliament, tamed regional leaders, and – not to be downplayed – control of the forces of violence. If these fortifications do not suffice, the Putin system will either disintegrate into an attempt at total authoritarianism or move toward a fully fledged democracy.

The pillar of a president-centred system is also its weakness. When the goals of the state become the choices of a single individual, he is also needed in the realisation effort. The people's interests become identified with the character of that individual. Anyone who criticises or opposes him may be labelled an opposer of the best interests of the people – close to being an enemy of the society. Such was the fate of Khodorkovsky, then Glaziev.

Another weakness is that in such a system the leader's entourage is often made up of implementers, who lack the ability and desire to think new thoughts. The burden grows beyond the carrying power of one person; few things are more troublesome to a yes-man than knowing what to say 'yes' to. The actual output of the system does not measure up to proclamations that expound essential and well-intended ideas but stay on the level of lofty generalities.

Besides the president's position, another political pillar of the Putin system is a history of inertia. Many institutions, operating habits, and modes of thinking still hark back to the era of Soviet socialism. That was, after all, the time of Russia's greatest accomplishments. So it is no wonder that a yearning for it remains and that it is difficult to break away from it completely. The Soviet system left some useful bequests, such as a relatively highly educated populace, but still more burdens. The latter include an oversized military industry, geographically misallocated (à la economics) activities and people, a variety of security systems, and a plethora of outmoded thinking.

Another element of the Putin system is the striving for a more normal market economy. I have elsewhere labelled Russia's economy as a market economy but a peculiar one (Sutela 2003). The economy is in many ways normal by international standards: a typical (especially for large developing countries) and familiar dual economy. It is divided into an energy and raw materials sector, which is tightly linked to world markets, and a sector serving the domestic market comprising domestic industry and service providers. Russia's energy sector produces about a fifth of the GDP, by some estimates even more. In 2003, that fifth accounted for 55% of export income, about 40% of budget revenue, and about a half of total investment in the industrial sector. As an example, the weapons industry accounted for only a few per cent of export income. There are no signs of any diminishment of the economy's dependency on energy and raw materials. Fluctuations in GDP continue to closely track energy prices and production. According to an official estimate, energy accounted for about five percentage points of the nearly 7% growth in 2003.

The export sector, however, is characteristically not a provider of much employment. Most of the jobs are in old backward industries where productivity is low and job preservation requires quantitative restrictions, support, or an undervalued currency.

A dual economy can never be totally integrated with the international economy. For this reason, the establishment of free trade between the EU and Russia is necessarily a long-term goal. And so Russia is not under pressure to join the WTO anytime soon. Consumers would benefit most, but they do not have a voice in Russia's decision-making. It would appear that domestic producers do not believe they could keep up with international competitors in selling advanced industry- and service-based products. Thus the greatest pressure comes from traditional Soviet-backbone industries such as cars and aircraft, where there is a fear of being toppled in open competition. If Russia does make a hasty entry into the trade organisation, it will only be because of a decision at the top to join the international community.

Another unique characteristic of the Russian market economy concerns ownership rights. Most of the key exporters are included in conglomerates known as the oligarchy groups. These are controlled by very small clicks in which ownership is often cloudy and the companies represent a wide range of economic activities. The majority of jobs are in domestically oriented companies that are shrinking in size and are owned by managers and sometimes also workers. Although some oligarchy groups may have displayed dynamic and even internationally oriented thought processes, a common characteristic of the domestically oriented companies is defensiveness. In Russia the modern, small and medium-sized companies comprise a small sector, which has shown no signs of expanding.

The Russian market economy has other special features such as the smallness of the financial sector and the dearth of authentic foreign ownership. But even at this stage it helps to understand certain other special features of Russia.

The central position of the state means that companies often find it more profitable to focus on accumulating connections-capital vis-à-vis political decision-makers than to try to improve their competitiveness via product development and productivity. This is especially the case in the regions. The average Russian region is very small, containing less than two million inhabitants. A single company can be dominant in many areas, nor is there a real difference between the region's political and economic decision-making. Just as in the Soviet Union, too many economic decisions are made on political grounds, albeit to a diminishing extent. Too often political and economic power is encompassed in the same person or associated with promoting shared interests.

Repeatedly in surveys, small Russian companies have said that the prime obstacle to economically efficient operations is the arbitrary and discriminatory manner in which the public sector operates. The subjects of complaint are well-known: taxation, licensing, inspections, shifting interpretation of the law. But companies have also said that there was an improvement in the operating environment in 2001-2002. Only the competition, as they say, has gotten worse (tougher) – surely a good thing. These responses seem like very good news, but the interpretation is problematic. Has the environment actually improved or are companies learning to operate better in the same old environment? If the latter is the case, the pressure for improvement in the business environment is actually diminishing.

Russia is not merely an oil state. It inherited a fairly good educational system, some large-scale industry, and high-level research capability from the Soviet Union. But Russia could be drifting in that direction. There is little capacity to solve the problems of the educational system, at least according to the OECD's PISA study. A significant part of industry produces uncompetitive products in locations that are not rational in terms of a market economy. R&D

spending relative to GDP is only a third of that in Finland and is rising very sluggishly. Companies generally do not develop new products. Even though the price-competitiveness of Russian output is still very good, new internationally competitive industry- or service-based goods for export have not been forthcoming.

These risk factors are well-known to Russians. President Putin has recently on numerous occasions emphasised the importance of diversification of the structure of output and competitiveness. The prime minister has joined in, saying that the government will use all available resources to modernise the economy. The tax burden will be eased and competitiveness promoted.

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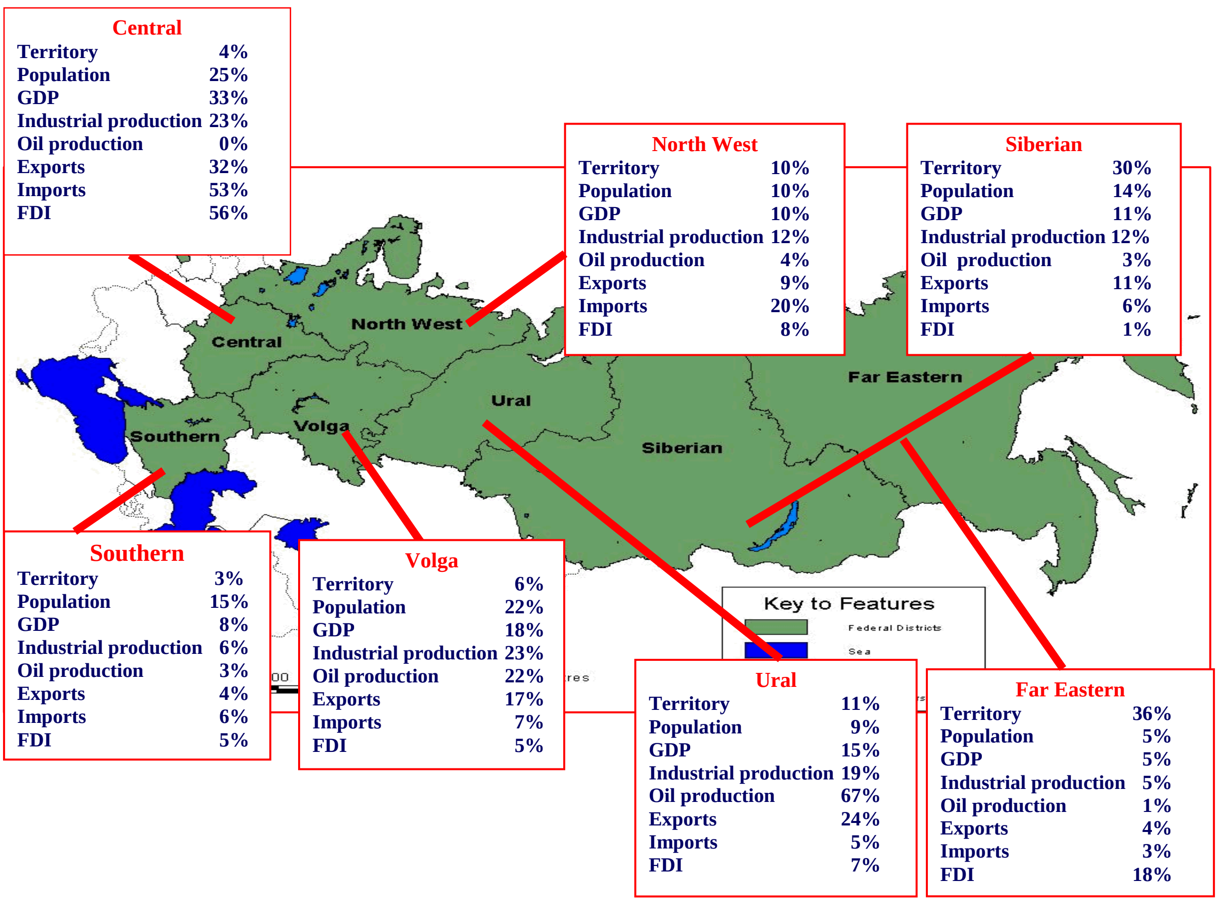
DOES RUSSIA BECOME AN INFORMATION SOCIETY OR ONLY A FORMATION SOCIETY?

Kari Liuhto

Introduction

The Russian Federation with her territory of 17 million square kilometers is the largest country in the world. She is almost twice larger than the USA and some four times larger than the EU25. Though Russia is a geographically huge state, one should keep in mind that 80% of the federation's 145-million population lives in the European part of Russia, covering only a third of the country's territory. Moreover, one should not forget that three quarters of the Russian population lives in urban centers (see Map 1).

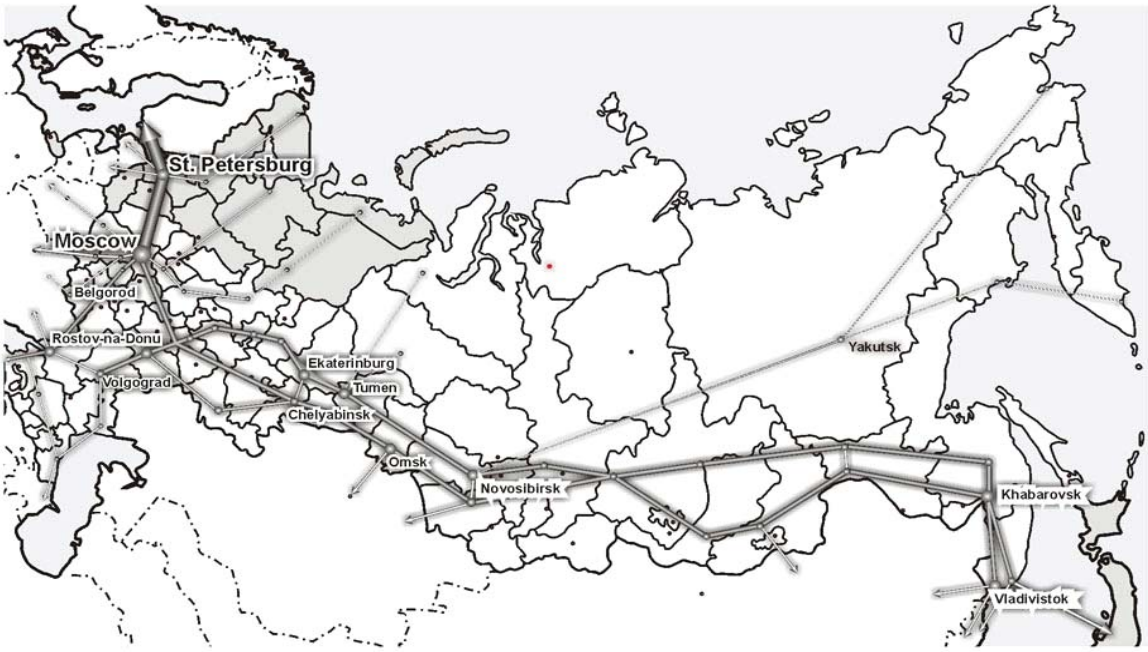
Map 1: Some basic facts of Russia's seven federal districts



Source: Goskomstat (2004), for reference see Liuhto et al. (2004).

The need for the information society becomes emphasized in a vast country with a relatively concentrated population. The main task of the information society is to link both the urban centers together and people living there into the web. The main obstacle in building the information society in Russia is not the absence of data transmission lines connecting the major cities but rather a lack of personal computers (PCs) preventing people to connect themselves into the information network (see Map 2).

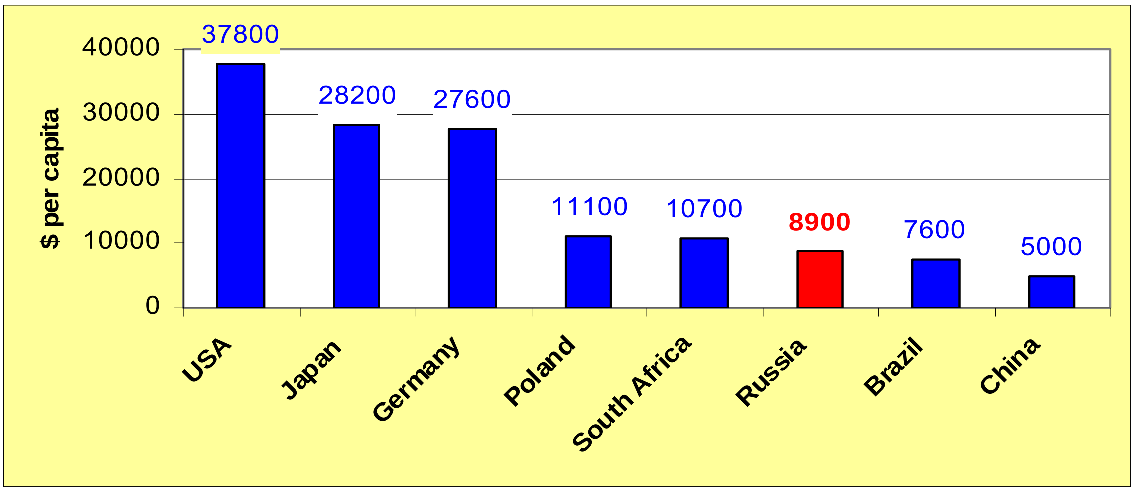
Map 2: Russia's main data transmission lines



Source: Sitra (2004).

A low PC intensity is due to the relatively low economic living standard of the Russians. The GDP per capita figure does tell the whole truth of the Russians' readiness to acquire a PC (see Table 1). Here, one should keep in mind that income is very unequally distributed in Russia; the highest 10% of income earners collect almost 50% of all the income paid in the country, whereas the lowest 10% receives only 6% (CIA, 2004). According to EIU (2004), a fifth of the Russians, or almost 30 million people, live under the subsistence minimum. Though the reality might be a bit brighter than the statistics refer, the aforementioned figures give a clear indication that a considerable part of the population cannot currently afford to participate in the information society.

Table 1: The economic living standard of the Russians in international comparison
(GDP per capita measured at purchasing power parity - 2003)



Source: CIA (2004).

The main objective of this article is to introduce a reader with the current state of Russia's information and communication technology (ICT) sector, and to analyze whether Russia has progressed on her way towards an information society.

The current state of the Russian information society

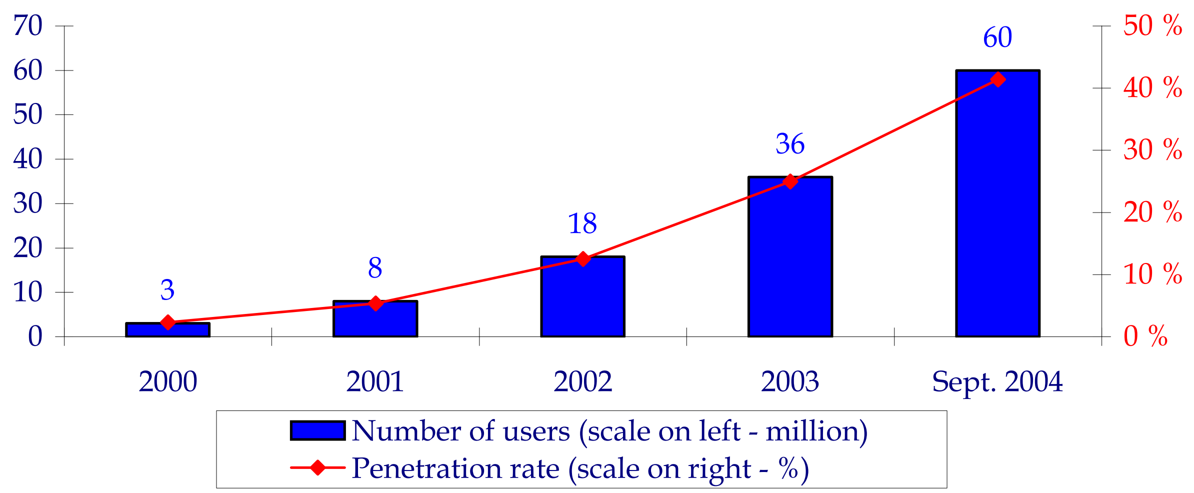
The Russian ICT sector

The telecommunication dominates Russia's ICT sector. It provides roughly 70% of all revenues generated in the Russian ICT sector. The telecommunications formed some 1.8% of the country's gross domestic product (GDP) in 2002, meaning that the whole ICT sector covered less than three per cent of Russia's GDP.

At the end of 2004, the fast-growing cellular communications represented more than 50% of the telecommunication sales in the country. An indication of the rapid growth in the cellular communications is the fact that approximately 60 million Russians were mobile-phone subscribers in September 2004 i.e. the penetration rate has climbed to over 40% (see Table 2)[1].

[1] According to the Bank of Finland (2004, 1), "*telecom investment boomed, equalling almost 7 % of the total in 1H04. Telecom sector activity has expanded around 20-25 % per year (in terms of volume of value added) since 2001, and may well continue at this pace. For one segment, the number of mobile phone subscribers rose this year from less than 40 million to almost 60 million, which is still nowhere near market saturation*".

Table 2: The cellular phone penetration in Russia



Source: CNews (2004), for reference see Sitra (2004).

The production of the ICT-related equipment has increased rapidly. The amount of the PCs produced in Russia was in 2002 some three times higher than four years earlier. During the period 1998-2002, the phone production has doubled and the TV set output has become 6-fold larger (see Table 3).

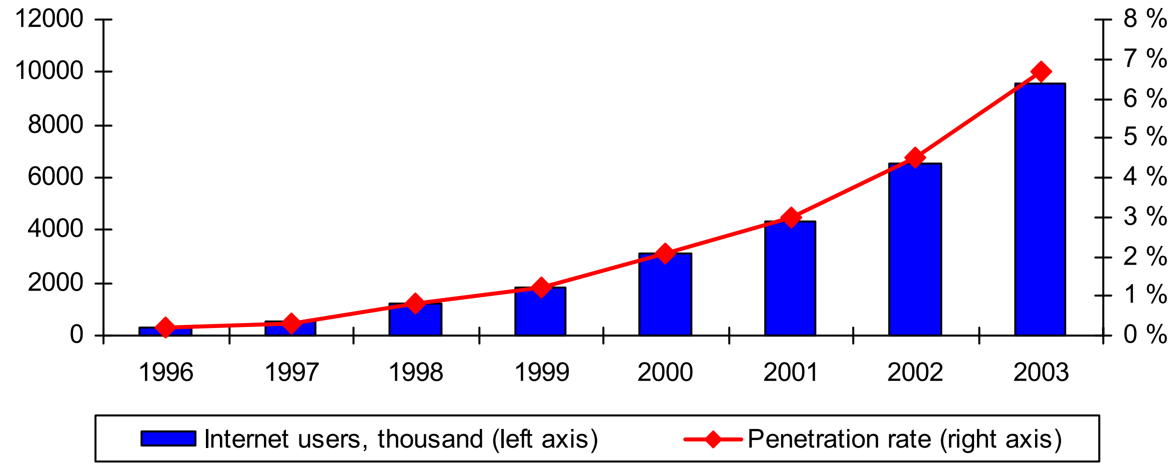
Table 3: The production of the ICT-related equipment in Russia

Equipment	**1998**	**1999**	**2000**	**2001**	**2002**
PC, thousand units	62	66	71	136	186
Phones, thousand units	235	534	783	716	525
Telephone cables, thousand kilometers	60	87	115	154	108
TV sets, thousand units	329	281	1116	1024	1980

Source: Goskomstat (2003), for reference see Sitra (2004).

Though the PC production has tripled, the penetration rate of PCs is still low. In 2003, there were only 9 PCs per 100 people in Russia. The Internet access ratio was even lower (see Table 4).

Table 4: The Internet penetration in Russia

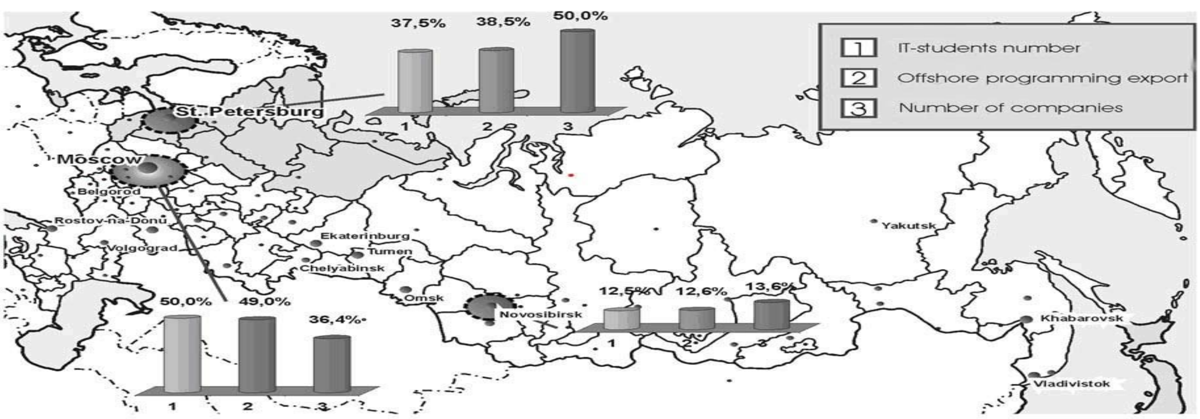


Source: CNews (2004), for reference see Sitra (2004).

Russia's foreign trade with the ICT goods

The Russian ICT goods are mainly consumed in the domestic market. The only significant export item in the ICT sector is software, namely offshore programming. The recorded value of software exports was close to $ 500 million in 2003. The real amount is significantly higher as the Russian tax and customs authorities receive only partial information about the real extent of the software production and their exports. Russia's main ICT centers are Moscow, St. Petersburg, and Novosibirsk. Almost 90% of the ICT-students and ICT-firms can be found in Russia's two largest cities, Moscow and St. Petersburg. These two cities also cover nearly 90% of exports related to the offshore programming. Practically, the remainder of the ICT-activity takes place in the peripheral city of Novosibirsk (see Map 3).

Map 3: Russia's main offshore programming centers



Source: Sitra (2004).

In addition to the software exports, Russia also sells electronic equipment components abroad, but the volumes are very modest (see Table 5).

Table 5: Russia's foreign trade with the ICT-related technology ($ million)

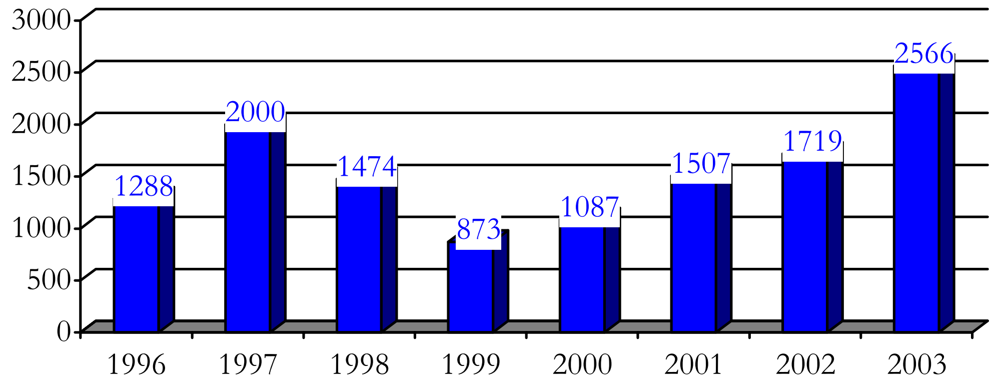
# HS	Product	2002		2003	
		Exports	Imports	Exports	Imports
8517	Electric apparatus for line telephony and line telegraphy	15	696	21	697
8525	Transmission apparatus for radio-telephony, radio-broadcasting	30	536	29	611
8527	Reception apparatus for radio-telephony, radio-telegraphy and radio-broadcasting	3	135	4	150
9001	Optical fibers and optical fiber bundles	14	16	14	21

Source: UN Commodity Trade Statistics (2004), for reference Sitra (2004).

The future development of Russia's ICT sector

In order to develop Russia's ICT sector, investments are needed both in technology and in human capital. Though the annual ICT-related investments have grown since the country's 1998-financial crisis, the current amount of the ICT investments is not sufficient to bring Russia among the front-runners in the global ICT competition. Thus, foreign capital, foreign know-how, and foreign management techniques are desperately needed, if Russia aims at catching up with the leading Western countries (see Table 6).

Table 6: Investments in fixed capital in Russia's telecommunication sector ($ million)



Source: Goskomstat (2003), for reference see Sitra (2004).

The number of ICT-related graduates in the Russian universities and technical schools has increased during the past years, but nevertheless, it is still far insufficient for building Russia as the information society of the 21st century. In comparison, China produced approximately 140 000 ICT-related graduates last year. Brain drain abroad, which is particularly intensive in Russia's ICT sector, does not make the human capital situation easier (see Table 7).

Table 7: The number of ICT-related graduates in Russia in 2002

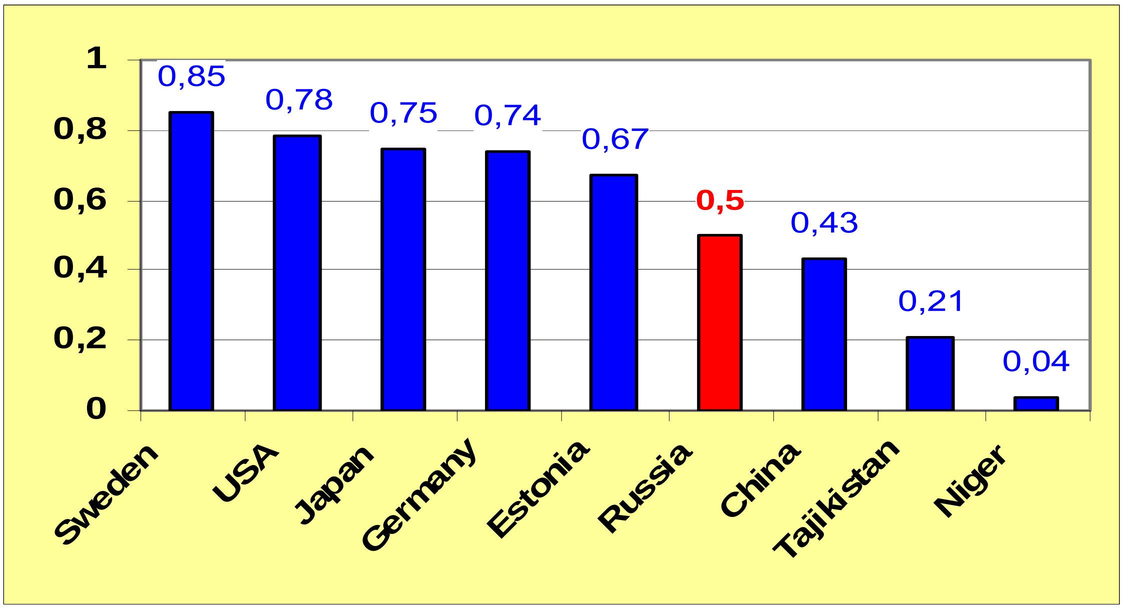
Universities	**3554**
Networks	1451
Multi-channel systems	1132
Radio, broadcasting and television	686
Other	285
Technical schools	**5851**
Networks	2363
Multi-channel systems	1190
Radio, broadcasting and television	512
Other	1786

Source: Goskomstat (2003), for reference see Sitra (2004).

The Russian government has acknowledged the need for developing the country's ICT sector. Already in 2001, the Russian Government approved a $ 2.6-billion program "Electronic Russia 2002-2010". The e-Russia program addresses four areas: (1) regulatory and legal environment, (2) Internet infrastructure, (3) e-Government, and (4) e-Education. The program aims at increasing the efficiency of the economy both in the public and private sector, to make a wider use of information technologies in government departments, and transfer much of the state's work online. It also aims at improving the quality of higher education in ICT and developing new independent media on the basis Internet resources. Distance learning programs via the Internet is a priority for the program.

Even if the e-Russia program is utmost necessary for the country's overall development, it is not without shortcomings. Firstly, the original budget is not sufficient enough. Secondly, the original budget has been cut, which hopefully, does not reflect a decreasing interest of the Russian Government in developing Russia towards an information society. Thirdly, the foreign involvement is far from sufficient to lift Russia among the world leaders in the ICT sector (see Table 8).

Table 8: Digital access index[2]: Russia among selected countries in 2002



Source: International Telecommunication Union (2004).

[2] This index measures the overall ability of individuals in a country to access and use new ICTs. It is built around four factors that impact a country's ability to access ICTs: (1) infrastructure, (2) affordability, (3) knowledge, and (4) quality. A fifth factor, actual usage of ICTs, is important for matching the theory of the index with the reality in a country.

Is Russia on her way towards an information society or towards a formation society?

The information society would offer Russia and her citizens many advantages. For example, the information society could improve the administration by transferring "best practices" across regions and cities. Moreover, it may provide information, education and medical services to people living in remote areas. And finally, it may aid the Russian Government to combat with the widely-spread corruption.

In this context, one should not forget that Russia is one of the most corrupted countries in the world. In 2004, Russia ranked as the 90^{th} country among the 146 states studied. In Europe, only four nations fell behind Russia, namely Serbia and Montenegro, Albania, Moldova, and Ukraine (Transparency International, 2004).

Another important advantage linked with the information society is the improvement it causes to the country's international competitiveness. Without steps towards the information society, it is hard to believe that Russia could transform herself from a natural resource-based economy towards a modern innovation society.

Here, one should remember that Russia has not managed to change her export structure since the collapse of the USSR. Despite the fact that Russia's exports have tripled since 1992, three quarters of Russia's exports even today consists of various natural resources, mainly of oil and natural gas.

The unchanged export structure should be an alarm signal for the Russian leadership, as the British Petroleum (2004) argues that at the current production ratio Russia's oil reserves will last less than 25 years and natural gas reserves less than 85 years. In other words, unless Russia manages to improve her competitiveness, the living standard of the Russians will inevitably start to fall at the second half of this century.

The World Economic Forum (2004) ranked Russia as the 70^{th} most competitive country in terms of her growth competitiveness among 104 nations surveyed. Unfortunately, Russia did not manage to improve her standing in the ranking of 2004 compared with the year earlier.

Another worrying aspect relevant for the future of Russia is her fast declining population. According to an expert estimation, the Russian population will go below 100 million already by the end of this century.

To conclude, in order to reach a sustainable economic development, Russia needs reformers also in the future, as one cannot have a reform without reformists i.e. liberally-minded government advisors. Correspondingly, one cannot achieve competitiveness without free and fair enterprise competition. Hence, the Russian Government should intensify its fight against inefficient and corrupt administration.

In order to reach the aforementioned targets, Russia urgently needs the information society and the reform the information society brings with it. Unfortunately, the author has lately become a bit dubious whether Russia is genuinely directing herself towards an information society or whether she is heading to a formation society, where the democratic development is regarded as an obstacle rather than a core value of the society. One should not forget that during the past five years, all the major powers – political, economic, regional, and even information (media) power – have to a large extent been concentrated inside the Kremlin walls.

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A VISION FOR EUROPE?

Markku Wilenius

In his well known book "Preparing for the Twenty-first Century", written long before the latest phases of European Union enlargement, Paul Kennedy assumed two challenges for Europe: (1) What organizational *form* Europe will assume as it moves on in twenty-first century and secondly (2) whatever its shape, how the region will *fare* as it grapples with transnational changes (Kennedy 1993).We know now that we are much better position than ten years ago to respond to this first question, but with the second question we are still waiting to have affirmative answers, to say the least. But the core dilemma, underlying these above mentioned challenges and without which they are hard to tackle is the following: Does Europe has a vision and accompanying strategy for its future whereby to embrace these topics?

The answer is no. European Union, for the time being, do not have a clearly stated vision or mission. Of course it has Lisbon targets and strategy and many other supporting statements, but these documents are not sufficient ingredients for the kind of vision we are looking for here. The point is that Europe has been, and still is, weak in its common ideological basis and for the future process of integration, this feature may turn out to be crucial driving force political development. Europe, drawing from its rich cultural history, has in the past been dominated by its dividing ideologies rather than integrating ideologies which is obvious if we only reflect the bloody history of the continent. For the future, the lesson European countries have to learn is to live and co-exist in multiple political and ideological atmospheres and still have a common vision so strong as to unite them in at least in the mental sense.

However, let me first explore the idea of Europe as expressed in the formation of European Union. European integration has been foremost a political process. This means there has been some fundamental ideas upon which the present expression of integrated Europe has been formed: they concern the pursuit towards peace, democratisation and economic prosperity. These are fundamental ideas that have given the umbrella shape to build a post-war Europe. No one can say that these are targets we should not try to attain. Today they are thus accepted by every political rank.

At the same time we must confess, nevertheless, that in spite European integration the member states still act mostly like individual nation-states. The idea of politically and ideologically strong nation-state that was developed over two hundred years ago as an essential element for Industrial Age, is still dominating the political debate and practice over the "the United Europe" –idea. In many of these debates, there is now a tendency to see that there is actually no point to endeavour to build a strong united identity for European Union in the same fashion as modern nation-states were built. Instead, we should think EU as a framework for multiple political identities (see Tiilikainen 2002).

From the historic point of view, perhaps the strongest ideological element for European integration has come from catholic world-view. It has always been in the interest of Catholic Church to unite different parties in Christendom under same political institutions. No wonder then that Catholic countries in Europe has been the strongest supporters of integration whereas political leaders in protestant countries have had difficulties in finding the persuasive arguments for political integration. At the end of the day, the justification has been found particularly from two sources very different to those just mentioned above: from pragmatic peace-policy (no more wars for Europe) and secondly from the logic of economic competitiveness (we cannot compete with US or Asians if we are not united).

We can perhaps now understand somewhat better why we hear in public discussions so little reflections about future visions of Europe and much more about the present challenges Europe faces. EU lacks the uniting vision because of its multicultural and multi-ideological historical heritage. Simply put, European countries do not share their past in terms of their political or cultural identities and this is surely making a common vision all the more complex issue. Thus the Enlargement towards the east is not making things easier, on the contrary. Moreover, what we are going to see in the future, are the next phases of enlargements that will be directed towards South-East and this shall make the cultural and ideological constitution all the more complex.

However, even after these remarks we simply cannot avoid the fact that politically and economically integrating Europe needs, perhaps more than ever, a clear vision for future Europe. This vision must be much more than just a plain economic agenda that we now see dominating societal debates. We get easily stuck with the obvious need to increase productivity and to rationalise operations of European economies and we miss those issues that are related to the question what we want Europe to be in the future. Increasing the economic competitiveness can never serve as a genuine target for European Union. It would be as simplifying as to state that the mission of any single company is to bring profits to its customers. Competitiveness is certainly an essential precondition for successful operations and it may serve as a means to attain the goals of company but the goals themselves must be found elsewhere.

Let me remind you of the basic conditions of the vision building. There are four factors that adds up to good vision: first, it gives you a clear picture of the *modus operandi*, the modes of action. Secondly, it provides an idea of the position you have in the field and also gives account of the environment within which you are acting. Thirdly, it must be challenging and inspiring enough to make people to do their best and to exceed their present performance. And fourthly, it gives a promise to those who are respondents of the vision.

There must be a clear starting point for vision. In case of Europe, what about happiness that is the base for human welfare? Should Europe become a continent of happiness, which is much more bold a target than what is stated in Lisbon strategy? We may determine that whatever the stated vision of Europe stand for, it should bring greater happiness to its citizens.

So what are the determinants for happiness in Europe? The first condition for Happy Europe is that we cannot tolerate wars. Evidently, Europe has become pretty far to tackle this condition but we are not as yet there. The only viable solution is to unite Europe as single network of states, to build European Union as a foundation for first truly Network State in the history of the world. This needs another EU enlargement, next towards Balkan, to bring these states under common framework within which war becomes an impossible option.

The second condition for Happy Europe is that all its citizens are entitled to such public services and economic and social stability where hunger and absolute poverty are only rare exceptions. In this respect there are still a lot to do, particularly in those European countries that have participated recent wars at Balkan and in those countries whose economic performance was severely damaged during communist regime. The welfare model, particularly that which has been created in Nordic countries, is a best cure for these social challenges.

The third condition for Happier Europe is more complex and thus hard to grasp: it should promote its cultural diversity and consider it as its strength vis-à-vis other economic blocks. Here we encounter lots of prejudices that simply do not adhere to the present day conditions of wealth creation. Richard Florida, in his now famous treatise on "Rise of Creative Class", consider tolerance as one of the three key determinants for regional economic success, in addition to talent (educated human capital) and technology (companies that uses and produces high technology). Based on detailed empirical research he states that tolerance – meaning places that embrace wide array of ethnic, religious, sexual and political identities – forms a kind of mental platform where individuals can live fuller, in other words happier life, and at the same time being able to contribute to economic success of region or country (Florida 2002).

Thus, I argue, understanding the new and more fundamental role of culture in building a vision for Europe is the most crucial challenge we face (see Wilenius 2004). What we need to understand is that this is exactly the unique strength Europe possess, vis-à-vis many other parts of the world. Unlike many other parts of the world, Europe for its most parts, has for such a long time been a real cultural melting pot. Thus it is not a great leap forward to assume that the vision for wider Europe should incorporate the idea of cultural diversity as a competitive advantage.

In building a vision for Europe we must also observe some obvious challenges Europe is facing. Let me just pick up some that are most essential[1]:

1) Europe will be lacking the human capital to maintain its competitive edge as against United States and rising Asia. Europe is aging at a alarming rate and this will put enormous burden on its welfare system. In addition, Europe is the only continent whose population is expected to decrease during the next 50 years

[1] Some of these points were elaborated in the discussions in the New Europe 2020 Conference

(Narsakka 2002). In countries like Italy, the fertility rates have dropped to the level where the amount of population already have begun to decrease. While this is true in the light of numbers we may, in part turn this view the other way round: what if it was exactly this point that makes Europe more competitive: never before have we had a access to such amount of human wisdom. Therefore the problem, from human capital point of view, is not just how do we cope with our declining service ratio in our national economies but how we provide people more opportunities to play an active role even after and beyond normal working career. To sum up, the question of how we make use of our human capital is a crucialone for Europe.

2) Europe as a whole is not investing sufficiently on innovation and research. As economic competitiveness is increasingly based on intangible assets, it should indeed be a topmost priority not just to all member states but to the European Union itself to increase its stakes here. In the light of sheer numbers, what is happening is that Europe, for the time being, is lagging far behind its most important competitors, particularly United States and Japan. There are but few countries in Europe, notably Finland and Sweden, that has been able to raise their R&D expenditures around 3% of their GDP, resembling performance of US and Japan. As that level of R&D activity was the cornerstone of EU's Lisbon strategy, we may at least expect strong measures in European countries to shift their activities towards this goal. Obviously, there is much more than just the question of how much R&D stakes we have invested. Particularly, Europe needs much more cooperation between Universities, corporations and public authorities to build more creative and innovative economic system. Moreover, in the future, the competition is much more about that standards and regulations and not just about the goods. This means also, that we need not just competitive corporations, we also need more competitive public authorities.
3) The future of Europe cannot be properly treated unless the potential role of Russia is considered in the making of wider and stronger Europe. For the time being, Russia is still in the situation where necessary institutional frameworks for modern economy are just simply not there. As some Russians have expressed the issue, there has been a tendency to privatize the profits and nationalize the costs. New social, political and economic institutions are needed in Russia. Present Russian elite seem to hold a view that Russia will not be a member of European Union in the future but that instead what they want is to create common markets with European Union.. The relationship between Russia and European Union can be described by the hybrid concept of **cocompetition.**
4) The vision of European Union as a stronghold of economic prosperity and power includes that Europe is indeed able to create a space called European economy. We may argue that at present this is not the case in the strong sense of the word. New political institutions do no necessarily lead economic integration and the mobility of labour and investments have not developed in the way it has been

projected. The real challenge for European Union is whether it is able to put in practice the basic principles of common markets.

5) In 2020, in order to attain the vision of a strong European Union, it should be able to speak with one voice in spite of its heterogeneous nature which is presently often not the case. Europe wants to play a global role but it can be argued that for the time being it does not live up to this promise. Thus, the idea to give elevated status to European neighbourhood policy is very much in line of the vision of Europe as an entity with strong voice.

It is very much clear that Europe and European Union in its enlargened form, needs a vision that it most likely lacks today. The low rates of participation in the EU parliament elections demonstrate the existing gap between the policy-makers and citizens. Europe need not just to be a stronger, but, what is more important, it needs to be wiser and have such goals where citizens of the union can relate to. Then we are not just talking about economic competitiveness, but also of such things as environmental protection and social welfare.

In order to be on the right track with our vision building, we must turn our eye on things that will determine our operating environment in 2020. As a futurist, my vision is that the toughest political dilemma at that point in the future, and indeed during ongoing century, in international politics is the accelerating depletion of our natural resources, particularly those of water, oil and clean air and the manifold consequences of the use of these resources. We already see numerous symptoms of this development around the world, in Europe as well. For this reason, European Union, to be viable solution for its member countries, should adopt the idea of sustainable development at the core of its vision. This idea goes fully hand in hand with the idea to modernize the European economic system to compete in the global markets.

But the question remains, what is real Europe and do we define it by geographical, mental or other aspects. As we know, Europe as it is now, is united with shared political institutions and cultural heritage and again divided by political borders and country-wise and individual aspirations. As the European Union may further expand to East and South-east, it is for sure that cultural, political and economical diversity increases accordingly. This means, in essence, that there growing interest for vision and strategies of what Europe is and what is its place in the future world.

Let me eventually provide you with my personal vision of Europe by 2020:

"By 2020 as we have entered the Age of Network Society, Europe will be the first real network state in the history of the world, which is, because of its dynamism, the strongest economy in the world, drawing from its flexible, decentralized political system and its heterogeneous cultural heritage. The European Union, now comprising some 30 member states, have united all the essential regions of the old Europe, thus giving Europe a unique opportunity to create a platform for interaction and prosperity with its economic and political aspirations geared around worldwide sustainable development and happiness for its citizens."

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Chapter 2

EUROPEAN UNION, RUSSIA AND BETWEEN

EU-RUSSIAN LEGAL HARMONIZATION AS THE BUSINESS FOR DEEPENING RELATIONS IN THE NEW EUROPE: POLITICAL AND LEGAL ASPECTS

Tatiana Romanova

Abstract

The establishment of the Common European Economic Space between Russia and the European Union requires quite close legal approximation of the two parties. This goal was recognised from the very beginning but only recently did it acquire a central place in EU-Russian relations. This paper traces the origin of the debate, and discusses the current definition of legal approximation, its methods, forms and levels. It also analyses some likely political consequences of the harmonisation process. In examining these issues the paper traces how political and legal issues are intertwined in EU-Russian legal approximation.

Keywords: EU-Russian relations, legal approximation / harmonisation, europeanisation, democratic deficit

Introduction

The discussion on legal approximation and legal harmonisation is not new for EU-Russian relations. It has existed in EU-Russian relations since the establishment of the official relations between the two parties in early 1990s and was inserted in the guiding document of these relations – Partnership and Co-operation agreement, concluded in 1994. However, recently (since 2001) this discussion has intensified considerably and led to more intense co-operation and activities.

This paper will try to answer the main questions that surround the issue of EU-Russian legal harmonization / legal approximation[1] today. In short, these are the questions "WHY", "WHAT", "HOW", and "With WHAT POLITICAL CONSEQUENCES". I believe that the answer to these four questions allows the reader to get a full picture of the phenomenon of EU-Russian legal harmonization and to grasp all its facets since they help to trace the roots of the issue of legal harmonization, then define the phenomenon as such, and continue to discuss the legal instruments and consequences for Russia's political development. Through answering these questions I will show the interplay between political and legal aspects in each of the four chapters.

Therefore the paper is structured around these four questions. In the first chapter I will outline the reasons why we speak about EU-Russian legal harmonization at all and how we got to the current intensity of the debates. The second chapter is devoted to the question "What is legal harmonization". Here I will define the issue of legal approximation in the practice of both the EU and of Russia, put this issue in the context of their broader activities and define the specificity of their particular case. Chapter three concentrates on the instruments of the bilateral legal approximation. In other words the question is: "How are we getting there?" To present a full picture I will have to ponder three aspects here: the methods of harmonization, its forms and levels. Finally, I will discuss the most plausible political consequences of EU-Russian legal harmonization and try to locate the study of these consequences within the broader European studies.

Why Do We Speak about Legal Harmonisation

To trace the origins of the discussion on EU-Russian legal harmonisation it is essential to address several issues. One is the official EU-Russian discussion and the place that legal harmonisation takes in this discussion. Another one is the beginning of some parallel

[1] The terms "legislative approximation" and "legislative harmonisation" are used as synonyms in this paper except where explicitly provided otherwise to clarify the difference in the provisions of articles 94 and 95 of the Treaty establishing the European Communities.

processes that sustain EU-Russian legal harmonisation. Finally, I will briefly discuss the economic reasons that underlie EU-Russian legal harmonisation.

Official Discussion on Legal Harmonisation

Already in 1994 the Partnership and Co-operation Agreement (PCA), first basic and legally binding document that appeared between the two relatively new actors in the world arena – Russia and the European Union, contained a clause on the approximation of the EU's and Russian legal systems. Article 55 of the PCA on legislative approximation stated that:
"The Parties recognize that an important condition for strengthening the economic links between Russia and the Community is the approximation of legislation. Russia shall endeavour to ensure that its legislation will be gradually made compatible with that of the Community." (Agreement on Partnership and Cooperation 1994)

Thus the PCA laid the ground for two processes. Firstly, it affirmed that any closer relations between the European Union and Russia will require legislative approximation, and the statement in the PCA was quite blunt indeed – it was a one-sided approximation of the Russian legislation to the European one. Secondly, the PCA foresaw a rather broad approximation and identified numerous fields where legislative approximation was needed (see paragraph 2 of article 55).

The course on legislative approximation between the European Union and Russia was preserved in the Common Strategy of the European Union on Russia, prepared in 1999. According to this document, the progressive approximation of legislation and standards between Russia and the European Union, in accordance with the PCA, will facilitate the creation of a common economic area. (Common Strategy of the European Union 1999).

It is noteworthy that although the Common Strategy of the European Union is a unilateral document, the statement on the legislative harmonisation is much milder here and the notion of reciprocal convergence can be identified. Moreover, the Common Strategy is much more modest in terms of scope of the legislative approximation: it is defined as touching primarily upon "*the field of customs as well as standards and certification, competition policy and the environment*" (Common Strategy of the European Union 1999).

However, the discussion on legislative approximation has greatly intensified only recently. Several factors influenced this development. Firstly, a general intensification of EU-Russian relations and a transfer from the political dialogue to a genuine co-operation played an important part here. A new debate on a Common European Economic Space between Russia and the European Union, initiated in 2001, is a good indicator of the intensification of relations. Secondly, EU enlargement and the need to preserve and enhance the economic ties between the new European Union and Russia had a significant impact although we also witnessed hard debates on the adaptation of the PCA agreement as well as the development of the discussion on legislative competition in the immediate neighbourhood of Russia and the

European Union.[2] Thirdly, the reform of Russian legislation coupled with its aspirations to accede to the WTO and accompanied by the general globalisation of economic activities greatly contributed to the intensification of the discussion on EU-Russian legislative approximation. Globalisation is creating a need for a harmonised legal base for relations and the WTO discussion is nothing but the first stage of this dialogue. Thus the global legal approximation creates a very favourable background for the EU-Russian discussion on regulatory convergence[3].

The question of legal harmonisation became one of the central pieces of the discussion within the High Level Group created for the development of the concept of the Common European Economic Space (CEES) between Russia and the European Union. In its final report this High Level Group stated that it "considered the opportunities offered by greater economic integration and legislative approximation and assessed options for further work" (Joint Press Statement 2003b). The main instruments to be deployed for the creation of this Common European Economic Space are market opening, regulatory convergence and trade facilitation (Joint Press Statement 2003a). This logic was preserved in the discussion on the four EU-Russian common spaces (one of them being economic) that followed in 2003 and the debates surrounding the action plans for these four spaces.

Thus through political agreements and legally binding documents legislative approximation was made a centrepiece of EU-Russian co-operation, upon which hinged the intensification of all fields of co-operation. Mild formulas, according to which legislative approximation was a reciprocal convergence rather then Russia's unilateral alignment, was preserved but it became increasingly obvious that this formula is nothing but a disguise for the process of Russia's unilateral legislative harmonisation with the EU's norms, regulations and standards.

Flanking Measures to Support the EU-Russian Legal Harmonisation

The official discussion on legal approximation was framed with several parallel processes supporting the legal harmonisation. Significantly they originated from both public and private parties and put some flesh on the bones of official declarations.

Firstly, the EU-Russian business dialogue that develops in parallel with the official public discussions recognized the value of legislative approximation. The Fourth EU-Russian Round Table of Industrialists that took place in 2002 is particularly noteworthy. It declared that the development of [Russia's] national legislation in the context of international law, its unification and harmonisation with European legislation, primarily in the areas that are of

[2] The discussion emerged following the development of the concept of the Single Economic Space, involving several countries of the CIS. In particular Ukraine was warned that it had to choose between the European Union's acquis and the Common Economic Space provisions.

[3] Another word that describes the process of legal approximation and appears in the EU-Russian discussion. It obviously signifies the logic of mutual adaptation as oppose to the one-sided approximation or harmonisation.

practical meaning to business are key priorities of EU-Russian relations (Chetvertyj Kruglyj stol promyshlennikov … 2002). Thus the process gained the support of the private sector. Moreover, in fact this means that the process is no longer exclusively controlled by the public administration of the European Union and Russia. The pressure from business on public administration to harmonise law will be growing as economic ties intensify.

Secondly, the programme of EU technical assistance to Russia (known as TACIS) was gradually restructured so as to support the goal of legislative approximation. The 2001 EU Country Strategy Paper on Russia, which determines the directions of EU technical assistance, "foresees the development of a mature partnership. It highlights the approximation of economic legislation and co-operation in the sphere of law enforcement" (Country Strategy Paper 2001). It goes on to state that "particular attention will be paid to the approximation requirements of a possible future common European economic space". To give just a few examples of TACIS activities in Russia we can mention the following projects.

- 4 million euro was spent on the programme "Approximation of rules and standards" to address technical barriers to trade as a precondition for further economic integration in 2001;
- 4 million euro was invested in the programme of harmonisation in the framework of the EU-Russian Energy Dialogue only in 2002;
- in 2003 technical standards harmonisation in the gas sector was considered (3 million euro);
- in 2003 3 million euro was spent on the project of approximation of regulatory and legislative frameworks for competition.

The place that energy and competition issues took in this discussion is quite outstanding and in a way it hints at the critical aspects of EU-Russian relations with the high potential for legal approximation - a role we will consider in chapter 2.

According to the new National Indicative Programme of the EU's technical assistance for the period 2004-2006, "support to the further integration of the EU and Russian economies is an essential component of the NIP, aiming to help remove non-tariff barriers to trade and investment through the progressive approximation of relevant Russian legislation with the "acquis communautaire"". Furthermore, the National Indicative Programme considers "linking the EU and Russia in a special, closer relationship reflecting their proximity to each other, which will focus on legislative harmonisation, regulatory convergence and trade facilitation" (European Commission 2003a). Thus the policy of TACIS structuring so as to support EU-Russian legislative approximation will be continued.

Thirdly, the TACIS programme was used to finance the EU-Russian centre for economic policy (RECEP). Throughout the first stage of its activity it explored different models of EU-Russian co-operation. Currently it provides consultancy services to different public institutes. Several requests that were submitted in the summer of 2004 are noteworthy:

1. On July, 13 the Ministry of Industry and Energy of Russia asked for a description of the development and current state of EU single market legislation, including customs legislation, competition policy and state aid, free

movement of goods and services (in the area of regulating technical standardization, certification and accreditation, financial services and corporate regulation); economic and monetary union legislation; statistics legislation; freedom of movement legislation.

2. On June 30 the State Duma of Russia's Federal Assembly asked for the creation of an analytical database for developing basic economic, legal and political mechanisms for creating a favourable environment for cooperation in the Common European Economic Space, preparation of both federal and regional legal basis in the Russian Federation.

   Simultaneously the State Duma ordered the analysis of 1) anti-monopoly legislation of the Russian Federation (legal novels, duplicate clauses), its comparison with the acting legislation of the European Union, ways to improve the efficiency of its implementation, and 2) the project of law on Concessions, revealing its advances in legislation and cross-links with the other acting legislation; its comparison with the acting legislation of the EU.

3. The Presidential Administration on June 28 asked for the provision inter alia, of

   - Research of international experience of harmonisation of national law and common practices, together with the commonly used instruments.
   - Estimation of a more efficient appliance of PCA and advisability of supplementing it with new agreements between Russia and the EU.[4]

This is a good illustration that Russian public administration is becoming receptive to the idea of Russia's legal approximation to the acquis of the European Union and is gradually transferring the issue into the practical dimension. Moreover, the experts are gaining in importance in EU-Russian relations.

Fourthly, the European Union tries to use international fora to strengthen EU-Russian legal approximation stances (Romanova 2003b, 2004). Initially the European Commission used the Energy Charter mechanism for this purpose insisting on the creation of a fourth European Community with boundaries that go beyond the borders of the European Union. However, for multiple reasons (that are beyond the scope of this paper) the Energy Charter Treaty has not been ratified by Russia and is unlikely to come into force in the near future. Recently negotiations within the framework of Russia's accession to the WTO were used as a forum for the EU to insist on certain legal harmonisation in the field of energy (in particular liberalisation of the gas sector), telecommunication, air traffic services, banking and insurance. In April-May 2004 the European Union and Russia finally reached an agreement on the terms of Russia's accession to the WTO. Although not all the demands of the

[4] For a more detailed description of requests see http://www.recep.ru

European Union were taken into consideration, the trend to further legislative approximation became unavoidable and it is now fixed through Russia's international obligations.

Thus several processes accompany the official EU-Russian discussion on legal harmonisation and sustain it. It is important to note that most of them originate from the side of the European Union although Russia is becoming more and more active in searching for political and legal advice. The domination of the European partners supports the argument of the previous paragraph of this chapter that the EU is a dominant actor in the process of legal harmonisation.

Economic Reasons behind EU-Russian Legal Harmonisation

The economic reasons for legal harmonisation are relatively straightforward although not void of some contradictions.

First, if the amount of economic transactions is high enough there is an incentive to decrease the regulatory barriers facilitating further increase in trade and provision of services. Legal diversity increases the transaction costs of cross-border contracting, and discourages consumers and small and medium-size enterprises from engaging in such transactions in the first place. (Wagner 2002). The question what level of transactions is needed to intensify legal approximation is debated among the economists. However, it is clear that with 50% of its trade going to and from the enlarged European Union Russia has to approximate its norms to the EU's as closely as possible.

Secondly, the intensity of contacts and the division of labour lead to gradual integration, which legal hamonisation facilitates. As the head of the Delegation of the European Commission in the Russian Federation rightly said, approximation and harmonisation of the normative basis may seem to be a very boring and bureaucratic business. However … this is the essence of the economic integration. (Wright, in: Arbatova (ed.) 2002). A Russian official from the Ministry of Economic Development and Trade made the very similar statement that economic integration is primarily about regulatory convergence of Russia and its partners (Danilova, in: Arbatova (ed.) 2002).

The question is, however, whether the nature of EU-Russian economic relations is such as to favour economic integration. It is not a secret that hydrocarbons and fuel make up for 65% of Russian exports to the European Union and Russia imports manufactured goods. Not only the amount that is traded but also the quality of the exchanged goods matter. The Russian economy is qualitatively different from the EU's. It is still industrial as opposed to the post-industrial type that was formed in the European Union. This fact therefore casts doubts on whether economic integration is currently possible between the European Union and Russia on terms comparable to integration within the EU or between the EU and EFTA countries.

Current trade transactions definitely require certain legislative approximation. However, it is opening up domestic markets for international services transactions that involves policy instruments, which are more familiar as domestic tools than as traditional trade policy measures and whose approximation therefore leads to comprehensive economic integration

(Ruegger 2000). This is not yet the case of EU-Russian relations and the discussion on telecom and aviation services in the context of Russia's accession to the WTO revealed all the controversies of the issue.

Thirdly, orientation towards EU norms will greatly enhance Russia's investment climate and will create the basis for the activity of the private sector. It should be kept in mind, however, that Russia first has to create its own harmonised internal legal space (including tuning of the federal and local levels as well as laws and bylaws and regulations) and only then can it approximate it to an external one.

The question also remains whether Russian business can bear the pressure of this harmonisation (in particular in the area of social and environmental standards) while developing production.

In sum, all the arguments are not without their counterarguments, but the arrow of substantial economic reasoning is pointing in the direction of EU-Russian legal approximation while leaving open the question of the scope and mechanisms of this approximation. Having explained the reasons for the discussion on legal approximation I will now proceed to the phenomenon of legal approximation per se.

What Exactly Do We Talk About?

To define the nature of EU-Russian legal approximation one will first have to address the experience that the two parties have in this process, then put the issue in context to demonstrate the already existing practices. Thirdly, the final goal of this legal approximation should be determined since only when the parties know what exactly they want to achieve can they determine the nature of legal approximation. Therefore, the second chapter will explore these three issues through political and legal reasoning.

Legal Approximation in the understanding of the European Union and Russia

The notion of legal approximation in EU-Russian relations is now being developed. However, it does exist both in the practice of the European Union (in the relations of member-states, EU relations with the EFTA countries and with Switzerland) and in Russia's dialogue with the CIS countries.

In Russian tradition legal harmonisation is a complex system that includes the analysis of the legal basis of every state in question, comparison of their legal basis to identify contradictions, differences and flaws; assessment of the advantages of different legal systems; analysis of the consequences of developing a single or unified legal system and organisation of the work on every law according to the adequacy of its inclusion into the single legal space. (Programma garmonizacii 1999). Its final destination is the establishment of the grand system of law that is shared fully by all the participants.

It should be stressed that legal harmonisation within the CIS (with Russia in the centre of the process) is only nascent and has not so far demonstrated any particular success.

Legal approximation/harmonization has been present in the practice of the European Communities from their very establishment. The EU's tradition is different in that it does not foresee the establishment of a grand system of law but is rather targeted at the elimination of barriers to the internal market and instances of unfair competition. Sometimes legal approximation even defined as a mere elimination of differences adversely affecting the sound-functioning of the common market in certain areas of the national legislation of individual member states. That is why EU legislation may seem to be quite patchy.

The culture of legislative approximation/harmonisation has started in the European Communities as maximum harmonisation on the basis of article 94 of the Consolidated Treaty establishing the European Community. This process was conducted through the consultation procedure and unanimous vote in the Council with the view to establish a common market and achieve the highest possible harmonisation. When it became obvious that this task is enormous the European Union turned towards broad use of the principle of mutual recognition and the so-called minimum harmonisation on the basis of article 95 with co-decision procedure, qualified majority vote in the Council and possibility of derogation to set up higher standards. The whole philosophy has changed from the detailed regulation to the provision of only essential standards and framework legislation that allowed the EU to complete the internal market.[5] The terms "legislative approximation" and "legislative harmonisation" are now used interchangeably in EU law.

The multilateral legal approximation in the European Union is a well-developed practice with a clearly defined goal and a full set of instruments.

On the basis of these competing understandings current EU-Russia legal approximation can be defined as a complex of actions targeted at levelling the differences in the regulation of the firms' and individual activities. The goal is to achieve the degree of approximation that allows the CEES to function effectively and competition conditions to remain equal on the territory of both the EU and Russia.

From a practical point of view this means:

- Adoption of EU norms, rules and laws or rules compatible with the EU's practice in the Russian legal system (possibly with minor derogations);
- Creation of the conditions for their action and effective enforcement through the transformation of other parts of Russia's legislation;

[5] Interestingly, some EU experts deny this evolution and say that even after the adoption of the Single Market Programme the European Commission relied heavily on detailed maximum harmonisation. See Holmes (2001) for example.

- Elimination of contradictions between new (EU dictated) norms and rules and other laws and bylaws both at the federal and regional levels.

In fact the EU dictates the concept of legal approximation whereas Russia plays a rather subordinate role. I already mentioned the wording of the bilateral documents and numerous EU activities to support the process of Russia's approximation to the EU's norms. Moreover, the European Union has a rich experience in this sphere, which by far outstrips that of Russia and places the later in a subordinate role. But the real reason behind the unilateral direction of the approximation is that the complex of legal norms and acts is well established in the EU whereas Russia is still in the process of transformation and it is Russia that is trying to catch up with the EU's level of development not the other way around.

Is EU-Russian Legal Harmonisation an Exclusive Case?

While talking about EU-Russian legislative harmonisation we should bear in mind that this is not an exclusive policy. The European Union has a long history of legislative approximation with different actors in Europe. Primarily we mean member-states and countries that are acceding to the European Union. Their legislative approximation is defined as convergence of regulation on the basis of articles 94 and 95 of the Treaty establishing the European Community and other specific provisions with the view to setting up the internal market and later economic and monetary union. The European Commission and European Court of Justice control the compliance of the present and future member states with the provisions and their legal approximation.

Secondly, the EU extended its practice of legal approximation to the neighbouring countries. One example of such a policy is the establishment of the European Economic Area (EEA) between the European Union, on the one side, and Norway, Iceland and Liechtenstein, on the other side. The EEA agreement came into force in 1994 and led to the copying of thousands of existing and newly adopted EU legislative acts. This resulted in the creation of the common market (with fully functioning four freedoms) that exceeds the current 25 members of the European Union. The EFTA Surveillance Authority and EFTA Court guarantee the compliance of the EFTA member states with EU directives and other EEA norms. In fact "EEA sought to establish common rules without a common supranational power" but eventually recreated some supranational elements in its structure and ways of operation (Graver 2000, 2002).

Thirdly, Switzerland, although it refused to take part in the EEA, carries out work of voluntary compliance and autonomous implementation. The amount of economic transactions requires that for every new act Switzerland conduct a test of compatibility with EU legislation. Moreover, it concluded seven sectoral agreements with the European Union (on agriculture, public procurement, research, land transport, air transport, free movement of persons, and technical barriers to trade) bound together by the principle of parallelism. Last autumn another series of nine sectoral bilateral agreements followed. The arrangements do not preview the establishment of any controlling institute but the amount of economic transactions and the threat of undermining them as well as the guillotine clause providing for the disruption of all the agreements if one is violated are powerful deterrents of any kind of violation. Still the scope of EU-Swiss relations is much narrower compared to relations within the EEA.

Fourthly, the neighbouring countries of the European Union are striving for closer relations with the European Union with the eventual long-term prospect of membership of the EU. Weaker clauses on legal approximation (without sanctions for non-compliance and creation of controlling bodies) are included in the majority of EU agreements on partnership and co-operation and on association. The concept of externalization of EU legal norms also found its way into the already mentioned European Neighbourhood Policy that the European Union has been developing since 2003.

Already the Wider Europe communication (European Commission 2003b) stated that legislative approximation that was contained in both Association and Partnership and Co-operation Agreements would play an important part in new relations of the enlarged EU and its neighbours. The Communication on the European Neighbourhood Policy (ENP) brings the issue even further. It bluntly states that the EU "offers neighbouring countries the prospect of a stake in the EU Internal Market based on legislative and regulatory approximation, the participation in a number of EU programmes and improved interconnection and physical links with the EU". "Legislative and regulatory approximation will be pursued on the basis of commonly agreed priorities, focusing on the most relevant elements of the acquis for stimulation of trade and economic integration, taking into account the economic structure of the partner country, and the current level of harmonisation with EU legislation" (European Commission 2004b). Initially the attention will be focused on liberalization of trade and services, regulatory approximation of competition policy and statistical standards. No particular controlling bodies are previewed in these arrangements but it is clearly stated that the progressive development of the relations between the European Union and its ENP partners with them eventually getting a stake in the internal market will directly depend on the degree of their compliance with the obligations.

Russia is included as one of the neighbouring countries into the ENP, however, it is clear that it is a specific case that has to be dealt with both within and outside the framework of the Neighbourhood policy. Several factors contribute to this. Firstly, Russia is huge in terms of its territory and amount of trade that it conducts with the present European Union. Secondly, Russia does not aspire to become a member of the European Union in any foreseeable future (although we might argue that the obligation per se would be beneficial for the reform and further development of Russian legal system). Thirdly, Russia has strong political ambitions in the world (which do not always correlate with the EU strategy and thus contradict the European Neighbourhood Policy) and it strives to preserve and enhance its economic influence in Europe and Asia. All these aspects make Russia a specific case for the European Union to harmonise its norms with.

Thus we see that the EU's practice of legal harmonisation is very well developed and its reach goes far beyond its borders while the achievements of Russia are much more modest. This fact sustains the idea that future EU-Russian relations are bound to be one-sided legal harmonisation rather than EU-Russian legal convergence as the European Union is a much stronger partner. Moreover, it is important to note that the degree and tightness of legal obligations is proportional to the pursued goals and the intensity of searched integration.

Defining the Scope of EU-Russian Legal Harmonisation

In the previous paragraphs we outlined the nature of EU-Russian legal harmonisation and put it in the framework of broader strategies of the European Union and Russia on the continent. To complete our discussion on WHAT legal harmonisation is we have to determine the final goal of EU-Russian legal harmonization. In order to achieve that we have to answer two questions – what is the paradigm of EU-Russian future relations and whether partial legal harmonisation is possible in any way.

In Search of the Paradigm?

The theory of economic integration is quite developed by now and stages of economic integration are well defined. They are free trade zone, custom union, single market, and economic and monetary union.

The PCA defines the final goal of EU-Russian relations as a free trade area, which means that 1) EU and Russia are trying to create the first stage of economic integration and 2) attention should mainly be paid to tariff and non-tariff barriers and technical regulations.

However, the discussion on the Common European Economic Space as well as the Energy Dialogue fundamentally transformed the goal. EU-Russian relations as a prospect now have something that is similar to the restricted internal market. The Concept of the Common European Economic Space foresees "an open and integrated market between the EU and Russia, based on the implementation of common or compatible rules and regulations, including compatible administrative practices, as a basis for synergies and economies of scale associated with a higher degree of competition in bigger markets" (Joint Press Statement 2003a). In essence, it will include the freedom of movement for goods, services and capital as well as a very limited freedom of labour movement.

Frequent discussions about the competition policy and importance of its harmonisation as well as TACIS activities show that the type of integration that is foreseen exceeds the notion of a free trade fixed in the PCA. At the same time there is no discussion about any common custom tariff and custom policy, therefore, we can hardly speak about any possible custom union between the European Union and Russia. Thus the EU and Russia talk about jumping over at least one stage of economic integration (custom union) to proceed to the stage of the internal market.

In fact the official discussion between the EU and Russia that is supported by the statements and declarations is about the creation of a certain type of integration that combines certain elements of a free trade zone, a custom union and an internal market. It is also noteworthy that we talk about a *Common* and not a *Single* European Economic Space. Ivan Samson rightly points out that the concept of the Common European Economic Space is currently limited to a reciprocal growth of export and foreign direct investments as a result of the realization of Russia's economic growth and structural adjustments, oriented towards the EC acquis (Samson 2002).

The amount of legal harmonisation foreseen in the concept of the Common European Economic Space is for now restricted to the following aspects

- "cross-border trade of goods, covering substantially all industrial and agricultural goods, including the necessary rules … organisational structures and procedures",
- "cross-border trade in services, including relevant regulatory standards and requirements",
- "establishment and operation of companies, including, *inter alia*, issues related to movement of capital, environmental standards and good corporate governance",
- "related aspects of movement of persons, in the relevant fields of economic activity" (Joint Press Statement 2003a).

This gives us the first limitation of the legal spheres and sectors to be harmonised between the European Union and Russia that will, hopefully, be better defined in an Action Plan on four EU-Russian spaces that is to appear by the next summit in May 2005.

The ill-defined nature of the future relations between the European Union and Russia can be both an advantage and a disadvantage. On the one hand, it is flexible to be receptive to any positive development in EU-Russian relations. On the other hand, ill definition of the nature of EU-Russian relations can transfer practical EU-Russian relations to a diplomatic game and dull search for compromises (Samson 2002). In fact it has already produced a long diplomatic wrangle on whether PCA is an adequate framework for EU-Russian relations today. In the worst case this ill-defined nature of EU-Russian relations can lead to the stagnation of EU-Russian relations.

Is Partial Legal Harmonisation Possible

The debate is further complicated by an apparent difference in the declarations of the two parties. According to EU representatives the discussion is about regulatory approximation and gradual establishment of the four freedoms between Russia and the European Union. This basically means the extension of the EFTA model of relations with the EU to Russia. Oli Rehn (2004), current Commissioner for Enlargement, summed it up by saying:

"The ultimate goal of the CES is to create an open and integrated market between the EU and Russia, to promote trade, investment and the competitiveness of our economic operators. However, to promote economic integration it is not enough to liberalise trade. The essential efforts must be geared towards the promotion of compatible regulatory frameworks and the proper enforcement of rules. "

Thus in the EU's view the CES is about gradual liberalization and regulatory and legal convergence.

At the same time there is a popular opinion in Russia that Moscow can choose among the EU's acquis and decide which to adopt depending on the analysis of their applicability in Russia and on whether their application will be favourable for Russian economic actors or not.

According to its chief negotiator, Viktor Khristenko, real economic integration will be based on investments and industrial co-operation. However, the work should be based on two pillars, which are soft legal harmonization and deep economic co-operation in some specific spheres. In the present situation, according to Mr. Khristenko (2004) full harmonization of economic and legal systems seems to be the issue of the long-term perspective. Therefore, in the short-term Russian and the EU have to stress co-operation in separate, prepared for the intense co-operation and integration sectors.

V. Mau and V. Novikov (2002) suggest excluding social policy, environmental issues, consumer and health policy from harmonisation. This is evidence of good intentions to create favourable conditions for the stabilisation and growth of the Russian economy. Furthermore, it can be justified on the grounds that Russia does not aspire to either become a member of the European Union, or to get a full stake in the internal market of the EU.

Some EU experts support this point of view. In particular, it was argued that "if the EU is to give its neighbours models based on the acquis, it needs to look very carefully at which elements would be most appropriate" (Grabbe 2004).

However, this is highly unlikely to be welcomed by the European Commission, European Court of Justice and EU companies. Elsewhere I argued that there are at least two reasons why this won't be well accepted by the EU public and private sectors.

- The idea of the internal market and four freedoms (or even a part of them) was gradually developed in the EU and different parts of EU legislation are very well adjusted to each other. The EU acquis can seem to be very patchy but in fact it is a carefully designed complex of norms where the absence of one regulation can deprive another one of its meaning;
- The EU paying such substantial attention to the competition issues will not look favourably on Russia violating social and environmental legislation. It is neither popularly acceptable nor justified from the point of view of fare competition. (Bordachev – Romanova 2003, Romanova 2003).

Therefore, if we talk about the establishment of a common space between the EU and Russia that has at least three freedoms as its centrepiece we should talk about the eventual adoption of all the acquis of the internal market. In sum, Russia cannot avoid any layer (any horizontal sphere) of harmonisation be it environmental or social layer. V. Zagorsky is right to argue that we probably have to speak about the nuances but today we need to realize all clauses related to the four freedoms as well as a bunch of other parts of EU legislation (Zagorsky in: Kazin-Kuznetsov 2004).

This does not mean that Russia has no right to be selective as to the means, implementation instruments and timeframe to adopt the acquis. But all these instruments give only a limited space for choice.

In contrast to the horizontal spheres we can talk about a certain selectivity of the vertical spheres for harmonisation. This is closely related to two issues: readiness of the sphere and its critical potential for the development of EU-Russian relations. From the very beginning of the European Union there has been an argument that there are a number of key areas that can foster integration tendencies in the European Union and from which due to the spill-over effect the integration tendencies will spread to other fields. At least two such fields can be identified in the current EU-Russian relations.

The first one is energy. The mutual advantage of co-operation in this field has been widely discussed. The EU's external dependence on energy resources is growing and it is interested in a stable supply of energy resources and access to the exploration of these resources. Russia is interested in investments in the production of both oil and gas as well as access to the profitable EU distribution carbohydrate and electricity markets. This is a good basis for the legislative approximation in the energy field and this sphere of EU-Russian relations is quite burgeoning from the point of view of legal approximation.

The second field is competition policy that the European Union insists upon and that has recently become an issue of Russia's attention. This issue touches upon co-operation in all the fields and is the basic concept for any common / internal market discussions.

It remains to be seen, however, whether these promising fields will create a spill-over effect or will remain closed fields, i.e. where highly developed co-operation will not influence other fields. I believe that the two identified fields can generate a strong spill-over effect.

One more issue that was recently brought into the discussion is that of the Kaliningrad region. It is suggested that Russia can start its legal approximation to the EU's norms in Kaliningrad and later spread the positive experience of co-operation to the other regions of the Federation. It is, however, hardly acceptable for Moscow as it means the creation of two different legal spaces within one country. Moreover, it will contradict the current strategy of constructing a single legal space within Russia.

In sum, the second chapter defined the nature of EU-Russian legal approximation. I started with divergent definitions that exist in Russia and the European Union as to the definition of the very project and drew a mutually acceptable definition of this process. Then I addressed the context of the legal approximation to demonstrate that the EU will definitely dominate the process. Finally, I completed the argument by showing that despite the definition of the process per se the goal that is pursued by the parties is far from certain. This creates a huge obscurity of the WHAT part and immensely complicates the task of harmonisation, i.e. the determination of exact instruments and methods (the HOW part of the debate). But this is the task of politicians not the jurists to clearly determine the final goal.

How Can EU-Russian Legal Harmonisation Be Achieved

Once we identified the essence of the process and mapped its final goal we have to discuss the "instrumental part" of legal harmonisation. It mainly has to do with the range of the legal instruments that exist for the purpose of harmonisation. In this chapter I will discuss three issues: methods of harmonisation, forms of harmonisation and, last but not least, levels of harmonisation. In doing so, I will concentrate on the range of the EU's instruments since I have already explained that the EU's role is central to the process of EU-Russian legal harmonisation.

Methods of Harmonisation

Currently the following harmonisation methods are identified within the European Union and are projected on both, its member states as well as EFTA countries and Switzerland:

- total (or maximum) harmonisation;
- optional harmonisation (allowing producers to apply either national or Community measures);
- partial harmonisation (regulating some aspects of the subject matter);
- minimum harmonisation (allowing member states to provide for more stringent rules);
- alternative harmonisation (allowing member states to choose between alternative methods of harmonisation);
- mutual recognition (Van Gerven 2004);
- open method of co-ordination;
- harmonisation through the case law of the European Court of Justice.

The general trend today is to start from the weakest possible method and to gradually strengthen the convergence requirements. In a way the European Union evolved from insistence on maximum approximation to setting minimum necessary standards to eliminate possible distortions.

Open method of co-ordination can act as the first step in sensitive areas. According to this method, member states decide to exchange information on specific issues to identify the most efficient solution. This is a developed practice in such spheres of EU policy as justice and home affairs or employment policy. It can also serve as a good start for fully-fledged harmonization. The positive side of this method is that member states remain in control of their own policy choices and can respond to divergent trends in their country while exchanging information with other member states (Van Gerven 2004). The negative side of the open method of co-ordination is the uncertainty of whether naming and shaming will be enough to persuade countries to change their practices as no other instrument of compliance is applied.

Mutual recognition of the existing standards and norms in the EU's member states is also a useful tool for the start of harmonisation. It allows member states to profit from the internal market and increase the quantity of transactions that will eventually serve to encourage more stringent harmonisation. The negative side of this method is a problem of information sharing on how the standards and regulations are created, imposed and controlled as well as a constant suspicion of all the participating states that another one will cheat them.

The evolution from total (maximum) harmonisation to all forms of partial solution in legal approximation within the EU as well as the spread of the open method of co-ordination and mutual recognition is quite favourable for Russia. It would allow for the preservation of some degree of national specificity in the process of legal harmonisation and achieve at least minimum harmonisation reasonably quickly. In particular the open method of co-ordination and mutual recognition in certain spheres would be a very useful start for a more ambitious process of further legislative approximation. Moreover, certain practices and norms do not exist in Russia at all, which makes it difficult to talk about legislative approximation. Soft practices would allow for a gradual introduction of new practices and standards.

However, Russia carries more risk implementing only minimum legislative requirements or soft law approximation techniques. There are several reasons to explain that. First, there is an inherent question of political trust in Russian institutions and their wish to comply with the general provisions, regulations and norms, thus the member states of the European Union will permanently suspect Russia of violating the voluntary provisions of harmonisation. Secondly, Russia is more likely to face discrimination from the EU's member states on the grounds that soft approximation is not strong enough to guarantee equal competition conditions in the Common European Economic Space. This can provoke a vicious circle of further non-compliance by the Russian actors.

Still, I believe that soft and partial forms of legal approximation should be explored at the first stage of EU-Russian legal approximation. In parallel EU legal education of Russian judges, preliminary European compatibility checks for all new legislative drafts in Russia and encouragement to use European law and norms as an argumentative tool for consistent development and interpretation of domestic law (the way it was done in the candidate countries (Kuhn 2003) would also greatly contributed to the approximation of EU and Russian legal norms. This, however, requires substantial political will on the part of the Russian legislative and judicial system and can function only as a self-imposed obligation not as a requirement.

Thus the EU's methods of legal harmonisation can accommodate specific Russian concerns but Russia will have to display its willingness to adopt certain practices.

Forms of Harmonisation

The forms of harmonisation that have been developed by the EU's permanent outsiders, such as EEA member states and Switzerland are highly divergent as well. They can serve as a pattern for the sequence of adaptation of new acquis. Two criteria distinguish the form applied within the EEA from that of Switzerland.

1. *Sectoral vs. Wholesale.* Switzerland undertakes sectoral (or vertical) harmonisation in the sixteen sectors as opposed to the wholesale EEA harmonisation. It seems that sectoral harmonisation (with particular emphasis on energy and competition issues) will be a useful start for EU-Russian legal approximation. Russia can also agree in advance that some spheres will be preserved outside the common legal framework. (Even Norway, which follows the EU's example everywhere, took out of the harmonisation such important spheres as agriculture, fishery, and continues to regulate them independently.) However, it is important that both partners decide on what sectors to work in and that no permanent 'horizontal' exclusions are fixed.

   Some Russian officials from the Ministry of Economic Development and Trade consider that the EU-Russian convergence can be based upon the discussion within the WTO, i.e. the general WTO framework as the basis for extensive co-operation in some spheres. The advantage of such a strategy is depoliticisation of EU-Russian economic relations and reciprocal movement as opposed to Russia's unilateral alignment (Ivanov 2003).

   However, sectoral co-operation should only serve the first stage of co-operation.

2. *Compulsory vs. Voluntory.* Switzerland carries out a voluntary harmonisation (that is also called an autonomous implementation). There is neither an obligation to take on new directives and regulations, nor any judicial mechanism to sanction Switzerland for non-compliance. The case of the EEA is different: EFTA members are obliged to adopt all the acts that are relevant to the internal market and are marked as "acts with EEA relevance". The EFTA Surveillance Authority and the EFTA Court control the application of new legislative acts and norms. Given the absence in Moscow of the "EU reflex", developed in Bern, the obligatory form of Russia's compliance with the EU norms and regulations and establishment of the control agencies can be more practical for the achievement of legal approximation. However, the process should be very careful not to averse Russia from the co-operation.

Thus examining the most appropriate forms of harmonisation I would say that Russia would benefit from initial sectoral harmonisation with the EU but through obligatory mechanisms and creation of controlling bodies. In other words a hybrid of the two described forms is needed.

Levels of Harmonisation

The process of legal harmonisation is much broader than a mere creation of a new harmonised norm. In fact we should speak about several levels of harmonisation:

1. *Development of norms and its transposition in national law*. For successful completion of this stage it is essential to assess existing national law and practices that are touched upon by it and to set realistic priorities and develop mechanisms and action plans to address the priorities identified in the assessment stage.
2. *Implementation* that means practical application of the developed norms by the public authorities and provision of adequate administrative and judicial infrastructure for these norms as well as provision of the necessary budget. It is significant that so far this part of the legal approximation has not surfaced in the discussions on EU-Russian legal approximation. Moreover, it is absent from the discussion on the harmonisation within the CIS framework. However, it is precisely this level that can cause the most significant problems in EU-Russian legal harmonisation. The fear of corruption plays a significant part here. However, it remains to be seen what results the current administrative reform will bring and whether it will enable Russia to create the necessary institutional capacities for further approximation with the EU.
3. *Interpretation* of the adopted norms within the legislative and judicial framework of the states in question is of key importance. Within the European Union it is done through the preliminary reference procedure (article 234 of the Consolidated Treaty Establishing the European Community). This is, however, absent from the EEA provisions and the EFTA Court competences.
4. *Compliance* with the new norms which involves both private and public actors forms an essential part of legal harmonisation. It should be said that due to the low legal culture in Russia there might be substantial problems with this level of EU-Russian legal approximation.
5. *Enforcement* (including adjudication) that encourages actors to comply with the new legal provision completes the levels of legal approximation. Insufficient staff, low fines, low awareness of requirements, and resistance towards new legislation can cause weak compliance and enforcement. This can also become quite a serious problem in Russia. The EU-Russian legal approximation would require the empowerment of the court to enforce new norms. This is the only way to provide a legal certainty to individuals.
6. Finally, *monitoring and evaluation* of the achieved results is essential to ascertain the fulfilment and suggest any possible measures to improve the application of new norms. However, this should be done in a weaker form than the screening process that was applied to the candidate countries.

These levels demonstrate the complexity of the process of legal approximation and also the numerous difficulties that Russia can face in the process.

I would like to conclude this chapter by saying that legal harmonisation is a difficult process that can be implemented through multiple methods and forms. Russia would benefit from soft approximation with sectoral emphasis at the beginning. However obligatory compliance and institutions and procedures to control it should be created. Furthermore, legal approximation requires the realisation of the norms at multiple levels and stages of development. Russia both in the discussion with the EU and in through its CIS activity has so far paid attention only to initial stages that cannot fully guarantee de facto legislative approximation and therefore would not allow Russia to benefit from the establishment of a truly CEES.

It is also essential to note that the instruments of legal approximation are well developed and are ready to be applied but the obscurity of the exact final goal of the harmonisation complicates application of the instruments. In other words we can only select the instruments of the HOW part when the WHAT part is well defined and legal instruments can only be applied efficiently once both the EU and Russian parties are clear with their political priorities and goals. Therefore, only political decision can enable the choice of legal instruments and their being effective. For now the obscurity of the WHAT part is in opposition to the clarity of the HOW part.

What are the Political Consequences of EU-Russian Legal Harmonisation?

The third chapter discussed EU-Russian legal approximation mainly in legal terms. However, this should not disguise the fact that legal approximation will lead to significant consequences for Russian political life. Therefore, the final chapter of this essay touches upon the question of the political consequences of the process of legal approximation. I will identify three major political arguments for Russia: the change in the dynamics of international and supranational; the problem of democracy and governance in Russia; and the effect of europeanisation on Russia. This will allow me to picture the palette of the political consequences. Importantly I concentrate on the consequences for Russia primarily because the process of legal approximation is one-sided, dominated by the European Union with Russia playing a rather submissive role and being a policy-taker rather than a policy-maker.

The Dynamics of International and Supranational

The problem of the interconnection between the legal approximation on the one hand and the dynamics of international and supranational has at least two facets.

The internal facet is reflected in the phenomena of dependence and gradual empowerment of the individual against the state in economic activities. Legal approximation and the obligation to take on all the new norms create a pattern of dependency. Close economic integration will allow for a considerable direct effect of the European directives (strengthened by the judicial authorities) as the example of Norway shows (Baudenbacher 2003, Egeberg

2003, Forman 1999). This in turn gives the basis to individuals to more effectively defend their rights and sue the state in case of non-compliance with the decisions in the framework of the Common European Economic Space. In a way individuals get leverages against the arbitral behaviour of the state. This phenomenon can work as a positive supranationalism for Russia although the current political leadership is unlikely to welcome it.

In order to achieve positive results in this internal aspect of supranationalism several basic conditions should be fulfilled. Firstly, the court must be established by law, be permanent, and should exercise compulsory jurisdiction, it has to apply rules of law and evidence, and be independent. Secondly, it should be decided on the division of competences between a sovereign state and a supranational court or the court that applies certain supranational norms (Baudenbacher 2003). Additionally the emergence of such a rule will require a transformation of Russian mentality and a favourable combination of Russia's internal political forces.

The second facet is the interrelation between economic supranationalism and Russia's foreign policy. It is well known that extensive economic co-operation creates a basis for strong political ties and foreign policy co-operation. The European Union has used economic tools to pursue political goals since the 1970s, first in its development policy, then in the accession dialogue and association agreements. It is becoming more and more assertive in this field and the European Neighbourhood Policy places affiliation with the EU's foreign policy as one of the most important factors for getting a stake in the EU's internal market. In fact, in the absence of other instruments of foreign policy conduct, economic tools of the European Union become the only instrument to create the so-called EU actorness, i.e. its presence, visibility and ability to act.

Thus legislative harmonisation between Russia and the European Union might lead to a substantial loss of Russia's independence in the political arena. For a Russia that is struggling to remain an independent actor in the international arena a dependent role in the international economic sphere does not look like a very attractive solution. However, it should be weighed against economic stagnation and autocracy. Moreover, Russia is a fully-fledged actor as opposed to the European Union and therefore possesses other than economic instruments to conduct foreign policy. In future this can provide for a certain complimentarity between Russia and the European Union in their external actions.

Finally, a certain loss of Russian sovereignty will serve to reinforce certain Russian obligations in the international arena (like those linked to the WTO). Some of the provisions are similar to the EU's ones (the phenomenon of cross-referring conditionality (Harding 2000) and these will be controlled by the EU through a number of institutions and procedures. In turn it will lead to Russia's augmented credibility in the economic sphere of international relations.

These facts manifest a trend from international to the supranational structure of EU-Russian relations with a considerable dilution of Russia's sovereignty but it is unavoidable in the world of today.

Democracy and Governance

The problem of democratic deficit becomes urgent with EU-Russian legal approximation. Several factors contribute to the worsening of the already imperfect situation in Russia. First, there is a well-known stance about undemocratic decision-making process in the European Union, which is technocratic and ill understood by most European citizens. If Russia decides to align its legislation with the EU's one it will bear the fruits of this way of proceeding. Secondly, the problem will be even worse for Russia because it will have to embrace obligations and norms, which were developed for the member states of the European Union without any participation of Russian officials. Thus Russia has to answer the democracy challenge through restructuring of the work of its executive and legislative branches to influence decision-making in Brussels but also through considering how to answer the democracy challenge as such.

How can Russia answer the challenge of democracy? There are several avenues to be explored.

First, the European Commission is right to say that all the necessary institutions (Co-operation Council, Co-operation Committee and subcommittees) have already been created (European Commission 2004b) and the question is rather to use them efficiently and to intensify the dialogue through these institutions. This institutional architecture allows for a combination of technical and highly specialised questions and strategic co-ordination, it also gives the possibility for compromise and trade-off. The creation of the Permanent Partnership Council at the St. Petersburg summit in May 2003 is indeed a positive trend as it provides for the possibility of a continuous dialogue.

Secondly, it is essential to enlarge relevant working groups on EU-Russian co-operation in specialized ministries and committees and to attract more people into the work of related EU-Russian sub-committees. It will facilitate the creation of administrative capacity in Russia to implement new norms and thus to develop legal approximation. Work contracts with people dealing with similar questions in the European Union will significantly simplify consultations and search for mutually acceptable solutions.

Thirdly, the task of co-ordination of the EU-related issues in multiple Russian ministries (around 30) is constantly growing in importance. Today the Government Commission performs the task of co-ordination. However, in my view, Russia needs more regular meetings and consultations at both political and expert level (i.e. jumbo meetings of different ministries because quite often issues in question touch upon the competence of several government bodies). One more need is to clarify the division of labour between the President Administration, the Government and the Russian Federal Assembly on the guidance in the process of legal approximation.

Fourthly, the question of participation of Russian experts and public servants in the preparatory work on EC legal drafts is inevitable. If Russia cannot escape legal harmonisation it should create mechanisms to inform its EU colleagues on existing Russian regulations and its preferences. This can be reached through official participation of Russian delegations in the work of expert groups and advisory committees as well as in the Council working groups.

Finally Russia can defend its interests through EU member-states, as is done by Norway and Switzerland. Following its second negative voting on EU membership (1994) Oslo has been persistent in strengthening its partnership with the Nordic Council expecting other Nordic Council members to influence EU decision-making (Sverdrup – Kux 1997). Moreover, Norway often uses EU member-states with relevant problems to further its goals (Claes 2002). Switzerland bets on tripartite commissions in ecology (with Germany and Austria), transport (Germany and Italy) and internal affairs (Germany and France). Russia can probably count on Finland and some Central and Eastern European newcomers.

There is also a need to find a way to preserve some autonomy for Russian national legislators in the process of legal approximation as a way to make the process of Russia's legal adaptation more democratic. Several methods can be used. First, it is essential to intensify the work of the EU-Russian Parliamentary committee. Secondly, in accordance with article 7 of the European Economic Area legal approximation should be conducted through setting the goals and leaving to all the participating parties the question of how to achieve those goals. This formula would also allow Russia room of manoeuvre to develop precise mechanisms of co-operation. Therefore it is essential to guarantee maximum freedom to the Federal Assembly while negotiating with the European Union. Thirdly, it would be extremely helpful to create a mechanism of constant information of the Federal Assembly about the questions on the table in the EU that can potentially affect Russia's economy. This would give extra time to Russian MPs to think over the question and define their relations to the draft as well as to use more intensively the mechanism of EU-Russian parliamentary co-operation.

These are some actions on the part of the legislative and executive branches that can help to ease the situation of the democratic deficit in the short term. In the long term, however, the idea of their participation in the process of decision-making might be gradually substituted by the system of governance though which the EU will take Russian interests into consideration. In particular, it means that in defending Russian interests public structures will more closely co-operate with business circles and other groups of interest. The fact that EU-Russian co-operation with the EU is getting a more practical character is an argument in favour of this approach. Moreover, the access of business people and experts to information on changes in technical regulation and legal norms is far better and broader than that of public structures, which don't have enough time to assess all aspects of legislation and co-operation. Furthermore, the European Commission is traditionally susceptible to the business opinion and public pressure in the process of legal norms' preparation.

It is logical to talk about Russian business representatives participating in advisory committees that help the Commission prepare drafts of future legislative acts on a par with their EU colleagues. It is essential for Russian companies to work in such business associations as different industrial groups and associations and closely involve the EU-Russian Round Table of Industrialists.

While developing this policy, however, it is important to keep in mind that business people are but a part of the story. The interests of other groups (consumers, ecological organisations etc) should be taken into account. Because of their specificity they are worse organised and have less resources to pursue their goals. Relevant Russian groups following the example of business representatives have to accede to respective association at the EU level. Only consideration of all points of views can solve the problem of democratic deficit (Romanova 2003a).

The activity of interest groups will lead to the gradual rise of the system of governance in EU-Russian relations that will establish its rule on the Common European Economic Space in the long term.

Thus Russia will face considerable internal institutional adaptation due to the democratic deficit and rise of governance.

Towards Europeanisation?

The empowerment of the individual, the loss of some foreign policy freedom and considerable institutional adaptation, caused by the legal approximation, bring us to the very fashionable recent debates on Europeanisation. Recently (since the 1990s) there have been a number of papers and research projects on this phenomenon.

At least three broad lines of Europeanisation can be identified (Church 2000). The first one is Europeanisation as a socio-political convergence and growing similarity of societal trends in European countries (i.e. migration, social movements, internationalisation of social conflicts) (O'Leary 1987, Padoa-Schioppa 1999, Tarrow 1995). The second approach is to view Europeanisation as value approximation and formation of a European identity (Marcussen et al 1999, Sobell 1999) Finally, the third approach is about Europeanisation as a combination of processes within the European Union (such as transfer of competences to the Union and Community level, adaptation of national institutions to communitarian decision-making and creation of a new style of governance that can unite both public and private actors). In short, it is the focus on how supranationalism affects the political system of a nation state and now the nation state fights back (Borzel 1999, Bulmer - Burch 2000, Radaelli 2000). In this third approach both changes in *politics* and *polity* are objects of attention and close examination and it is the most relevant approach for our study of political consequences of legal approximation.

J. Olsen (2002) gives further classification of the Europeanisation phenomenon. He concentrates on the third approach to the europeanisation and differentiates between five uses of the term 'europeanisation': these are

- changes in external borders,
- developing institutions at the European level,
- central penetration of national systems of governance,
- exporting forms of political organisation,

- a political unification project.

The combination of all these aspects is relevant to our discussion.

Initially Europeanisation and its study were confined to the EU member states but recently there has been a rise in the interests of neighbouring countries, particularly Switzerland and Norway, which have also initiated adaptation of their political process to the situation in Brussels (Andersen 2000, Archer 2001, Baudenbacher 2003, Church 2000, Church - Dardanelli 2003, Claes - Fossum 2002, Egeberg 2003, Egeberg - Trondal 1999, Eliassen – Sitter 2003, Emmert 1998, Forman 1999, Goetschel 2003, Graver 2000, 2002, 2003, Mach et al 2003, Peers 2000, Schwok– Levrat 2001, Sciarini – Listhaug 1997 Sverdrup - Kux 1997). This fact demonstrates that the European Union activates centripetal tendencies making all the contingent countries change their national institutions in accordance with the situation in Brussels, the pressure that it exerts and the search for the avenues to influence the Brussels decision-making mode. This process is also consistent with the argument, presented earlier in this essay that the process of legal approximation stretches beyond the boundaries of the European Union. Therefore there is a very firm link between legal approximation and the political process of europeanisation.

The development of the concept of the Common European Economic Space with legal approximation as an integral part is very likely to provoke the Europeanisation of Russia resulting in profound changes in the political system. The experience of countries like Norway or Switzerland can serve as an example for Russia. This is not to deny, however, that culturally these are dramatically different countries but their experience is very helpful in exploring the future of EU-Russian relations. Thus Europeanisation of Russia along the lines of Norway or Switzerland can be expected and relevant research tools can be applied for the study of the phenomenon and forecasting the development of the process.

To sum up the arguments of this last chapter I would like to stress that legal approximation with its very precise legal practices will trigger considerable changes in the Russian political system and its foreign policy-making. It will empower the individual; transform the internal decision-making process with some loss of democracy and the evolution towards governance. It will also limit the freedom of foreign policy-making. All these phenomena will be proportional to the level of legal approximation between Russia and the European Union and the applied instruments, and they will indisputably lead to some Europeanisation of Russia thus putting practices and study of EU-Russian relations into a broader framework of relations in Europe.

Conclusion: the Way Ahead

In the first chapter of the essay I explained WHY we came to the centrality of the issues of legal harmonisation in EU-Russian relations. This problem has always been around but with the growing intensity of the relations and their transferral to a more practical level it became unavoidable.

There are, however, currently more questions than answers in the process of legal harmonisation between the European Union and Russia. They touch upon most of the aspects of legal harmonisation between the European Union and Russia.

The question WHAT legal harmonisation is yet to be answered. The understanding of the legal approximation is more or less shared between the parties and the joint understanding on the basis of EU and Russian relevant cultures is being constructed. Yet the parties diverge on the exact final goal that they pursue the definitions of the nature of the CEES remains quite obscure. This political choice is still to be made. It is complicated for Russia by the fact that the EU will dominate the process of legal approximation.

The methods, forms and levels of legal approximation constitute the HOW of the EU-Russian legal approximation. The methods and forms of the harmonisation are numerous and well developed in EU practice. Their choice is, however, complicated by the obscurity of the pursued goal. Thus the political choice is to be made to enable the legal part of the process work. The levels of legal harmonisation, the third part of the HOW, are multiple and it is obvious that Russia will have numerous difficulties with practical implementation and adjudication of new laws, rules and norms. This will require substantial institutional change in Russia.

Finally, legal approximation provokes numerous political consequences. In the fourth chapter of the essay I answered WHAT POLITICAL CONSEQUENCES will parties face as a result of the legal harmonisation. These political consequences will surface only if legal instruments are applied; in other words they are the direct result of the HOW part application. Moreover, the intensity of the political consequences will be in direct proportion to the intensity of the use of legal instruments.

Thus the essay tried to raise central questions of the process of legal harmonisation between Russian and the European Union. Yet a lot of problems remain open and are to be examined by both politicians and political scientists and legal practitioners. To name but the most urgent ones:

- The exact scope of the targeted legal approximation is to be evaluated keeping in mind the level of development of the Russian and EU economies and their respective interests. In doing this, one can pay particular attention to the selection of vertical sectors with strong spill-over potential; as a result the question WHAT will be answered. This task should involve both experts and practitioners (public and private) to be in tune with the interests of the majority and consistent with the prospect of Russia's development.
- Only when the question WHAT is answered can one proceed to the selection of the range of instruments and the determination of the HOW. This is mainly the task of the legal experts. Yet policy-makers have to provide their input on the feasibility of different aspects as they are to implement the instruments and to put the flesh on the bones.

- Moreover political scientists have to be involved already at the stage of deciding HOW to help estimate the likely political consequences. In doing that the EU and Russia avoid unwanted political consequences.
- In any case Russian will have to be examined in the context of the study of Europeanisation. Already now, when we only discuss the possibility of the legal approximation the political system adopts to the possible consequences. The examples of Norway and Switzerland can be used as reference cases for Russia.
- Importantly the discussion should mainly concentrate on the political consequences for Russia, as the policy-taker, whereas the European Union is rather a policy-maker. However, the development will definitely have some political consequences for the European Union as well and the study of this aspect might also be considered.

These issues certainly ask for further discussion and evaluation and are both questions for the public authorities to answer and a research agenda for the scholars of EU-Russian relations. Successful solutions to these identified problems will create a firm basis for deepening EU-Russian economic relations.

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RUSSIAN APPROACHES TO REGIONAL INTEGRATION: EU IN FOCUS

Dmitri Lanko and Natalia Zaslavskaya

Abstract

Theory of International Relations has provided a scholar with various definitions of region. One might distinguish at least six definitions of a region: an area of domination, a defense alliance, an institution to achieve “absolute gains”, a result of spillover effect, a result of deterritorialization, and a security community. Of course, this is not the exhaustive list of definitions; we have chosen only those most relevant for Russian domestic context of regionality. The European Union, formerly a post-modernist region, is currently on the way towards more stable European identity; however, it is too early today to speak of what the EU will look like by 2020.

Russian mainstream context of regional integration in Europe made a significant change in the early 2000s, simultaneously, but not because of the EU enlargement. Previously, Russian agents used to perceive the EU as an international regime, today the main perception is that of the EU as an international actor. This change gives the ground to speak about significant changes in political implications of EU-Russian relations to occur in the years to come.

First, Russia has realised that the EU might be a partner not only in economic relations, but also in the political and security spheres. As a result, “strategic partnership” between Russia and the EU has come to the top of Russian foreign policy agenda. Second, thanks to the EU enlargement Russia has realised the new opportunities for the relations with the EU, such as the European Neighbourhood Policy. These two factors combined create the background for deeper integration of Russian into wider Europe, of which one of the indicators will be the creation of the four spaces.

Keywords: regionalisation, European integration, Russian foreign policy.

Regionality in the contexts of international relations theories

The Merriam-Webster's Dictionary traces the roots of the word "region" into Latin verb "*regere*", which means "to rule". This constructs the realist understanding of a region as a territory controlled by a state (or, in neo-realist tradition, by any actor) but larger than the state. A region perceived this way may thus be referred to as "purview" – a synonym to the word "region", which is at the same time a synonym to the word "border". Our analysis of regionality in different conceptual contexts will take this definition of a region as a point of departure. The keyword for evaluation on this particular perception of regions is hegemony; thus, it is not surprising that regional issues flourished at the last year's International Studies Association Convention in Montreal, the topic of which sounded as "Hegemony and its discontents". In particular, the convention indicated that the realist approach is still relevant for the construction of regional discourses: one of the papers questioned, if regions are "[a result of] globalization or just good old areas of influence" (Perea & Heidrich, 2004).

The roots of the realist perception of a region may be found in classical geopolitics. In this context, if a state is not able for some reasons to encircle its *Lebensraum* (Ratzel, 1901) within its borders, the state should do its best to create a region under its hegemony with the borders of the region being equal to the state's *Lebensraum*. Gearoid O'Tuathail (1996: 46) quotes in this respect Karl Haushofer, who used to write that "[t]he essence of regions as comprehended from the geographical point of view provides the framework for geopolitics within which the course of political process must proceed of they are to succeed in the long run". In order to make that Haushofer's "course of political process" proceed, on the one hand, but meet the requirements of the changing international environment, on the other hand, *Lebensraum* in today's international relations has changed its name and is sometimes referred to as "areas of influence", "areas of interest", "areas of responsibility" etc. At the same time, all the listed contexts create the realist discourse of regionality, which finds its adherents also in Russian domestic context, especially, among the scholars positioning themselves as "geopoliticians". A good example here may be Alexander Dugin (1997: 199 - 201), who thinks that becoming a regional great power is a catch for Russia, which will once make the country even less powerful than in mid-1990s.

In order to avoid falling into the sphere of interests of a hegemon, small states cannot help organizing into groups against possible competitors (Makarychev, 2002: 8). Thus, the second realist perception of a region descends directly from the first one: regionalization is the process of alliance building. In classical realist terms, the needs of defense against possible hegemon require that the regions should be compact and contiguous (Hodar, 1992: 314) with good logistics (railways in Rudolf Kjellen's original text) facilitating communication and accumulation of power. As logistical options continued developing, from aircrafts to information technologies, possibilities of creation of regions, the territories of which were neither compact nor contiguous, emerged. A good example here is the North Atlantic Region built in order to meet the UN framework, which allowed alliance building on regional level only. Today regions continue being perceived as geopolitical basis for security alliances, both in small countries, like, for example, Estonia (cf. Leito, 2001), to large countries, like Russia. Here Valeriy Konyshev (2002), for example, quotes realist Kenneth Waltz (2000: 55) claiming that the enlargement of NATO understood as a regional alliance against possible future hegemonic ambitions of Russia hurts the security interests of the latter.

From the neo-realist perspective, states are not the only actors to create regions. Sub-national units may also unite across borders to protect themselves from national hegemony. For example, Andrey Makarychev (2002: 9) considers centre-periphery relations in Russia of 1990s as based on "the logic of realism". As a result, Russian sub-national unites could not help joining regional cooperative initiatives: from the numerous Finnish initiatives for Karelia on cross-border basis to wider examples, like the Council of Baltic Sea Sub-State Regions. Inspired with Francis Fukuyama's concept of the "end of history", which predicted states to become irrelevant in the near future, some realists considered regions consisting of sub-national actors as future substitute to states, asking if history will turn "back to realism" (cf. Käkönen & Lähteenmäki, 1995) after regions gain power and become "acting subjects" (Hettne, 1994: 8). Though Russian ex-Foreign Minister Igor Ivanov (2002: 73) rejects such a possibility in his memoirs, the logic of Russian regional policy in the 1990s and beyond indicates that such possibility was not rejected completely by decision-makers.

Liberal theories went further in their discussion on regionality assuming that security cannot be the only reason for region building. In this context, security is only one and not the most important example of "absolute gains" achieved through regional cooperation. Here lies the foundation for the so-called neo-neo debate, i.e. the debate between neo-realists and neo-liberalists. In this debate realists focus their attention at "relative gains" claiming that the aim of any state is to achieve more than another state. The anxiety that another state might gain more from cooperation prevents states from cooperation, including on the regional basis, "even when they have common interests" (Grieco, 1990: 27). The Baltic Sea Region might represent a good example of such approach, for some scholars perceive the Council of the Baltic Sea States as "too Swedish" (cf. Birckenbach, 2003) and thus are skeptical about cooperation within its framework, being concerned about Sweden achieving more gains from such cooperation. Other theorists continue arguing that fear of being suckered is the main obstacle for regional cooperation, proving that statement with the use of different methods, including international political psychology (cf. Mulford & Berejikian, 2002).

To the contrary, neo-liberalists focus their attention at "absolute gains" to be achieved through minimization of costs and maximization of outcome that is possible only by means of cooperation, including regional cooperation. This approach became popular in Russian foreign political decision-making after Igor Ivanov became Foreign Minister in 1998. Ivanov was among the first to speak about "pragmatic" foreign policy. Even before the label "pragmatic" was attached to federal policies, it became popular on sub-national level creating the group of "managers" to replace "politicians" in the posts of governors in a vast number of Russia's regions at elections in 1995 – 1997. In St. Petersburg, for example, Governor Vladimir Yakovlev (today's Minister of Regional Affairs) came to replace liberal Mayor Anatoliy Sobchak in 1996; Yakovlev's electoral campaign was based on his image as “effective manager”. Evaluating on the results of regional elections, Nikolay Petrov (1999: 112) wrote that those elections indicated “maturity” of Russian regional political elites, an indicator of which was “creation of mechanisms of coordination of interests” within and among regions.

Liberalists divide regional institutions into formal transnational (intergovernmental and beyond) organizations and international regimes (Vitkus, 2000: 110 - 111). The regimes, whether formal or informal, create common rules, which help people being less afraid of being suckered and thus more willing to cooperate. Once the common rules are created, it comes the time for the so-called functional organizations (“managers” in Russian domestic context) to replace political organizations as main subjects of regional integration. According to classical functionalists, such as David Mitrany, these functional organizations play a more important role in regional cooperation than political organizations. Neo-functionalists, such as Ernst Haas (1964), went further claiming that deepening of cooperation between functional organizations, not only inter-governmental organizations, but also NGOs, leads to so-called spillover effect, when “active” form of regionalization comes to replace its “passive” form: region-building becomes a deliberate form of international actors’ activities. Thus, a new wave of political cooperation comes to replace the functional phase.

Trans-nationalists, like Robert Keohane and Joseph Nye (1972), focused their attention at growth of international trade, development of transport infrastructure to connect nations, rise of people’s diplomacy, and, last but not least, tourism as a form of contact between individuals of different nations. As a result of those processed, interdependence between nations emerges; a group of states, companies, NGOs and individuals depending on each other form a region. In the situation, when there are no significant differences between contracts tying companies of one country and companies of different countries, between domestic and foreign tourism etc., domestic structure approaches may be applied to regions. One may give many examples of writings on interdependence in different spheres of regional affairs: those of James Rosenau (cf. 1969) on political interdependence, Andrew Moravcsik’s (cf. 1997) works on interdependence of societal actors etc. This approach presumes that regions are areas of convergence of national and international systems.

The classical (realist and liberalist) and modernist (neo-realist and neo-liberalist) scripts of regional integration perceive the creation of regions as a top-down process shifted by international actors (Tassinar, 2004: 32). Thus, two other concepts of regionalism had to emerge, similar to neo-realist and neo-liberalist correspondingly in terms of their approaches to the levels-of-analysis problem, but perceiving regionalization as a bottom-up process. Fabrizio Tassinar refers to those concepts as “globalization” and “critical”. One may outline three general features of a region in terms of the globalization concept. First, region-building is not only a result of “deliberate forms of regional actors’ activities”, but is more related to wider process (globalization as such). Globalization does not exhaust the list of related processes as factors of region-building, for example, European integration may play the similar role. As Helmut Hubel (2004) has noted, the Baltic Sea Region is a European sub-region, not an independent region. Here the globalization approach is close to realism, which perceives region-building as a result of an outside factor (possible hegemon). At the same time, unlike realism, the globalization approach pays less attention to stable forms of international relations (a hegemon and a region) and focuses on processes (globalization and region-building).

Second, region-building is a result of de-nationalization of the states composing the region; here de-nationalization cannot be perceived as a side-by process of globalization, for different forms of what we today refer to as de-nationalization have taken place through history also in pre-globalization period together with evolution from tribe to city-state to feudal kingdom to nation state (Ouellet, 2004: 36) and beyond. One should note here that the "evolution beyond" is not necessarily connected to globalization: a variety of authors claim the ability of globalization to put an end to nation state as overstated (cf. Steinmo, 2002). The Baltic Sea Region again is a good example here, for those are international non-governmental networks, not inter-state or inter-governmental organizations that construct the basic for region-building in this part of the world (cf. Perko, 1995). In the European Union the link between de-etatization and region-building takes the form of the debate between adherents of community vs. inter-governmental approaches.

Third, region-building is a result of unification of societal processes, of which an important example is legal harmonization (see Tatiana Romanova's contribution to this volume). Unification of societal processes might take the form of rising correlation among quantitative indicators in some area: that is how global economic organizations distinguish regions in their statistical reports. A good example here is the "Europe and Central Asia"-region constructed by the World Bank's (2004) experts, who have noticed a high correlation among quantitative indicators of such different, at first glance, countries, as, for instance, Great Britain and Turkmenistan. Unification of societal processes might also take the form of applying common standards to countries with different level of fulfillment of those standards. For example, the Human Rights Watch (2005) also perceives Europe and Central Asia as one region and applies common human rights standards to all countries of this region, though Great Britain and Turkmenistan, again, are very different to apply those standards domestically.

Russian experts pay more attention to possible results of globalization that on the related processes to globalization; thus, their perception of region-building as a result of globalization depends on their perception of the results of globalization they expect. Different Russian approaches to the expected results of globalization have been analyzed by Yuriy Kosov (1991). One may outline three different scenarios in this respect. First, it is the concept of "Pax Americana", which is close to the neo-realist concept of a global hegemon. Within this concept regions are perceived as instruments to remove the existing obstacles towards such a world order. For example, the regional Northern European Initiative of the U.S. Department of State was perceived by some Russian experts as an attempt to weaken the ties between Northwest Russia and Moscow as a federal centre, for those experts considered the Russian Federation one of the poles of the "multi-polar" world order – opposite Pax Americana. Second, it is the concept of global governance, which (when and if it is created) will focus on world regions in its regional policy. Third, it is the concept of global village, which approached to regions as instruments of peace opposite to the disappearing nation states that had become famous through history as instruments of conflict.

The variety of critical approaches to region-building is similar to the globalization approaches in terms of that they also contraposition states to regions as instruments of peace. Consequently, the critical approaches came to criticize the classical approaches to international relations, first of all, realism; that was how the word “critical” has come to identify this wide range of approaches. As Mathias Albert, David Jacobson and Yosef Lapid (2001: vii) have indicated, the new approaches came to “operate against a background of North American-style international relations”. First of all, this critique targeted on realism, which remains a popular construct not only of the North American academic international relations discourse, but also of the U.S. foreign political decision-making discourse. As Valeriy Konyshev (2002: 32) noticed, the Administration of George W. Bush is making its foreign policy decisions according to what neo-realists have prescribed. Thus, the critical approaches targeted their critique at the cornerstone concept of realism, namely power, introducing a number of non-power concepts, of which one was a region. Most often power is not a construct of regional discourse at all; but even if it is, writers refer to regions as “different powers” (Antola & Suominen, 2004).

This critique of realism went hand-in-hand with critique of classical and even modern geopolitics. The idea to apply post-modernist gaze to “writing of global space” (O’Tuathail, 1996: 225 - 256) resulted in appearance of the critical geopolitics, which claimed that politics of a nation depend not on the territory, in which the nation lives, as classical geopolitics used to claims, but that politics of a group (which might be different from a nation) depend of how this group perceives the territory it lives on. Even though sometimes the critique of classical geopolitics was not purely academic in the narrow term (for example, Alfred Mahan was criticized for his “six conditions of sea power… mirror exactly those found…” in another article published several years prior to “The Influence of Sea Power Upon History” – O’Tuathail, 1996: 39 – 40), it has provided not only the basic for the concept of deterritorialization, which is a cornerstone concept for the globalist discourse of regionality, but also has given ground to the concept of “security community”, which became the cornerstone of the critical discourse.

At the same time, while attacking realism with trough critique, the critical approach does not target other classical and modernist approaches in international relations, moreover, it has borrowed several concepts from, for example, liberalism. One of those concepts is security community, which was present in the writings of, for example, Karl Deutsch, as long ago as in mid-1950s (1968). At the same time, it was Karl Deutsch himself, who claimed that his theoretical evaluation does not contradict the classical realist gaze, but is only an attempt to make it corresponding to the crisis in the political culture of his time, noticed by many of his contemporaries (cf. Binder et al., 1971). Regardless of whether the critical approach is as post-modernist as it declares itself, the perception of a region as a security community has occupied a firm position in the theory of international relations. This concept is different from the liberalist perception of a region, for it represents a more bottom-up, rather than top-down, approach to regionalization. Again, Unto Vesa and Frank Moeller (2003: 17 – 18) come to criticize the attempts to imply that "security communities would require some institutional or formal structures".

Seemingly, it is different from the realist and the globalist approaches, for it does not focus on any power or other phenomenon outside the region, such as existing or possible hegemon or globalization itself, but only assume that minor outside factors of region-building might influence the process. According to Unto Vesa and Frank Moeller (Ibid.), it would be wrong to "confuse and equate [security community] with defense agreements on alliances". Fellows of a security community do not attack each other not because they consider such an attack dangerous in terms of shaking the balance of power against an outside aggressor, and not because they consider it harmful to the community's international trade and other kinds of exchange relations. It is integration that prevents fellows of a security community from attacking each other; integration here means different from just a defense alliance or intense economic cooperation. Though this kind of integration is difficult to define (Boulding, 1989), it is integration that prevents fellows of a security community from even imagining an attack against each other.

To sum up, one might distinguish at least six definitions of a region: an area of domination, a defense alliance, an institution to achieve "absolute gains", a result of spillover effect, a result of deterritorialization, and a security community. Of course, this is not the exhaustive list of definitions; we have chosen only those most relevant for Russian domestic context of regionality. Next we will examine the change in the mainstream Russian context of the European Union (approached as a structure based on the region of Europe) that has taken place together, though not necessarily as a result of, the last years' EU enlargement. We assume that foreign affairs in Russia, similarly to any other vast country (the U.S. in 2000, where George W. Bush won at presidential elections positioning himself as a person not knowing much about international affairs and willing to concentrate on domestic problems), are not very important for the political discourse and are often used as constructs of contexts of domestic affairs.

Thus, we will study Russian approaches to European integration based on narrations made by Russian decision-makers for the country's domestic purposes and, thus, contrasting "us" (Russia) with the "other" (EU). This approach is not unique, for it is based mostly on Iver B. Neumann's (1998) writings. In accordance with the approach, we have selected narratives related to the 2003 parliamentary campaign in Russia, for EU enlargement came to be one of the important constructs of Russian political discourse of that time. In the next section we will show, how Russian mainstream political context of European integration changed in the early 2000s from perception of the EU as an international regime (neo-liberal institutionalist context) to the perception of the EU as an actor (neo-realist concept). In the concluding section we will evaluate on the policy implications in Russian-EU relations concerning the change occurred.

Russian Approaches to Regional Integration

Russian political parties tend to be very accurate in their attitudes towards the European Union. At the same time, a study of narrations by Russian political parties' leaders can contribute greatly to the analysis of Russian approaches to European integration and, consequently, to the understanding of the vision of the current Russian position vis-à-vis the European Union. In this paper, I will focus on the political parties that played important role at the parliamentary elections a year ago. The parliamentary elections in Russia took place on December 7, 2003. The results of the elections were not surprising to European experts, neither to their Russian colleagues. Four parties managed to receive more than 5% of votes required to establish a faction inside the parliament. United Russia won 222 of the total 450 seats in the State Duma, the lower house of the Russian parliament, therefore the present section will make a special focus on the United Russia's approach to the European integration. Another focus will be made on the Motherland Party, which is a new party. Smaller parties, like the Communist Party of the Russian Federation (KPRF) and the Liberal Democratic Party of Russia (LDPR), will be analyzed too, as well as the right-wing parties that failed to achieve the required 5% of votes: Yabloko and Right Forces Union (SPS). At the same time, one should take into consideration that neither the State Duma, nor political parties are important actors in Russian foreign political decision-making (Tkachenko & Petermann, 2002: 25). Consequently, approaches to European integration of the Russia's main interest groups will be analyzed.

The United Russia party has frequently identified itself as "centrist"; under "centrist parties" Russian politicians consider the parties of loyalists to the executive. At the 1999 parliamentary elections Russia used to have two centrist parties of the kind: Unity, which consisted of loyalists to the President, and Fatherland All Russia, which consisted of loyalists to the leaders of regional executive. Through the past four years President Putin has implemented the policy of centralization, as a result, the two centrist parties merged; today the United Russia party consists of loyalists to the President of all types, including many leaders of regional executive. This party of loyalists supports the foreign political course towards creation of the European common space (in the fields of economy, freedom, security and education), as President Putin has declared it at the Russian-EU summit in Rome in November 2003. According to the party's program, Russia should "actively participate in European integration" (United Russia, IX).

With this objective declared in the party's program, it is trying to establish better relations also with the candidate countries. For example, United Russia member and Chair of the Foreign Affairs Committee of the Federation Council, the upper house of the Russian parliament, Mikhail Margelov, called upon Russian politicians to make the relations with Estonia better. Margelov is a representative of the Pskov Region to the Federation Council, the region, which borders two ex-Soviet republics: Estonia and Latvia. During his visit to Estonia in November 2003, Margelov said that Russian-Estonian relations would improve only when "some Russian politicians stop viewing Estonia as a part of the Soviet Union or of the Russian Empire" (Sildam, 2003). At the same time, the party views the European common space as an international regime, in which Russia should participate. For example, according to the party's leader Boris Gryzlov, Russia should integrate into Europe "on the conditions, based only on our national and state interests" (Gryzlov, 2002); in other words, the United Russia considers the United Europe as an international organisation, consisting of states and nations.

Like the United Russia, the Liberal Democratic Party of Russia considers the United Europe an international organisation. At the same time, it is not only "a union of states and nations", but supranational institutions play also an important role in it. On one hand, the LDPR's program considers Germany as Russia's geopolitical partner (LDPR, III). It is astonishing, that France, which opposed more successively to the war in Iraq, an important issue to the LDPR's foreign political rhetoric, is not mentioned in the party's program. On the other hand, just a few lines behind the call for partnership with Germany, the party's program condemns the European Parliament as an "actor, which tends to interfere into Russia's domestic problems and to act against Russia's national interests". Here the program means the discussion in the European Parliament on the war in Chechnya. In this respect the European Parliament is mentioned among other international organizations, such as the OSCE, NATO and the Council of Europe. As to the European Union, it is not mentioned in the party's program at all. This may indicate that, first, the party failed to work out a common approach to the European integration or, second, that it considers the EU a weak international actor. One should add here that Vladimir Zhirinovskiy rules the LDPR in the authoritarian style; so, absence of a common approach is hardly possible in this case.

The Communist Party of the Russian Federation also considers the EU a weak actor on the international arena. For example, only a year ago KPRF member Oleg Leonov considered that "the war in Iraq would bury the United Europe" (Leonov, 2003), like the Kosovo war in 1999 led to devaluation of the Euro. To the contrary, the war in Iraq led to devaluation of the U.S. dollar, but so far the KPRF failed to work out a new approach to the European Union. At the same time, though the KPRF considers the EU a weak actor on the international scale, the approach to the EU as to an international actor is dominating in the party's rhetoric. For example, another party member Vladimir Bubnov writes that "the U.S. want to provoke a conflict between Russia and the European Union" (Bubnov, 2003), which means that the writer considers the EU an actor to have a conflict with. According to the article, Russian military presence in Transdnestria could have provided background for a conflict between Russia and the EU, if Romania joined the Union in 2004. The article was published before the 2003 European Council in Copenhagen; therefore, the writer could not know that Romania would not join the EU in 2004. It is worth being mentioned here that the writer predicted the OSCE ministerial conference in December 2003, where Russia came to oppose the EU and the U.S. on peacekeeping in Transdnestria.

Like Russian communists, the biggest right-wing parties consider the European Union as an international actor. At the same time, the approaches of the two parties to the European integration vary from the neutral view of Grigoriy Yavlinskiy of Yabloko to a more positive of Irina Khakamada of the SPS. Yavlinskiy identifies himself and his voters with Europe; therefore, he writes that Putin should "build a door to Europe" (Yavlinskiy, 2003: 357), like Peter the Great built "a window to Europe", when founding St. Petersburg three hundred years ago. At the same time, he thinks that Russia's integration into Europe should be limited with a common space of freedom. As to other aspects of integration, Yavlinskiy warns his voters about the weaknesses of the European Union, among which "bureaucracy in Brussels" (Ibid.) plays the leading role. To the contrary, Khakamada sees the EU as a source of modernization for Russia, for example, the Russian-EU energetic dialogue, according to her, could pose some "pressure on the Russian executive" (Khakamada, 2003) in order to pass the necessary reforms that it would not pass otherwise.

The recently founded "Motherland" ("Rodina") Bloc, led by Sergey Glaz'yev, Dmitri Rogozin and Valentin Varennikov, became the only new party to enter the State Duma at the December 2003 elections. Their victory did not surprise experts in Russia and abroad. For example, Kenneth Benoit and Michael Laver included "People's Patriotic Bloc of Sergey Glaz'yev", the basis for what became later the "Motherland" Bloc, into their questionnaire for Russian experts, released in the framework of their Policy and Party Competition research project several months prior to the elections. The program of the Bloc mentions the EU only once; it claims that "Russia, like the European Union, should become basis for a new union state" (Rodina, VI). Bloc's leaders consider the European Union not a common space, but an actor, which may be source of modernization for other countries, with which other countries may identify themselves, and which may exert influence on other countries.

Dmitri Rogozin, Chair of the International Affairs Committee in the previous composition of the State Duma, considers the European Union a source of modernization for Eastern European countries only in the field of human rights. According to him, the European Union is a "coalition of countries, most developed in the field of human rights" (Rogozin, 2003c). He believes that Latvia should not become a member of the European Union, since it is a country, where members of parliament march together with Nazi ex-veterans, while the rights of the vast Russian-speaking minority are frequently abused. At the same time, he does not think that Russia should follow the recommendations of the EU in the field of human rights in domestic affairs, for example, in the cases of Chechnya and freedom of mass media. Instead, the Bloc proposes to "ban further privatisation of mass media" in order to "protect the people… from "screen terrorism", i.e. from propaganda of violence (Rodina, VII).

Neither Rogozin considers the European model of economic development suitable for Russia; instead, the Bloc's leader Sergey Glaz'ev proposes his own model of economic evelopment for the country, based on ground-rent (the Bloc strictly opposes any rights to purchase and own land in Russia) and rent of other natural resources. The Bloc warns Russian people from identifying liberal economic model with "being European", as many people in Russia believe. According to Rogozin, Russia does not have to rush to join the European Union, since "membership in the EU does not separate Europeans from non-Europeans" (Rogozin, 2003b: 51). At the same time, Rogozin does not consider himself a European, neither has he considered Russia a European country. According to him, the Eurasian model of development, tradition for Russian foreign political and geopolitical thinking, is more natural for the country.

As to the European Union as an international actor, which may exert influence on other countries, members of the Bloc consider it not very powerful. For example, Natalia Narochnitskaya, one of the Block's leaders and researcher at the Institute of World Economy and International Relations of the Russian Academy of Science, distinguishes the "old" and the "new" Europe (Narochnitskaya, 2003a). She considers "old" Europe (Germany, France, Italy and some smaller countries) as natural partners of Russia, while the "new" Europe (Central and part of East European states, first of all, the Baltic States) is viewed as a bearer of "Euro-Atlantic values", among which the perception of Russia as an enemy plays an important role. According to Narochnitskaya, the "old" Europe failed to exert influence on the "new" Europe after the collapse of the bi-polar system; "the Anglo-Saxon states" thus became able to fill the emerged "vacuum of influence".

Narochnitskaya sees the roots of such international political weakness of the European Union in the absence of a "cultural background" in the European Union. According to her, the European Union is "nothing more than a gigantic organizational project" (Narochnitskaya, 2003b), based on "common profits", not "common values". She claims that what is known under "common European values", such as individualism, are indeed the values of "the Anglo-Saxon states", while the "old" Europe, i.e. continental Europe, and especially Catholic Europe, failed to make its values sound in the European Union. As a result, the European Union became an idealistic project, created mostly by social democrats and liberals. In the times, when conservatives and, like today, nationalists take more votes in Europe, European integration slows down. The same thing happens, when economic crisis makes "common profits" not that big.

The Bloc considers the "Kaliningrad problem" an issue of special importance, since Dmitri Rogozin gained vast part of his popularity as Russian special envoy on Kaliningrad. His approach to the role of the EU, as well as of international organizations, in the negotiations on Kaliningrad reversed through the past three years. In 2001 Rogozin used to claim that Kaliningrad should become a subject for the OSCE (Rogozin, 2001); he also considered the European Union as Russia's natural partner in the negotiations with Poland and Lithuania on Kaliningrad. To the contrary, today he thinks that the EU, which is too "bureaucratic", should allow Poland and Lithuania some exceptions from the Schengen acquis, in order to allow the people of Kaliningrad travelling to and from mainland Russia (Rogozin, 2003a). As to the role of the OSCE, Rogozin considers it an organization that behaves "against us". At the same time, Rogozin views the efforts of the Council of Europe on Kaliningrad positively; he has frequently stated that all EU member states should follow the decisions of the Council of Europe.

Besides Russian political parties, analysis of the approaches of Russian basic interest groups is very indicative for a study of Russian approaches to European integration. One may distinguish two basic interest groups in the today's Russia, facing the presidential elections next spring. The first group, often referred to as "The Family" gained strength during Boris

Yeltsin's almost ten-year-long tenure as Russian President. According to Yelena Dikun, by the end of the second Yeltsin's presidential term "the Family led the President around like a dog" (Dikun, 1999). By that time the "family" used to include Yeltsin's younger daughter Tatyana Dyachenko, president's image consultant, Alexander Voloshin, head of president's administration, Pavel Borodin, head of the general services office of president's administration, vast part of the so-called oligarchs, heads of Russia's biggest financial holdings, such as Boris Berezovskiy and Roman Abramovich, part of federal ministers, such as Railways Minister Nikolay Aksenenko, and many others.

Yeltsin's resignation in December 1999 affected the destiny of the "family" members greatly. Boris Berezovskiy left Russia after being accused of tax avoidance and financial rauds; Nikolay Aksenenko was arrested after accusations of exceeding his commission and embezzlement. The "family" has also suffered numerous less sensitive hits from the other most important Russia's interest group, often referred to as siloviki. According to Olga Kryshtanovkaya, the proportion of siloviki – police, military and security service veterans – in the top echelons of Russian power has increased from 4.8 percent in the beginning of Yeltsin's first presidential term to 58.3 percent in 2002 (Kryshtanovkaya & White, 2003). The arrest of Mikhail Khodorkovskiy, one of the oligarchs, became the most recent and probably strongest strike on what used to be the "family"; Alexander Voloshin resigned after and in connection with the arrest. At the same time, one cannot claim that by today the "family" has totally lost its influence over Russian foreign and domestic affairs.

The viewpoints of the two interest groups on the most urgent issues of Russian politics differ to a great extent. According to the "family", President Vladimir Putin's policy of "establishment of a law-based order in the country" put the country to the road towards dictatorship, his "vertical of power" policy violated the federal organization of Russia, stated in the Constitution, his policy in Chechnya led to mass violations of human rights and failed to put an end to terrorism in Russia, his mass media policy led to limitation of freedom of mass media, while his economic policy put Russia to the edge of a collapse. To the contrary, the "siloviki" continue supporting the above mentioned Putin's policies. As a result, public approaches to those policies are rather controversial. According to VTSIOM Russia's biggest Gallup company, only 34% of the population consider Putin's economic policy successful, only 24% favour the policy towards Chechnya, and 47% consider Putin's efforts to establish law and order in the country effective (Tsvetkova, 2003).

At the same time, 72% of the population considers Putin's foreign policy a success; this makes one perceive the viewpoints of both the "family" and "siloviki" on the Russian foreign policy close to each other. Their approach towards European integration is not an exception here: both interest groups view it suspiciously. In mid-2000, when the confrontation of the two interest groups had just started, and high-rank officials preferred to keep silence on important foreign and domestic political issues, former Foreign Minister Igor Ivanov announced that there are at least fifteen reasons for Russia to oppose the EU enlargement (Mukhina, 2002). Almost at the same time, Russian Council on Foreign and Defence Policy (SVOP) , a foreign political think tank founded by the "family" and supported by it until now, announced that “the European Union is promoting the erosion of economic relations between the candidate countries and their neighbours, which are neither candidate nor member states” (SVOP, 2000). The Institute for Foreign and Defense Policy, founded in 2003 by SVOP and Russian Union of Manufacturers and Businesspersons, which became a lobbyist institution of the “family” in 2001, continues insisting that “Russia is not fully a European country” (Bordachev, 2003).

The “family’s” negative approach towards the EU is based on the fact that in order to create “a common economic space” between Russia and the Union, Russia will have to adopt “a complex of European legal norms” in the situation, when “nobody has promised that Russia would participate in working out of those norms” (Ibid.). In other words, like some of the Russian political parties, the “family” considers the EU an international regime. The approach of top “siloviki” authorities to the EU is not that clear, since the majority of them are not experts in international relations, while those, who are experts, work for intelligence services and are seldom willing to give interviews. The keyword for understanding their approach is “unjustified concessions” (Kulagin, 2002), which, according to top “siloviki” the President could have made at negotiations with the EU. In other words, they view the EU not as an international regime that cannot be changes, but only joined or ignored, but as a partner at negotiations. The reason for suspicious approach of “siloviki” to the EU is based on the fact that so far the partner has not been very compliant.

Policy Implications

Of course, different perception of the European integration process by the Russian politicians caused various reactions on the EU Eastern enlargement. In contrast to the NATO’s extension to the East, which united the Russian political elite in its predominantly negative response, the EU enlargement process resulted in mixed reaction of the Russian officials.

Firstly, Russia did not demonstrate any objection to the possibility of the EU Eastern enlargement. It seems that the Russian authorities did not realize that the EU extension closer to the Russian borders and the EU membership of the neighboring countries definitely would have significant consequences to the Russian economy and might have some political implications for Russia. At that time they were preoccupied with the problems caused by NATO enlargement. It was a highly securitized issue while importance of the EU enlargement was underestimated. Then the Russian authorities indicated certain problems that enlargement would cause, among those problems transit of people and goods to Kaliningrad region was one of the most important. The efforts of the Russian politicians were targeted at the search for a proper solution of this problem: how to provide access to the Russian nationals to this far-away piece of the Russian territory.

It was much later that the Russian officials considered all the consequences of the enlargement and calculated its total impact on Russia and her economy. Their verdict was negative. It appeared that the EU enlargement would have a dramatic effect on Russia, as it can undermine her influence on the European politics, risk her relations with the Central and

Eastern European countries and cause serious losses to the Russian economy. Analysis of the major economic tendencies caused by the enlargement process demonstrated that extension of the Single European Market to accession countries would have substantial negative impact on EU-Russian trade relations, in particular on the Russian business specializing on export to the EU and to the Central and Eastern European countries (Tkachenko 2002). Though it was problematic to estimate particular effect on the Russian economy, several attempts to calculate it were made. They produced different results estimating the damage to the Russian economy from 100 to 300 million dollars per year (Shliamin 2004).

Several factors were named among the most troublesome for the Russian economy with particularly negative impact on it. First, extension of the common market meaning the common external tariffs, Community technical standards, and Community antidumping procedures to the Central and Eastern European countries would cause serious troubles for the Russian producers traditionally working on the markets of these countries. Second, competitiveness of the Russian products could be undermined by potential increase of the Community trade defense measure and quantitative restrictions. Third, Russian traditional export of certain goods, e.g. nuclear materials and steel, to the acceding countries could be hurt by Community regulations. Fourth, competitiveness of the Russian products could be undermined by transit problem because extension of *acquis communautaire* to some of the new Member States, e.g. Lithuania, would destroy traditional transit routes and raise the transport costs. Finally, Russian agricultural export to the Central and Eastern Europe would be in danger because of difficulties to compete with the agricultural products subsidized from the Common Agricultural Policy (CAP) budget.

Obviously, this mixed reaction of Moscow to the EU enlargement caused serious problems in the EU-Russian relations. On the one hand, the Russian authorities failed to express consistent Russian approach to the enlargement process and eventually made it very difficult to prevent negative impact of the enlargement. On the other hand, for the European officials it was very difficult to deal with Moscow when their Russian counterparts tended to change their negotiation position.

Why it appeared difficult for the Russian political elite to pursue single approach to the enlargement even at the expense of deteriorating of EU-Russian relations and causing political and economic troubles to Russia? One can suggest a number of explanations to these shifts of the Russian official approach to the EU enlargement. We would look at two of them. The first explanation comes from the assumption that it was shifting approach to 'regional integration' that caused inconsistencies of the Russian policy towards the European Union. The second would be based on the analysis of the Russian foreign policy, its priorities and the major factors that influenced Russia's relations with the 'West' meaning European countries and the United States.

According to the first idea, inconsistencies of the Russian foreign policy towards the European Union could be explained by shifting approach to regional integration, in particular European integration. In the previous chapters it was already explained that there existed a number of approaches to the European integration supported by different Russian politicians.

We argue that it is possible to track approaches supported by the Russian officials and their transformation. The first dominating approach to the European integration was that the European Union/European Community/ is a regime meaning a set of certain rules. Besides this regime is not targeted against Russia, so it can not be considered unfriendly. From this perspective, the EU enlargement means that the growing number of states is eager to follow this set of rules. For Russia there was no sense to prevent states from following joining this regime. Therefore, Russia originally did not oppose the prospect of EU Eastern enlargement in contrast to enlargement of a regional alliance like NATO (Konyshev, 2002).

Then this perception of the European Union was changed by an idea that it was not a regime but an international actor. This change largely resulted in intensified activities of the European Union on the international arena, from the fact that the EU started developing the Common Foreign and Security Policy (CFSP), then European Security and Defense Policy, etc. It was difficult to continue to treat the EU/EC as a regime when it extended its competencies to the foreign policy, security and defense issues. It caused growing concerns of the Russian authorities about the territorial extension of this international actor towards her borders. Eventually, it resulted in increased opposition of Russia to the EU enlargement process.

The second explanation requires review of the Russian foreign policy at that time. With no ambitions to give substantial analysis of the Russian foreign policy, we will try to outline the main factors that influence the Russian European policy. Though in early 90s the Russian officials tried to develop productive relations with the West, by mid 90s these relations were preoccupied with the problem of NATO enlargement as Russia tried to use all possible means to stop this process. Moscow considered it a major security threat. It perceived NATO a relic of the Cold War and expected that after the end of the Cold War, collapse of the Soviet Union and dissolution of the Warsaw Treaty Organization NATO would follow its opponent and would be dissolved. When the Transatlantic alliance survived and even demonstrated its readiness to extend its activities, Russia reacted very nervously. The Russian leaders regarded this situation in terms of the Cold War relations and bilateral confrontation with the United States. In this sense, extension of the most powerful military alliance in Europe to her borders, which was created as an instrument of confrontation with Moscow and in the situation of the shrinking Russian military resources, was declared a major threat to the national security.

Besides, it was seen as betrayal of the promise made by the Western political leaders to Michael Gorbachev, the President of the Soviet Union, during negotiations on the reunification of Germany. They agreed that the alliance would stay in the borders of its territory at that time (Khudoley 2002: 7). NATO enlargement eastwards meant significant territorial changes. When the former Soviet allies expressed their intention to join NATO, it was considered as a sign of redistribution of territory after the end of the Cold War. The fact that NATO was established to "keep Russia out" of the European politics enabled the Russian politicians to claim that NATO enlargement was targeted to create new dividing lines in Europe and to isolate Russia from the rest of Europe. However, it was this perception of the NATO enlargement process that eventually caused serious confrontation between Russia and the West and undermined Russia's influence on the European politics. It was very difficult to overcome this confrontation and to return to productive relations with NATO in order to work together on the common agenda and to confront new security challenges. Therefore, the EU enlargement was in the shadow of more controversial NATO enlargement.

In contrast to the Cold War period when the Soviet Union considered the European Communities an economic partner of the NATO and was reluctant to establish official relations with the communities, in the 90s the European Union was declared political and economic partner and eventually 'strategic partner' of Russia (the Russian Federation Middle Term Strategy towards the European Union (2000-2010), 1999). This change of attitude towards the EU in the post-Cold War period was demonstrated when in early 90s Russia started negotiations with the European authorities in order to prepare an agreement which would reflect new phase of the EU-Russian relations. In 1994 almost two years of negotiations resulted in the Partnership and Cooperation Agreement (PCA) signed in Corfu. The PCA came into force only in 1997 after ratification process was completed. It was complicated by the 1995 enlargement and war in Chechnya (Romanova & Zaslavskaya, 2004). The agreement confirmed that the European Union and Russia agreed to upgrade their relations to partnership based on common 'respect for democratic principles and human rights'. However, the 1992-1994 negotiations indicated major contradiction in the priorities of the parties and their expectations from this cooperation. While Russia was interested in the development of economic cooperation, particularly trade relations, the European Union emphasized the importance of political cooperation. Eventually, interests of both parties were reflected in the PCA final text which determined major areas of cooperation including political cooperation and economic ones.

In 1994, the Russian authorities were more-or-less satisfied with the outcome of negotiations. The major part of PCA was devoted to the issues of economic cooperation. Moreover, the PCA included several important decisions. First, Russia was granted transit economy status. Second, the PCA promised that in 1998 the parties would consider opportunity to open negotiations on a free trade area. Third, it abolished quantitative restrictions for the Russian goods with the exception of steel, textile and nuclear materials. The PCA provided new legal basis for economic and technical assistance from the European Communities to Russia which started in 1991 on the basis of Agreement on Trade and Economic Cooperation between the European Economic Community and the Soviet Union. The major instrument of Brussels' assistance to Russia was TACIS (Technical Assistance to the Commonwealth of Independent States) program. In the framework of TACIS, Russia received 2.4 billion euro during 10 years from 1991 till 2001. Therefore, economic cooperation determined by the PCA corresponded to the Russian interests.

On the other hand, political cooperation introduced by the agreement in general was also consistent to the Russian interests. Traditionally Russia is very reluctant to political cooperation that can result in strict control of some external authorities over the domestic politics. Of course, one can come up with a number of exceptions, e.g., Russia's enthusiasm about the Council of Europe's membership even at the expense of external control. But

Russia's intention to join the Council of Europe was determined by other several important factors including necessity to indicate democratic nature of the new Russian state and to reconfirm Russia's role in the European politics. It was considered a reasonable deal. The PCA text was rather brief on a matter of political cooperation. Nevertheless, it does not mean that political cooperation part was less important than economic cooperation because it was smaller. The agreement introduced a new form of cooperation 'political dialogue' and determined its major objectives: (1) rapprochement between the EU and Russia, (2) political and economic reforms in Russia and (3) development of other forms of cooperation. It also created institutional structure to develop political dialogue and to arrange political consultations between the European and the Russian authorities on different levels of decision-making in order to develop political cooperation: at the top executive level (the EU-Russian summits), at ministerial level (Cooperation Council), at senior official level (Cooperation Committee), at experts' level (Sub-Committees), at parliamentary level (Parliamentary Cooperation Committee). The top officials from Russia (the President) and the European Union (the President of the Council and the President of the Commission) would meet twice a year (Ibid.).

Location of summits was determined later. It was decided that the meeting in the first half of the year would be organized in Russia (preferably in Moscow so far with the only exception when in 2003 it was organized in St. Petersburg due to 300th anniversary) and in the second half of the year it would take place in the country holding the Presidency in the Council. The Cooperation Council is organized on the ministerial level consisting of the representatives of the Council and representatives of the Commission at the EU side and of the members of the Russian government at the Russian side. Meeting of the Cooperation Council are arranged at least once a year to discuss cooperation in particular policy areas. In 2003 it was transformed into a Permanent Partnership Council. It was also decided that it should meet more frequently and in different formats depending on the negotiated issue. The Cooperation Committee is supposed to assist the Cooperation Council (Permanent Partnership Council). Moreover, experts meet to discuss particular issues in the framework of Sub-Committees or working groups. Democratic control over implementation of the agreement and development of the EU-Russian relations was organized in the form of the Parliamentary Cooperation Committee composed from the delegates of the European Parliament and Russia's Federal Assembly.

However, the 90s was a period of radical political and economic reforms in Russia and significant changes of the economic priorities resulting in changing expectations from the EU-Russian relations. By the time when the PCA came into force, there appeared dissatisfaction with it. This dissatisfaction increased when Russia faced a number of problems caused by the agreement. For example, the transit economy status which seemed so important in 1994 later caused serious troubles for the Russian producers; in particular it resulted in multiple anti-dumping procedures against the Russian goods. It took Russia other several years of negotiations to persuade the European Commission to grant Russia market economy status.

The promised negotiations on a free trade area were postponed because of major financial crises in Russia and significant reduction of trade between the EU and Russia.

Political cooperation had been developed in the direction indicated by the PCA. The established institutional structure enabled the EU and Russia to organize political consultations and to share each others concerns about the state of the EU-Russian relations. However, there also appeared certain problems. Russia found it difficult to deal with the EU because the CFSP was under strong influence of the Member State holding the Presidency. Inconsistency of the EU policy towards Russia and changing priorities of the EU undermined efficiency of the EU-Russian negotiations. Russia was also unhappy with the EU criticism of Chechnya problem and worked hard to delete it from the EU-Russian agenda. Still Chechnya problem influenced the EU-Russian relations. It was discussed by the European Parliament. It caused contradictions with particular Member States. In November 2002 because of the Chechen Convention held in Copenhagen Russia demanded the EU-Russian summit to be moved from Copenhagen to Brussels.

In the situation when several Central and Eastern European countries were applying for both NATO and the EU, Russia was interested if they join only the EU (Forsberg, 2004: 251). In comparison with the NATO enlargement, the prospect of the EU Eastern enlargement did not raise concerns of the Russian officials as the EU was never considered a threat to the Russian security, relations with the EU were better established and were positively developing. Besides Russia remembered experience of the 1995 enlargement, and this encouraged further development of the EU-Russian cooperation. It created a new framework for the EU economic assistance to Russia, as new Member States suggested development of the Northern dimension in order to promote economic growth and social stability in the Northern Europe, including North-Western Russia. It became an important instrument of the EU policy towards Russia. So Russia had no negative experience of the enlargement. When Poland suggested to reconsider EU policy towards the Eastern neighbors and to develop the Eastern dimension to promote cooperation with the countries neighboring the EU in the East, it was regarded as a positive consequence of the enlargement.

However, after the NATO enlargement occurred, the Russian authorities became more cautious about the EU enlargement. They tried to estimate political and economic consequences of this process and finally realized the problems it could cause to Russia. Transit of goods and persons to Kaliningrad from mainland Russia was the first problem that occurred because it emerged before the acceding countries, including Lithuania, joined the EU but when they had to implement Schengen acquis as a pre-accession requirement. Then the Russian authorities realized the problems that could be caused by extension of the PCA to the acceding states and tried to minimize them in accordance with neo-liberal approach. Russia was afraid that the EU membership of the Central and Eastern European countries would undermine their trade relations with Russia because of the extension of the single market and quantitative restrictions to the territory of the acceding countries. Only after several months of negotiations in early 90s finalized short before the enlargement Russia and the EU could find compromise solution, which enabled to extend the PCA to the acceding countries and to minimize negative impact on Russia.

Today Russia has to determine her priorities in the development of relations with the European Union. The PCA is widely criticized as being outdated. During the last decade, Russia and the EU have gone through serious reforms, their relations also have intensively developed. It is necessary either to amend the PCA according to the nowadays situation, or to adopt new documents that would better satisfy interests of both Russia and the European Union. Besides that, the enlargement also raised the question of further development of EU-Russian relations.

The EU has moved closer to the Russian borders and extended the common border to 2,200 km. Increase of the common border requires intensified cross-border cooperation in order to solve common problems. The Polish proposal of the Eastern dimension and idea of new policy towards the Eastern neighbors were transformed into New Neighborhood Policy of the European Union aimed at establishment of secure and stable environment eastwards and southwards of the European Union. Russia was considered one of these neighbors. The neighborhood policy provides only general approach and requires preparation of individual action plan for each of the neighboring countries. It allows developing deeper integration with some of the neighbors. So it enabled to continue negotiations with Russia on the establishment of the Common European Economic Space (Wider Europe – Neighborhood). These negotiations were prepared by the PCA which was supposed to 'provide an appropriate framework for the gradual integration between Russia and a wider area of cooperation in Europe'. The original idea adopted by the EU and Russian leaders in 2001 was to strengthen economic cooperation and to create the Common European Economic Space (CEES). In 2003 during EU-Russian summit in St. Petersburg it was decided to extend this common space concept to other policy areas and to prepare four common spaces: a common economic space, a common space of freedom, security and justice, a space of co-operation in the field of external security, a space of research and education, including cultural aspects. It was expected that during the EU-Russian summit in the Hague in November 2004 leaders of the EU and Russia would be able to agree on the first steps to establish common spaces, but the final decision was postponed to the Moscow summit in 2005.

Therefore, analysis of theoretical approaches to the European integration supported by the Russian authorities together with analysis of other factors influencing political discourse in Russia help to understand development of the Russian foreign policy and transformation of the Russian policy towards the European Union.

Conclusions

Theory of International Relations has provided a scholar with various definitions of region. Realists and neo-realists perceive regions in terms of alliance-building or hegemony. Liberalists and neo-liberalists refer to absolute gains and spill-over effect, when speaking about regions. Globalisation theory considers that regions appear as a result of the process of deterritorialization and states and further territorialization of space on a non-state basis. Critical theories view regions as security communities. There is no other solution to the disputes among the theoretic approaches and their definitions of regions than to say that a region is a piece of space that is called a region. If one applies the post-modernist concept of rhizome to regions one may say that a region exists only when there is a dispute between different concepts of the region. Consequently, the region disappears, when the different concepts of it prove not relevant any longer for the regional discourse. Finally, a region in the post-modernist context might turn into a region in the modernist context, when all the different concepts of it turn into a "common opinion". The European Union, formerly a post-modernist region, is currently on the way towards more stable European identity; however, it is too early today to speak of what the EU will look like by 2020.

Russian mainstream context of regional integration in Europe made a significant change in the early 2000s, simultaneously, but not because of the EU enlargement. Previously, Russian agents used to perceive the EU as an international regime, today the main perception is that of the EU as an international actor. This change gives the ground to conclusions on the changes in political implications of EU-Russian relations to occur in the years to come. First, Russia has realised that the EU might be a partner not only in economic relations, but also in the political and security spheres. As a result, "strategic partnership" between Russia and the EU has come to the top of Russian foreign policy agenda. Second, thanks to the EU enlargement Russia has realised the new opportunities for the relations with the EU, such as the European Neighbourhood Policy. These two factors combined create the background for deeper integration of Russian into wider Europe, of which one of the indicators will be the creation of the four spaces.

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THE ENLARGED EU AND RUSSIA – WHAT DO VISEGRAD-COUNTRIES CONTRIBUTE TO EU-RUSSIAN ECONOMIC RELATIONSHIP?

Zsuzsa Ludvig

Abstract

The European Union's economic strategy on Russia had not been clearly and consistently worked out by the time of 2004 May enlargement. Major questions still needed to be answered. Since new member-states had not been really involved into the process of shaping EU policy toward its „strategic partner", their approaches should be also included into the EU Russia-policy in the future. Though enlargement certainly brings about growing importance and new perspectives into the EU-Russia dialog, it will create new problems or deepen some old ones as well.

Beside Baltic-states, that have their special interests and attitudes - Visegrad–countries (Poland, Hungary, Slovakia and to a less degree the Czech Republic) are the most interested new-members in this dialog. They may turn to be either the most active ones in taking part of shaping EU-Russian economic and political dialog from among the 10 new-comers or the most influential ones in doing so. The role of Poland in this process is undoubtedly unique.

Notwithstanding the fact that characteristics of bilateral economic relations (Polish-Russian, Hungarian-Russian etc.) are common to a great extent, it seems to be unlikely that these countries will intend or will be able to co-operate on this issue. The reasons for potential and already sensible divergence in their attitudes toward Russia – contrary to their more or less similar approaches regarding Ukraine – are rooted more in politics then in different economic interests. Analysing figures concerning bilateral trade and investment flows indicates these common features. Energy is in the focus of Russian-Visegrad4 economic relations.

Keywords: Visegrad-countries, Russian-EU relations, foreign trade, FDI, energy[1]

[1] This paper is a partly modified version of an article of the author with the same title, under publishing in Journal of East-West Business, 2005. No.1.

Introduction

New period began in EU-Russian relations in the 2000-ies owing to several factors. Firstly, Russian president Vladimir Putin started to follow a more pragmatic policy toward Russia's foreign partners including both the EU and Central-East-European countries in a comparison with the Yeltsin times. Secondly, significant changes have been shaped in Russia inside, the economy has been stabilised to a great extent, while political scene has gone through deep modifications. Thirdly, the Russian issue itself has naturally gained more importance for the EU as the date of enlargement became nearer and nearer. Owing to these facts and processes the European Union and Russia began to consider each other not only as important partners on the European continent, but more as strategic ones. Rooted from the newly formulated strategic partnership two huge EU-Russian economic projects have been evolved for the past years. The first is the so-called energy dialog, and the second is the idea of the Common Economic Space (CES) linking Russia and the enlarging EU to each other more closely. However, although more than three years passed, the latter is still more an idea than a real program, it is more about wonderful words than real actions. (See more detailed Hamilton 2003.) It is rather a project for the future, time horizon and even content of which are still very uncertain. The energy dialog also owes answering some major questions even today. To put it briefly, though EU-Russian relations have gone through significant development for the last few years, consistent strategic thinking is missing on both sides. Beside the lack of a clear Brussels vision on Russia there have been different voices among the 'old' EU members-states (EU admits, 23. February, 2004), while on the other side Russia has also not yet come up to decision on the required depth and concrete ways of the strategic partnership (Bordachev 2003; Klitsounova 2004).

In May 2004 ten countries joined the EU. Several of them used to have special or unique relationship with Russia in the past. The three Baltic states formed part of the Soviet state for decades causing serious consequences socially, economically or politically even in the period of their newly regained independence. Visegrad-countries also had their special role in the Soviet area. They all were not only allies to the empire but neighbours to it as well, which had also its implications. Going back into history more deeply the picture on bilateral relations is however differentiated even within the group of Central-East-European countries. This phenomenon seems to impact significantly even in recent times on relationship with Russia. On the contrary, outstanding significance of Russian relations with Cyprus have not rooted in history, they are products of modern times, as symbols of Russian business cleverness to survive in hard circumstances.

Anyhow, due to the usual EU-mechanisms exceeding countries were not really involved into – perhaps only consulted over - the EU15-Russia dialog even in the 2000-ies. Although they could follow all proceedings of this partnership they did not participate in it as equal – deeply affected - partners, did not have the chance to contribute to it on the basis of their interests. This moment has been criticised both on their and Russian part. Some Russian analysts and officials clearly recognised that an important partner had been missing from the dialog (Bordachev 2001). This problem might have been resulted in a situation when several Polish experts argue that the Wider Europe – New Neighbourhood concept itself should be either redraft in order to involve Polish "expertise and experience" (politician Saryus-Wolski in Poland's Foreign Policy, 2004) or as Polish political scientist Aleksander Smolar puts the question: " how may the change in Poland's international positioning affect our (the Polish) capacity to co-formulate the future EU foreign policy including, primarily, its Eastern Dimension?" (Poland's Foreign Policy, 2004). Hungarian Anita Orbán also argues that "Budapest must attempt to change the Wider Europe concept" so that Eastern European states should be treated separately from the Southern Mediterranean region (Orbán 2004). Slovakian Alexander Duleba considers highly important to link together EU's Russian policy and policies on other European CIS-countries like Ukraine, Belarus and Moldova. (2004) On the other hand partly the lack of real involvement into the earlier phases of the EU-Russian dialog might have led also to the paradox situation that although the analysed (and Baltic) states might probably be mostly affected by the formulating EU policy or strategy on Russia (and other European CIS-countries), at the time being they also may be unprepared to become active partners of this process even now. Naturally it is not only Brussels that should be blamed for this. Most of them lack their consistent national vision on Russia and their reactions are often of ad hoc character. Nevertheless, bilateral (Visegrad-Russian, Baltic-Russian) relations are burdened by the legacy of the past with numerous unsolved problems that might be tackled in a more adequate way within the EU-framework (Bordachev 2001). Also, most of the new-comers are more deeply touched by either the "Russian issue" itself or the formulating EU New Neighbourhood Policy than the majority of the old member-states.

Enlargement itself created tensions between Russia and the enlarging EU. Some of the related problems were solved within the process of acceding negotiations, but major issues were answered only at the end of April, 'one minute' before the enlargement itself according to the new Protocol of the Partnership and Co-operation Agreement and the related Joint Statement on EU Enlargement and EU-Russia Relations. These answers were basically given from Brussels.

The 'contribution' of Visegrad-countries (Hungary, Poland, Slovakia and the Czech Republic) to the EU-Russia dialog is a controversial one. While they used to be very close partners some decades ago, their relations – including economic links – have declined dramatically after the collapse of the socialist system. Among the main reasons to this the following ones had major impacts: 1. Their political reorientation toward the West with desire to integrate into West-European and Euro-Atlantic integration structures; 2. Dramatic decline in their production caused by the sudden cut of direct – previously centralised - links among former socialist states; 3. Political and more importantly lasting economic problems inside Russia. However, according to certain opinions these countries still have special chances in developing their links with Russia due to their still existing "knowledge" on the country. Statistical figures on economic relations – trade and investment flows – in the past years do not prove these opinions. On the contrary, both West-European business circles and politicians seem to understand more the importance of Russia – more exactly the significance of the huge Russian market and resource abundance. It was partly this recognition that led to the "strategic partnership" between the EU and Russia, although major motives might have rooted rather in geopolitics. Since West-European (and US) firms possessed the necessary financial sources they soon occupied market and business positions formerly hold by (Central-)East-Europeans. On the other side economic links between Visegrad-countries and Russia have been narrowing to a great extent to a level much below both the artificially increased level of the past and a realistic level of present times. This relatively low level of recent economic interactions provides the main explanation to the missing of national thinking on their "already and again strategic partner", Russia.

The following chapters provide an analysis on Visegrad-countries recent and potential economic relations with Russia: Chapters 1-2. describe basic – trade and investment - flows, while Chapter 3. tries to identify policy-making features of these relations based on interests and approaches, that may influence future EU-Russia dialog with special regard to the two large EU-Russian economic issue: CES-concept and energy dialog.

Trade relations

Similarly to the EU15-Russia economic links basic form of economic ties between Visegrad-countries and Russia has been foreign trade. With their Euro-Atlantic reorientation almost all other types of business contacts declined suddenly and dramatically in the early nineties. Trade flows have also weakened to a great extent and also their scale has been narrowing. A second shock to bilateral economic relations was given by the Russian crisis in 1998, the year following the best year (1997) of mutual economic contacts.

While EC then EU has developed its trade contacts with Russia rather successfully even in the nineties both in volume terms and regarding range of products, the importance of both Russia in Visegrad-countries trade relations – especially in their exports – and versus, that of Visegrad-countries in Russian business with foreign countries have fallen through the past years. Right recently there are small signs of improving trade links, the four Visegrad-countries' share is stabilising at somewhat lower than 9% in Russian exports and between 5-6% in Russian imports. In volume terms Poland ranks first, followed by Hungary (concerning Russian supplies) and the Czech Republic (in Russian imports), while the latter is only on the 4th place in Russian exports within the group. Slovakia's share in Russian imports is the only one below 1 %, while its proportion on the export side is near 2%.

Table 1: Visegrad-countries shares and ranking in Russian foreign trade

In RUSSIAN EXPORTS				
	2002		2003	
	Share (%)	Ranking	Share (%)	Ranking
Hungary	2.0	16.	2.1	16.
Poland	3.5	10.	3.4	10.
Slovakia	1.9	17.	1.7	20.
Czech Republic	1.4	22.	1.4	22.
Visegrad countries together	8.8	…	8.6	…
EU15	*35.5*	...	*35.2*	...
In RUSSIAN IMPORTS				
	2002		2003	
	Share (%)	Ranking	Share (%)	Ranking
Hungary	1.1	25.	1.0	22.
Poland	2.8	11.	3.0	11.
Slovakia	0.3	39.	0.5	30.
Czech Republic	1.2	22.	1.2	21.
Visegrad countries together	5.4	…	5.7	…
EU15	*39.7*	...	*38.2*	...
Source: **www.customs.ru**				

On the Visegrad side Russia is a more important trading partner, though her share in total foreign trade of the four countries has been also declining until recent times. According to statistics on the previous years, that treat EU-countries still as normal foreign trade partners for them, Russia is only in the group of 10-20 most important partners concerning export values. Since their lists of major partners basically include EU15-countries and each others, Russia's ranking in nowadays foreign trade statistics is likely to be much better (1-2 place) than her ranking in EU15 foreign trade (5-6. place). According to Table 2, Russia was among major four partners regarding import side even before the time of enlargement, indicating that she will be on the first place(s) after it.

Table 2: Russia's share and ranking in Visegrad-countries foreign trade volumes and deficit

In Visegrad exports		
	Share (%)	Ranking
Hungary (2003)	1.5	15.
Poland (2002)	3.2	7.
Slovakia (2002)	1.2	13.
Czech Republic (2002)	1.3	14.
In EU15 exports (2003)	*3.4*	*(6).*
In Visegrad imports		
Hungary (2003)	6.2	5.
Poland (2002)	8.0	3.
Slovakia (2002)	10.7	3.
Czech Republic (2002)	4.5	5.
In EU15 imports(2003)	*5.2*	*(5).*
In Visegrad trade deficit		
Hungary (2003)	49.4	1.
Poland (2002)	21.8	1.
Slovakia (2002)	(336.4%)	1.
Czech Republic (2002)	57.7	2.
In EU15 trade balance (2003)	...	*(3).*

Source: Hungarian Ministry of Foreign Affairs (www.kulugyminiszterium.hu), Polish State Statistical Office (www.stat.gov.pl), Slovakian Statistical Office (www.statistics.sk), Czech Statistical Office (www.czso.cz) , Eurostat External and Intra-European Union Trade
Note: ranking includes both countries inside and outside the present EU for Visegrad4

For the past 2-3 years all Visegrad-countries have improved their export activities on the Russian market, meanwhile the value of their purchases from Russia has been basically dependent on the growing world market oil prices. Figures indicate a considerable trade growth in both directions with an increase around 20% in Visegrad exports already in 2002. It is important to note that the growth rate of Visegrad exports exceeded that of EU15 suppliers in both two analysed years, which might be a first sign of a possible trade recovery between Russia and the Visegrad4- countries.

Table 3: Dynamism of Visegrad-countries trade with Russia, 2002-2003

Russian exports	2002/2001	2003/2002
Hungary	91.1	129.0
Poland	88.6	122.4
Slovakia	92.1	113.1
Czech Republic	90.4	128.1
Visegrad average	90.2	122.1
EU15 average	102.3	124.3
All Russian exports	*106.2*	*125.3*
Visegrad exports	2002/2001	2003/2002
Hungary	114.3	116.4
Poland	134.9	131.4
Slovakia	119.6	188.5
Czech Republic	119.8	125.7
Visegrad average	125.8	130.7
EU15 average	118.4	119.7
All Russian imports	*110,2*	*124.3*
source: www.customs.ru		

According to figures in Table 4, for 2003 deliveries to Russia from all the three other Visegrad-countries, with the exception of Hungary, and the EU15 reached or even exceeded the level of 1997. However Russian exports to all of these countries increased by larger extent. Visegrad export volumes are still far from those that would be desirable by them in the light of their trade balance problems. Astonishing growth rates (like 188% in Slovakian exports) also have to be treated with cautious due to the previously very low base.

Table 4: Trade flows between Visegrad-countries and Russia in 1997 and 2003, million USD

	RUSSIAN EXPORTS		RUSSIAN IMPORTS	
	1997	2003	1997	2003
Hungary	1853.7	2796.7	920.6	596.9
Poland	2514.6	4551.9	1354.4	1708.3
Slovakia	1741.2	2298.5	284.8	299.4
Czech Republic	1822.2	1936.9	585.8	709.2
Visegrad4 together	7931.7	11584.0	3145.6	3313.8
EU15	27967.0	47097.0	19526.0	21928.3
Source: Russia in numbers (for 1997), www.customs.ru (for 2003)				

Newest figures for Hungary (first eleven months of 2004) show a still continuing dynamism in Hungarian exports. They increased by 38%. It is interesting that the still highly improving Hungarian export performance is widely explained within the country as a direct result of normalised bilateral political relations. However, similarly high or even higher figures of other countries and also the lack of such direct mechanism between politics and business life suggest that the main reason should be something else, more likely the growing import capacity of Russia.

All the four countries face the same problem: large trade deficit in their trade with Russia. Nevertheless a characteristic of Russian foreign trade flows has to be mentioned here. Russia buys year by year much less products than she sells. The average ratio of total Russian imports/total Russian exports in value terms during 2002-2003 was only 0.43. This means that most partners of Russia have the same problem, and the success of a country on the Russian market must be measured in the light of this. According to Table 5, on the eve of EU-enlargement Visegrad-countries 'performance' on the Russian market was much worse than that of an average partner of Russia, and especially poor in comparison with the EU indicator, which was above the average.

Table 5: Import/export ratio of trade with Russia in Visegrad and EU15- countries

	2002	2003
Hungary	0.24	0.21
Poland	0.35	0.37
Slovakia	0.08	0.13
Czech Republic	0.37	0.37
Visegrad average	0.27	0.29
EU15 average	*0.48*	*0.47*
Russia total	0.43	0.43
source: own calculations based on Russian customs statistics (www.customs.ru)		

Russian export patterns in the four countries show lots of similarities – also in comparison with EU15-countries, though extremities in the structure with the former group of countries are more striking. Mineral fuels total to more than 80% in Russian exports to the Visegrad-region, followed by product group No. 84. according to the Harmonised System classification, which – with the exception of Poland - includes the high value for the item of heating elements for nuclear stations. It is not surprising that these commodities were involved into the list of Russian major concerns regarding the impacts of EU-enlargement. Shares of all other commodity groups in total are only around 1-2% or even below that level. It is also worth mentioning that apart from fuels, other Russian export products are very much the same in the four countries. Table 6. shows the first ten Russian product groups in each country. The low level of Russian export product diversification is a common feature in the whole region. However, beside fuels and heating elements other products are also of major importance in the purchasing countries' total imports, like aluminium products in Hungary or iron ore in the Czech Republic. No agricultural product group is included into the list, and also the share of Russian machinery is extremely low amounting to only a few percent in total supplies.

Table 6: 10 main product groups in Russian exports to the Visegrad-countries, % in total

		Hungary		Poland		Slovakia		Czech Republic	
		2001	2002	2001	2002	2001	2002	2001	2002
26	Ores slag and ash	0.7	0.9	0.4	0.6	1.6	1.5	1.0	2.0
27	Mineral fuels	84.0	85.5	92.2	91.4	82.7	84.1	87.0	85.5
28	Inorganic chemicals, compounds of precious metals	0.8	0.9	0.5	0.6	0.4	0.4	1.0	0.9
29	Organic chemicals	0.9	…	0.5	1.0	0.7	0.9	…	…
31	Fertilisers	1.0	1.2	0.8	0.8	…	…	0.4	…
40	Rubbers and articles thereof	1.0	1.2	0.6	0.7	2.0	1.4	…	…
44	Wood and articles of wood	…	0.6	…	0.3	…	…	…	0.5
47	Pulp of wood, waste and scrap of paper	0.9	1.1	0.6	0.4	0.7	0.4	0.5	0.6
72	Iron and steel	…	…	0.8	0.9	0.7	1.0	1.0	0.9
76	Aluminium and article thereof	1.5	1.7	0.5	0.7	3.7	2.7	1.2	1.5
81	Base metals nesoi, cermets	…	…	…	…	…	…	0.7	…
84	Nuclear reactors, boilers, machinery and mechanical appliances, computers	3.0	2.0	0.5	…	3.7	3.9	3.7	3.8
85	Electrical machinery and equipment and parts, telecommunications equipment	…	…	…	…	0.6	0.7	0.5	0.8
86	Railway and tramway locomotives, rolling stock, track fixtures	…	0.6	…	…	…	…	…	…
89	Ships, boats	…	…	…	…	…	…	…	0.6
90	Optical, photographic, measuring, medical etc. instruments	1.0	…	…	…	…	…	…	…
10 major product group together (%)		94.8	95.7	97.4	97.4	96.8	97.0	97.0	97.1
Source: Customs Statistics on Foreign Trade of the Russian Federation (Tamozennaya statistica vnesney torgovlyi Rossyskoy Federaciyi), Russian State Customs Office, 2003									

It is a permanent issue on bilateral agendas with Visegrad-countries that the Russian side would like to widen the product range of her exports mainly with regard to machinery deliveries. But this is rather an issue of market competitiveness valued by company considerations than subject to political dialog. Significant changes in Russian trade patterns cannot be expected within short period regarding commodities.

On Visegrad export side list of major commodity groups is longer with the implication that export patterns of the four countries show a richer variability. However, several product groups involved into the ten major ones can be found at least in the lists of two states meaning that there is a sharp competition on the Russian market not only in general terms but among Visegrad-countries as well. Sometimes this competition is really keen like in the case of pharmaceutical products that are of major importance both in Hungarian and Czech exports to Russia. The share of the Russian market in total Hungarian pharmaceutical exports was as high as 19% in 2002, while the appropriate figure for the Czech Republic was 14%. Paper and plastic products beside pharmaceuticals are also subjects to rivalry among the four countries. Agricultural and food products represent important part in the Hungarian and Polish deliveries to Russia. These agricultural deliveries suffered a lot because of cheaper – and subsidised – supplies from the EU (and the United States) for the past years. In Hungary and Slovakia deliveries of machinery and equipment yearly reach somewhat more than 30% in total exports to Russia, which is still much lower than similar figure for EU15 (44%). It is only the Czech Republic that has even higher share for these products than the EU.

All the four countries face common problems on the Russian market: weak capitalisation of national firms, the lack of sufficient financial background leading to unfavourable position in competition with West-European companies. A special problem for all of them is the low level of investments made by their national companies on the Russian market. Nevertheless, in country-specific analysis high correlation between trade 'success' in Russia and the amount of investments made in the country is a characteristic of the Russian market. Russia's major trading partners are at the same time the biggest country-investors that beside the United States of America not surprisingly belong to West-Europe. As theory on FDI describes, foreign investments in many cases support trade goals. Russia is a good example to study these impacts, and it seems that West-European-based (German, Dutch, British etc.) companies understand this rule better than their East-European competitors. Until recent times transnational companies with location in the analysed countries delivered their exports to Russia not directly from the producing country that is from Hungary or Poland, but instead through the 'mother-country'. Modifications in this pattern may also contribute to a statistical 'picking up' in Visegrad exports directed to the Russian market.

Table 7: Comparison of 10 main product groups in Visegrad-countries exports to Russia, % in total

		Hungary		Poland		Slovakia		Czech Republic	
		2001	2002	2001	2002	2001	2002	2001	2002
2	Meat	…	…	3.4	4.2	…	…	…	…
4	Dairy, eggs, honey	…	…	…	…	…	…	…	2.3
8	Edible fruits and nuts	…	…	…	3.1	…	…	…	…
10	Cereals	1.5	4.9	…	…	…	…	…	…
11	Milling industry products	1.9	…	…	…	…	…	…	…
20	Preparations of vegetables, fruits, nuts	9.2	10.4	4.0	4.0	…	…	…	…
21	Misc.edible preparations	…	…	…	…	3.0	3.2	…	…
23	Residues from food industry, animal feed	2.9	2.8	…	…	…	…	…	…
28	Inorganic chemicals, compounds of precious metals	…	…	…	…	…	…	2.6	…
30	Pharmaceutical products	29.5	21.4	6.0	4.0	4.1	2.8	7.1	4.7
33	Oils, perfumery, cosmetic or toilet preparations	…	…	4.7	6.2	…	…	…	…
34	Soaps, waxes	…	…	…	…	…	…	2.4	…
38	Misc. chemical products	…	…	…	…	…	3.0	…	…
39	Plastics and articles thereof	4.6	4.8	5.8	6.1	5.4	6.4	2.4	…
48	Paper and paperboard	5.4	6.0	12.9	12.3	18.2	14.3	5.4	7.9
49	Printed books, newspapers, pictures	…	…	…	…	19.9	15.8	…	2.6
68	Articles of stone, plaster, cement	…	…	…	…	4.2	5.8	…	…
69	Ceramic products	…	…	…	…	3.4	…	…	…
70	Glass and glassware	…	…	4.3	3.6	…	…	3.3	4.3
73	Articles of iron or steel	…	…	…	…	…	…	3.8	3.5
76	Aluminium and articles thereof	…	…	2.8	…	…	…	…	…
84	Nuclear reactors, boilers, machinery and mechanical appliances, computers	10.5	7.8	8,3	6.3	11.7	12.7	16.1	18.4
85	Electrical machinery, telecommunications equipment	…	3.8	3.9	5.9	3.3	6.3	8.0	7.5
87	Vehicles other than railway or tramway stock	8.6	13.1	…	…	…	…	26.1	17.1
89	Ships, boats	…	…	…	…	…	…	…	4.8
90	Optical, photographic, measuring, medical etc. instruments	6.6	5.5	…	…	…	…	…	…
94	Furniture, bedding, mattresses, lamps	…	…	…	…	8.5	5.8	…	…
10 major product group together (%)		80.7	80.5	56.1	55.7	81.7	76.1	77.2	73.1

Source: Customs Statistics on Foreign Trade of the Russian Federation (Tamozennaya statistica vnesney torgovlyi Rossyskoy Federaciyi), Russian State Customs Office, 2003

In principle all Visegrad-countries are interested in a more open - at least for EU-countries - Russian market. Based on present trade structures free trade would be beneficial for all of them.

Capital flows

Capital flows both from the EU to Russia and versus from Russia to the EU were on a relatively low level even before enlargement. Capital invested in Russia from the EU could be considered as modest in comparison with the theoretically huge potentials in Russia even though the EU itself is certainly the biggest group of investors in Russia, and some EU15 countries (the Netherlands, Great-Britain, Germany, Sweden and Finland) are among ten major country-investors (World Investment Directory, 2003 p. 322.). On the other hand although Russian capital outflow to the EU15 has been growing significantly over the past few years, it is still marginal in comparison with the whole sums of FDI invested in the territory of the old EU. The movement of capital thus certainly will be a major issue in future Russian-EU dialog.

These flows are even more modest regarding Visegrad-countries. Reasons for this are different. First, the four analysed countries are naturally not among major investors neither in the world generally nor in Russia specifically, since their companies are mostly undercapitalised. In this respect Hungary has a leading role – after Russians - within the whole Central-East-European region. Second, owing to their Western reorientation the main direction of capital flows from this region has been rather Western Europe than the East. Their investment eastwards aimed more their neighbouring countries than countries laying further from their borders. In the first period of their investing activity a common characteristic for investments directed towards the East including Russia was the relatively high number of smaller enterprises established abroad with low sums of investments. These investments in most cases were related to trade (for example trade representatives) while one could find examples for real common production rare. For the past few years new tendency has been emerging at least for Hungary. Hungarian big national companies began to turn with interest also towards the East (Ukraine, Russia etc.).

Unfortunately both national statistical systems on inward and outward FDI and the access to them differ in the four Visegrad-countries to a great extent. This is why complex comparison cannot be made. Most probably it is Slovakia from where companies *relatively* show the largest interest towards investing in Russia as compared to total outward FDI, and the Czech Republic, that paradoxically provides the widest range of information on the subject, is the less interested one in doing business within Russia. While Russia is among the ten major destinations in Slovakian outward FDI, it is only on the 17th place in the Czech Republic with a low proportion of 0.2 % according to the latest available figures on outward FDI-stocks. However, in volume terms the Czech and Hungarian investments in Russia are manifold of the Slovakian figure. The amount of Hungarian capital invested in Russia (and in general terms as well) is by far the highest one, though Russia is not a major destination for Hungarian FDI-outflow, with a low percentage of 0.6 and ranking 15th.

Table 8: Russia's position in outward FDI stock from Hungary, Slovakia and the Czech Republic, 2003-2004

	Value	Share in FDI-stock (%)	Ranking in country-investors' list
Slovakia (January 2004) In thousand USD	12.3	2,2	*9.*
Czech Republic (January 2003) In thousand USD	3136	0,2	*17.*
Hungary (January 2003) In million euro	12.4	0.6	*15.*
Source: Slovakian National Bank (www.snb.sk), Czech National Bank (www.cnb.cz), Hungarian National Bank (www.mnb.hu)			

Hungarian National Bank provides more actual information on yearly flows. These figures also indicate that Russia has not really been attractive destination for Hungarian investors for the past few years relatively, and the tendency is rather of decreasing character. In (absolute) value terms one could observe a growing tendency from an amount of 1.5 million euro stock in 1998 to 12.4 million by the end of 2002. Major Hungarian investments were made in Russian pharmaceutical sector and by Hungarian oil company, MOL which has established a joint venture with Yukos to produce oil in West-Siberia. (A considerable part of investments made by MOL are probably not yet included into the presented statistics.)

Table 9: Yearly Hungarian net outward investments in Russia

	2000	2001	2002	2003	2004 I. half
In Russia, (million euro)	11.1	18.9	3.4	1.0	0.7
In Russia, % in total	1.7	4.6	1.8	0.08	0.2
Total Hungarian investments abroad (million euro)	*664.8*	*409.4*	*189.8*	*1297.1*	*215.7*

Source: Hungarian National Bank (www.mnb.hu)

As far as FDI originating from Russia is concerned it has been also more concentrated on the developed markets (EU15 and the United States) and CIS-countries. Another – but not main - reason for the low level of Russian invested money is the widely known 'reluctance' on part of some Visegrad-countries to let Russian capital into their economies considering

Russian money to be dangerous either from the point of view of national security (too high dependence on Russia) or simply because of its frequently non-transparent origin.

Anyhow the picture on the latter issue has been varying from the most 'reluctant' Poland to the indifferent Czech Republic or the controversial Slovakia. Interestingly, it is Poland where the share of Russian investments in total is the highest one due to one Russian giant, Gazprom interested in gas transfer through Yamal-pipeline. Gazprom, that invested 1284 million USD of total 1292 million USD Russian capital brought into Poland, possesses a 48% stake in Europol Gaz and a 32% stake in Polgaz Telekom. These capital investments put Gazprom into the list of ten major foreign investor-companies in the country (ranking 7. according to 2003 December information of Polish Information and Foreign Investment Agency, PAIiIZ). Beside Gazprom there are only two other Russian companies on the list of 996 company-investors with investments above 1 million USD of PAIiIZ: Lukoil (ranking 657.) with investments worth 5,5 million USD in gas station network and another firm in food-processing (ranking 825.) with 2,6 million USD! According to official Polish statistics Russian company presence is very rare in Poland, the figure for FDI (1292 million USD) originating from Russia stands rather steadily without significant changes since Gazprom transactions.

Poland is extremely cautious about admitting Russian capital into strategic positions. One example for this approach is the postponement of the planned fusion of Hungarian MOL and Polish PKN Orlen oil concerns in April 2004 arguing, that according to a study made for the Polish Ministry of Foreign Affairs, such a fusion would pave the way for an easier buying off of the company by Russians, namely Russian oil concern Yukos. However in the light of latest events with Yukos this threat is no longer realistic. The issue of Russian investments is heavily discussed in the country. While according to the new official strategy of PAIiIZ investments from two new directions – Russia and China – should be welcome apart from strategic sectors, such as defence or energy (PNB – Economic Review, 23. April, 2004). On the other hand voices calling for carefulness toward Russian capital are still strong. Another problem is that Russian investors are most interested just in the energy sector and those sectors suggested by Polish officers – food processing, mining, steel or heavy industries - might be not so attractive for them.

In Slovakia Russian investors are already near to strategic position. During first 2000-ies Russian firms entered Slovakian business connected with transportation of Russian fuels across the territory of the country. Yukos bought a 49% stake in the former Slovakian state company Transpetrol for 74 million USD. Then Gazprom became a member of international consortium together with German Ruhrgas and French Gaz de France that won the tender for a 49% package in Slovak Gaz Industry. Both companies used to be state monopolies before privatisation, but the state still holds a controlling share of 51 per cent in both companies (Duleba 2003). Russia is not among the ten major investor-countries, on which Slovakian central bank provides information.

Table 10: Russia’s position in FDI-stock in Visegrad-countries, 2002-2003

	Value	Share in FDI-stock (%)	Ranking in country-investors' list
Poland (January 2004)	1292 million USD	1.9	*11.*
Czech Republic (January 2003)	23.9 million euro	0.06	*29.*
Hungary (January 2003)	67.7 million euro	0.2	*21.*
source: national statistics (Polish Information and Foreign Investment Agency, Czech National Bank, Hungarian Central Statistical Office)			

Russia is not included into the list of main country-investors neither in Hungary. However, beside normal business decisions according to which Hungary was not too attractive state for Russian investors, another impediment to a more active presence of Russian capital in Hungarian economy for the last few years has been maintenance of excessive prejudices on part of Hungarian business circles and also country leadership toward Russian investments. The so-called Borsodchem affair burdened Hungarian-Russian bilateral relationship at high levels mainly because governmental communication was too open to say that Russian influence in the affected company was undesirable. (Russian offer made through intermediary firm registered in third country was refused on the competition for Hungarian chemical industrial company, Borsodchem’s stake.) Anyhow, most recent data still do not indicate a high interest on part of Russian companies in doing business in Hungary even under the already changed government that declared its readiness to intensify business contacts with Russia and smooth away bad experiences inherited in bilateral relationship (Ludvig 2004).

Table 11: Russian yearly net FDI-flows into Hungary, 2000-2004

Russian yearly net FDI-flows into Hungary, 2000-2004					
	2000	2001	2002	2003	2004 I. half
million euro	0.7	6.6	-7	-0.1	0.6
% in total yearly inward FDI, (%)	0.05	0.6	…	…	0.1
source: Hungarian National Bank (www.mnb.hu)					

As far as the Czech Republic is concerned Russian investments are at a very low level (see www.cnb.cz). Russian capital mainly aims at trade and health services, in the latter case meaning stakes in Czech baths at popular resort places.

Anyhow Russia’s presence in all the analysed countries is most evidentially more significant than the level that statistical data may reflect. Russian firms, similarly to other countries, have arrived into these states, through Cyprus or other tax-paradises. They also use other tricky means that are difficult to follow, in order not to be indicated as of Russian origin. It is most probably that statistics do not reflect the whole truth. (To give one example, in Hungarian bank ÁÉB that used to be in 100% Russian ownership belonging to the Gazprom empire, according to recent statistics Russian ownership share declined to a great extent, however it is still a Russian-led bank in reality.)

Policy issues – Implications for the "two big EU-Russian economic projects"

As one Slovakian analyst, Alexander Duleba argues (2004) "The way in which internal political processes in Russia, the Ukraine and Belarus are understand and perceived in Central Europe differs – due to a long historical, political and cultural experience – to a large extent from those of the 'old' Member States in Western Europe". Their interests and instruments also may reflect differences.

Accession of the Visegrad-countries will probably have impacts on both launched big EU-Russia projects that is on the proceedings of the Common Economic Space and the energy dialog. However, a basic problem is that the analysed countries are most probably not prepared enough to manifest their own well-formulated approach or "strategy" on Russia, as already mentioned before. Firstly, they all were so much concentrating on their EU accession process that they simply did not possess the necessary "energy" (staff and time) for issues related to Russia or other countries of the "Eastern Dimension" with perhaps the exception of Poland. These countries have hardly enough experts on Russia and other CIS-countries, especially when dealing with economic issues. Even examples for scientific researches in the subject are only a few. Concerning the "Eastern Dimension" perception Visegrad4 are lagging behind the old EU15's preparedness, notwithstanding the fact that the matter is much more theirs. They were not only missing their strategies on pure bilateral issues, but what is more important in today's circumstances they do not have that kind of a strategy as EU-members also. Nevertheless the necessity of these national approaches is well recognised by experts in almost all the analysed countries. For example Anita Orbán argues that the coming few years will provide Hungary with an opportunity to influence the Union's eastern policy in keeping line with her own interests (2004). Interestingly, basic standpoint of both recent Hungarian and Czech 'strategy' on Russia is emphasising the importance of normalised bilateral political relations (Ludvig 2004; Kratochvil 2004).

Secondly, Poland, as partly being an exemption, has developed and followed her own Eastern strategy that was made for and introduced in Brussels instead of having been discussed it at high levels among the Visegrad-countries that face very much similar problems to the Polish ones. This could not have happened in another way since other Visegrad-countries (for example Hungary or the Czech Republic) do not accept the well-formulated desire by the Polish of being leader in the matter among Central-East-European countries. (See as an example Czech political scientist, Jiri Pehe, cited by Katarzyna Kolodziejczykin in Poland's Foreign Policy, 2004 p.32. as being "sceptical about Poland's capacity to collaborate within the Visegrad-group framework".) As one Hungarian official put it into words, "the Polish want to monopolise the Eastern issue". It is most probably that Poland's communication on the issue toward other Central-East-European countries has been too aggressive by putting Poland into leading position in a one-sided way. In spite of the rhetoric will of the Visegrad4-countries the lack of ability or readiness of them in co-operating on such issues in the short term is evident. (To give an example: Hungary developed a joint proposal with Austria for projects concerning Ukraine in the framework of the outlining EU neighbourhood program, instead of involving into the work other acceded Central-European partners, Slovakia or Poland, countries with which she share very much common interests in the matter.)

Thirdly, consistent strategy on *economic* relations with Russia has been missing in all the four analysed countries. Polish approach, which is the most advanced formulated, is very much of political character, and the country does not have a strategy regarding economic issues (PNB- Economic Review – 23. April, 2004). Though it must be mentioned that Poland adopted a document, entitled "Guidelines on Polish Policy towards Russia", in 2000. In economic respect it mainly stands for enhancing Polish exports (Menkiszak 2003). Another document, adopted by the government in June 2001 reflected Poland's vision on future EU Eastern policy, in which main goals of EU Eastern policy, the Polish position and potential Polish input in the "Eastern Dimension" were formulated.

Fourthly, there is an emphasise-shift between EU15 and Visegrad-countries. Due to all implications for the latter of being in direct neighbourhood with Ukraine (and Belarus for Poland), they give preference to solving the problem of EU-Ukrainian relations within the enlarged EU. Sometimes, Russia, the strategic partner of the EU, ranks only on the third place in certain Polish analyses! Though Polish experts, unlikely to the practise in the past, underline the importance of taking active part in creating Brussels policy vis-à-vis Russia (politician Jozef Oleksy and expert Danuta Hübner, in Poland's Foreign Policy, 2004), concrete details of this contribution are very much unclear.

Anyhow, both Eastern and Western analysts and even Russian ones may agree that in a future process, which will aim at integrating Russia into the common political and economic development of the continent the role of the Central-European EU member countries, including Visegrad-states, will be significantly upgraded both for the EU and for Russia.

Common Economic Space

Visegrad-countries may have different approaches towards EU-Russian giant project of CES. As far as simple trade issues are concerned most probably they all are interested in liberalising process with hopes for better access to the attractive Russian market. According to recent official Hungarian statement Hungary is for liberalising trade with Russia including the introduction of free trade regime. However, it is only Slovakia – and to a less degree Poland - with which free trade was concretely on the bilateral political agenda already in the mid-nineties. The practical framework for the free trade regime between Slovakia and Russia was laid down in 1996, during the special in Russian-Slovakian relations Meciar-period. The idea had to be dropped due to Slovakia's other international obligations with the EU, the Czech

Republic, WTO and Central European Free Trade Association (CEFTA) that required consultations on this kind of issues (Duleba 2003). A declaration on trade liberalisation was signed in 1996 in Moscow also between Poland and Russia that provoked debate in Poland, although it did not initiated concrete steps before Russia's WTO-membership (Menkiszak 2003). However, in general terms Visegrad-countries' accession will not bring about further significant changes in the commercial and economic co-operation between them and Russia (and other CIS-countries), since the change in commercial reorientation already took place during the 1990-ies (Köves, 2004).

Further major goals of the CES project like free movement of capital or persons may draw dividing lines both among them and between old member-states. While free movement of capital is a widely accepted idea in the EU15, its wholly consistent implementation regarding Russian capital may raise concerns and strong emotions in some of the Visegrad-countries. The strengths of these emotions vary country to country and from time to time with different domestic political forces in power in the background. As a tendency leftist political forces in all Visegrad-countries tend to show readiness to intensify political and economic relations with Russia or to arrange old unsolved problems by compromise (Menkiszak, Duleba 2003; Ludvig 2004; Pehe 2002). Anyhow, the Russian issue – Russian capital that may lead to growing Russian influence - remains to be very sensitive under the government of all political forces in Poland provoking strong debates within the society. Poland will keep most probably her reservations towards Russian capital in the future as well especially if strategic sectors or companies are concerned. On the other hand it was possible in Slovakia for Russian oil company Yukos and giant Gazprom to enter the Slovak oil and gas industry even after the 'special' Slovakian-Russian period that is already in early 2000-ies. The issue of Russian capital 'invasion' is not a relevant problem for the Czech Republic, which is geographically out of major Russian interests, and with which relations are more on pragmatic basis than motivated by politics. (However, some Czech politicians also considered it important to normalise the formerly rather cool relations with Russia that was finally realised during the 2000-ies, similarly like in Hungary or partly in Poland. http://newsfromrussia.com/main/2003/04/25/46380_.html) As chairman of the Czech Parliament's foreign affairs committee, Lubomir Zaoralek said in an interview in April 2001, the Czech Republic was only then starting to think about Eastern Europe. (http://archiv.radio.cz) In Hungary relations with Russia also seem to be more depending on political fluctuations. The leftist-liberal government in 2002 (that was followed by present government in autumn 2004 appointed by the same political coalition) declared its openness toward Russian investments, which were said to be treated in the future like any other money, based on the same rules: prudence and transparency.

A most awkward question is more free movement of persons, the issue that seems to be of key importance for Russia on the EU-agenda. It is difficult to predict whether Visegrad-countries will be for or against the idea, but reservations on part of them cannot be excluded. It is worth mentioning that some of these countries – for example Hungary and Slovakia -

introduced visa regime with Russia earlier then it was a 'must' for them. The issue is likely to raise hard discussion within the old EU as well.

All the above mentioned facts and argues indicate that outlining CES concept that has not been discussed with the Visegrad-countries – and other new-members - before their accession will face more problems either to be finalised or to be fit to a concrete timetable either because new-comers may raise objections or – partly- due to their unpreparedness on the issue. By the time being officially all the four countries accept present approach of the union toward Russia in its main lines. Anyhow, the most realistic scenario for the foreseeable future – also in the light of Visegrad "contribution" – is to carry on negotiations only on free trade. In the light of hard EU15-Russia negotiations on Russian WTO-accession even this modest goal is likely to face difficulties both on Russian side and within the enlarged EU. Other goals aimed at deeper integration will probably remain for the future. However, Russian legislation convergence, that is also organic part of the CES concept, is naturally not against Visegrad interests but rather may be an issue of Russian reluctance and concerns.

Energy dialog

Energy dialog is a hot issue for the group of Visegrad-countries due to several factors: 1. their high dependency on Russian deliveries; 2. the direction of oil and gas transportation routes; 3. the potential Russian investments in their energy sectors. It is still a question whether these countries will become real active parts of this dialog or not. EU-membership means huge chance for them to become real partners of Russians in the energy issues which was not the case in their bilateral relations previously. "The lack of clear strategy has led to a situation in which Poland is an object rather than subject in the gas negotiations" stated Janusz Steinhoff minister of economy in the Buzek cabinet. (PNB – Economic Review, 23. April, 2004) The situation, that was similar between Hungarian MOL and Yukos for many years, finally turned into partnership based on common production of a joint company. After 1st May 2004 all the new-comers might have their words in the dialog, where the EU and Russia are equal partners.

Anyhow, energy dialog is also burdened with indefinite answers to key questions. Until May 2004 Russia was a major supplier of energy to the old EU, but EU dependency on these supplies was not exceeding certain limits (10% in gas and 20% in oil). It was only the commodity group of oil products in which Russian share was above 30%. With the enlargement, and especially with Visegrad-countries' membership this dependency has been increasing to 30% in oil and 67% in gas imports (Timmermann 2004). The enlarged EU still owes with answering the very question, whether this new high level is acceptable for the community or not. If the answer will be "Yes", EU-Russian relationship may develop and intensify in the future and strategic partnership may be filled with real content. According to recent communication of the Commission on the issue there will not be new direct limitations on Russian deliveries. However the EU Green Paper dealing with Europe's energy security expresses the need to further diversify external suppliers (Bordachev 2003; Dodonov 2003).

In the light of this, pressure from Brussels may come onto national (Visegrad) governments to take steps in order to reduce dependence on Russian deliveries. So, the answer may be a practical "No" that would create serious problems and impediments in EU-Russian partnership, since basic Russian interests would be touched. A very clear answer is not likely to be given from Brussels in the short term. Affected member-states may also have their own decisions in the matter. They may begin or continue to diversify their energy supplies independently from the Brussels answer which makes the dialog between Moscow and Brussels more complicated. At the moment probably it is Slovakia that has the poorest idea and intention to diversify her import sources, and probably the issue is most hot in Poland. According to some ideas Poland should take steps so as to decrease this dependence especially in the case of gas for example by substituting Russian gas by imports from Norway (Gromadzki 2002). In Hungary the main streamline in thinking is that the country must possess alternative transportation routes for vis major case – which have already been achieved - , but should maintain Russian supplies if such circumstances do not occur. Czech transportation system has already been linked to the West-European one also, and since the mid-nineties a gradual reduction of Russian percentage may be observed both in gas and oil supplies (Votápek 2003).

However, recent developments around major supplier in Visegrad-countries, Russian oil giant Yukos may confirm fears connected to the very high degree of dependence on Russian deliveries especially on one supplier. The Yukos affair also proves that Russia is still a 'special case' within the group of transition countries with her own 'values and norms', and opinions on the necessity of avoiding excessive Russian influence are not baseless.

Another major issue of energy dialog with high relevance for the Visegrad-countries is the issue of transit. Since they lay along main oil or gas pipelines they are interested in a transportation system that can be used by all interested parties with clear rules without discrimination. This has been a hot issue between the old EU and Russia even in negotiations on the Energy Charta. Signing of the Charta by Moscow would give more chances for other than Russian suppliers to enter the European gas and oil market that could pave the way for diversifying energy sources. However other analysts, for example Timmerman (2004) call attention, that diversification intentions on part of the enlarged EU should not necessary clash with Russian interests, since the Russian also intend to diversify their export routes, and naturally their export capacities will be limited to a certain extent.

Notwithstanding the mentioned problems energy dialog is a most promising field of co-operation between Russia and the enlarged EU, where Visegrad-states will also have to formulate their strategies taking into consideration both common European and national interests.

Summary

This paper tries to contribute to answering the challenging question, raised by the conference *New Europe 2020, Visions and Strategies for Wider Europe"* in Turku 2004 August, how relations between the enlarged European Union and its new neighbourhood are expected to change? Visegrad4-Russian economic relations are in its focus in the context of enlargement.

Though during the 2000-ies EU-Russian relations have arrived at both a more intensive and a more realistic stage in a comparison with the proceeding Yeltsin-period of the nineties, there is still lot to do in order to outline definite future directions. In principle both sides declared to be each others' strategic partner while in practise the content of the strategic partnership is still far from being clear. The situation with the Common Economic Space, the huge economic 'project' of the EU-Russian partnership is very much similar: wonderful loud words at high level meetings and rather silent but deep doubts at practical levels. Energy dialog that has already resulted in some concrete common steps also needs to answer basic issues of clashing interests besides putting the common ones into useful practise.

2004 May enlargement makes things even more complicated by increasing the number of parties with possibly different interests in the dialog on the one side and by the growing number of EU-members without clear objective national approaches on Russia on the other side. Though pure economic interests of the recently acceded Visegrad-states would call for intensifying economic relations with Russia political considerations in many cases prevent them from doing so. The 'legacy of the past' puts brakes into their dialog with Russia especially in Poland.

Regarding trade, Visegrad countries are interested in a more open Russian market envisaged also by the CES-concept. Since trade patterns between Visegrad –countries and Russia became extremely one-sided during the last more than ten years, Visegrad-countries are now very keen on getting back to the huge Russian market with a wider scale of industrial products or processed food. It is more and more apparent that old-fashioned trading methods will not bring the desired business results without other kinds of market presence that require capital investment. Although at moment investment links between Russia and the analysed four countries are rather weak, most probably they will turn to be more intensive in the future. It will be a 'must' for Visegrad-countries to invest in Russia in order to be able to preserve recent market positions or rather to acquire new ones. In line with Russian energy companies' strategies, but also with those in other sectors, Russian FDI in these countries will also show a rise even though statistics may not reflect this tendency correctly.

Energy is and will be in the focus of Russian-Visegrad4 economic links. However, the problem of Visegrad (and other Central-East-European) countries' high dependency on Russian deliveries should be tackled in a way that is acceptable for all affected parties. This will remain a major issue in future EU-Russia dialog.

Research on Visegrad-countries' potential policies concerning Russia within the EU-framework faces large limitations. Firstly, information on even their national policies on Russia is limited. With the exception of Poland's vision of Eastern Dimension, similar

strategies in other Visegrad-countries are either missing or non-available for analysts. Thinking about their countries role in future EU-Russia dialog has been started earlier within Visegrad think tanks. The still very few common conferences and published books on the issue are first signs of this kind of expert co-operation. However, their suggestions and findings do not necessarily coincide with official courses. Most analysts are aware of the importance of the missing policies and strategies, or of the fact that their countries are lagging behind in preparedness. An interesting research field in the future will be following these new-members' – active or passive – behaviour in forming EU-policies on Russia and other European CIS-countries. They have the chance to influence these policies, when at the same time they have their own interests and approaches that should be included. Will they take the opportunity? Will their business circles push them to do so or answers will be given rather based on political considerations?

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THE ENLARGED EUROPEAN UNION AND ITS EASTERN NEIGHBORHOOD[1]

Vasily Astrov and Peter Havlik

Abstract

This paper deals with the economic relations between Russia, Ukraine and the enlarged European Union. We start with some essential characteristics regarding the huge gaps in the size and trade structures of these three economic entities, before briefly outlining the development of their institutional relations. We discuss the impacts of EU enlargement on Russia and Ukraine, as well as the prospects for Russia–Ukraine relations. Given all the complexities of these relations, the mutual interdependence and the uncertainties concerning the future, we conclude that rather than devising grand new schemes, Russia, Ukraine and the EU should focus on practical steps that would facilitate closer cooperation in areas such as the development of border regions, the implementation of a free trade area and the support of economic reforms. Regarding Ukraine, whose official aspirations of EU membership seem highly unrealistic at least in the medium term and whose already high economic dependency on Russia is becoming even more pronounced, the policy challenges will be formidable. Whether Ukraine will succeed in a fine-tuned balancing act to establish closer relations with both the enlarged EU and Russia simultaneously, remains to be seen. As concerns economics, Ukraine's already intense eastward integration may even deepen – despite Ukraine possibly getting more hearing in the EU at the insistence of some new member states.

Keywords: foreign trade, foreign direct investment, integration, EU enlargement
JEL classification: F1, F15, F21

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Introduction

The accession of ten new countries, eight of them from Central and Eastern Europe, to the European Union in May 2004 shifted EU borders much further to the east. As a result, the European Union now finds itself neighboring Ukraine – the second biggest country in Europe. Also, the EU's border with the biggest European country – Russia – has become much longer, and one of the Russian regions (Kaliningrad) is now encircled by EU member states.
The new geopolitical realities cannot but have implications for the economic relations between the enlarged European Union and these two countries. The present paper attempts to

1. identify the individual economic dimensions of these relations, including trade, investment, and institutional aspects;
2. assess the likely impact of the EU enlargement on Russia and Ukraine in the short, medium and long run, as well as its possible consequences for Russia–Ukraine relations;
3. address the resulting policy challenges for future regional cooperation.

Economic asymmetries

The EU (European Union) and Russia are very unequal partners in nearly all respects; their cohabitation in the 21st century has been paraphrased as that of the European elephant and the Russian bear (Emerson, 2001). This is in many respects also true for EU–Ukrainian and, for that matter, Russia–Ukraine relations. In order to understand the complexity of EU–Russia and EU–Ukraine economic relations, it is useful to recall a few basic facts:

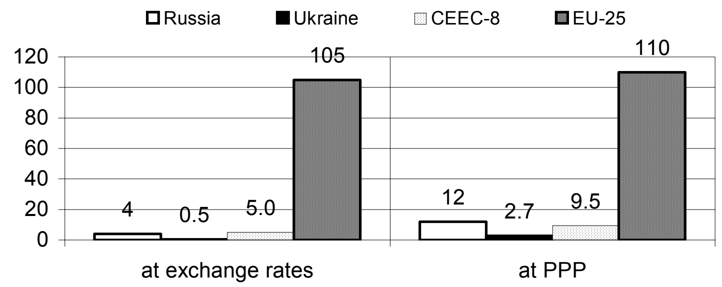
- The EU population of 455 million after enlargement with the CEEC-8 (the eight Central and East European countries Czech Republic, Hungary, Poland, Slovak Republic, Slovenia, Estonia, Latvia and Lithuania) on May 1, 2004 compares to the current 144 million population of Russia and the 47 million population of Ukraine (both declining). In terms of population and territory, both Russia and Ukraine are big countries – their combined population amounts to 42% of the enlarged EU-25.
- Russia's real GDP of about EUR 1100 billion in purchasing power parity (PPP) terms amounted, in 2003, to some 12% of that of the EU-15; in nominal terms (EUR 385 billion at the current exchange rate) it was just 4% of the EU-15 level. The real size of the Russian economy is thus about 30% bigger than that of the eight CEECs combined, but it is smaller in nominal terms. Consequently, the real size of the economy of the enlarged EU-25 is nearly ten times bigger than that of Russia (Figure 1).
- Ukraine's GDP in 2003 stood at about EUR 240 billion in real terms (less than 3% of the EU-15 level) and at a mere EUR 43 billion in nominal terms – a tiny 0.5% of the

EU-15 level. Ukraine's economy is thus rather small, about one fifth the size of Russia's.

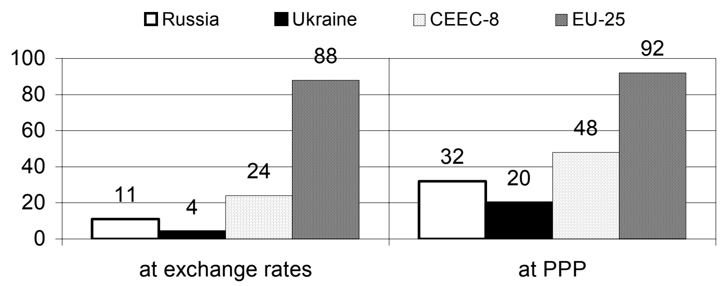
- Russia and Ukraine are also much poorer than the EU: in 2003 their respective per capita real GDP stood at just 32% and 20%, respectively, of the EU-15 average – much below the average of the CEECs. Russia's per capita real GDP amounted to just 35%, and Ukraine's to just 22% of the enlarged EU (EU-25) average. These huge income gaps are likely to persist in the foreseeable future, despite possibly faster GDP growth in both Russia and Ukraine in the coming years.

Figure1: Economic size and GDP per capita in Russia, Ukraine, CEECs and EU-25 in 2003 (EU-15 = 100)

Economic size (GDP)



GDP per capita

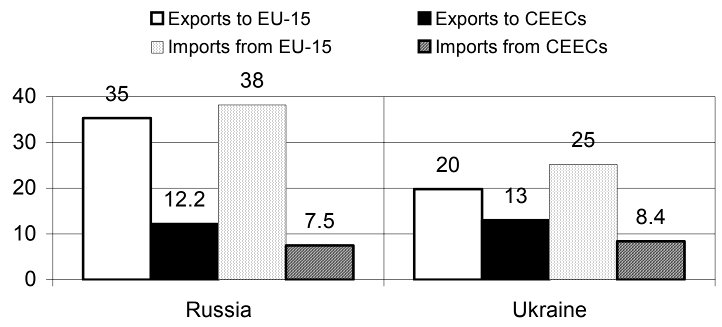


Source: Own calculations using national statistics and Eurostat

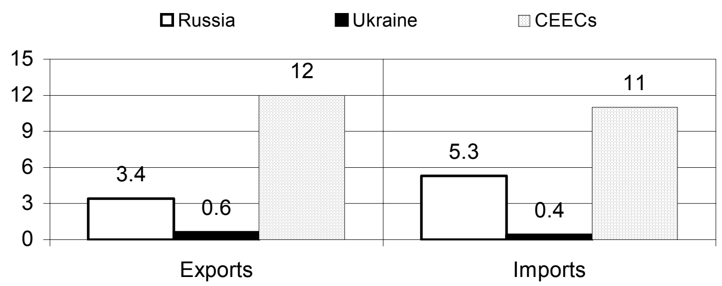
A similar asymmetry exists in trade. After the collapse of the CMEA (Council for Mutual Economic Assistance) and of the USSR in 1991, the EU soon became *Russia's* main trading partner. In 2003, more than 35% of Russian registered exports and nearly 40% of imports were traded with the EU-15. EU exports to Russia, by contrast, have fluctuated at just around 3% of total EU exports since the second half of the 1990s (peaking at 3.6% in 1997); in 2003 their share was 3.4%. Likewise, EU imports from Russia accounted for only 5% of total EU imports in 2003. In comparison, the CEECs' share in total EU exports exceeded 12% in 2003, while their share in total EU imports was 11% (Figure 2). Russia is thus a relatively small trading partner for the EU – its importance is currently about the same as that of Hungary. At the same time, the EU is by far the main trading partner for Russia, accounting for a larger part of its overall huge trade surplus. Moreover, the importance of the EU will grow further following the enlargement: assuming current trade structures, the EU-25 accounts for nearly half of total Russian exports and imports.

Figure 2: Directions of trade: Russia, Ukraine, CEECs and EU-15 in 2003, in % of total

Russia and Ukraine



EU-15 (extra)



Source: Own calculations using national statistics and Eurostat

Since 1995, *Ukraine's* exports to the EU have more than doubled; they reached EUR 4 billion by 2003. This development was well in line with the general trend of former Soviet republics' export re-orientation towards non-CIS (Commonwealth of Independent States) markets. Imports from the EU have increased dramatically as well, reaching EUR 5.1 billion in 2003. However, they underwent a temporary setback in 1999, following the Russian financial crisis and the subsequent devaluation of the UAH (Ukrainian *hryvnia*), which brought about a temporary reduction of Ukraine's persistent trade deficit with the EU. Since 1999 that deficit has been on the rise again, reaching EUR 1.1 billion in 2003. Despite its growing importance, the EU-15 accounted for only 19.8% of Ukraine's exports and 25.2% of its imports in 2003 (Figure 2). Both figures are well below not only those for the CEECs, which conduct about 70% of their trade with the EU, but also e.g. Russia. Thus, when it comes to trade, Ukraine's integration with the EU is even lower than Russia's. In turn, for the

EU-15, the importance of Ukraine as a trading partner is negligible (0.6% in terms of exports and 0.5% in terms of imports), reflecting the huge gap in the size of the two economies.

The *commodity structure* of Russian and Ukrainian trade with the EU is also indicative of the existing enormous economic asymmetries. There is virtually no intra-industry trade between the two countries and the EU (or, for that matter, between them and the CEECs). Whereas the EU sells to Russia *de facto* only manufactured products, 45% of which are made up of machinery, transport and electrical equipment, the latter three commodity groups represent only 1.3% of Russian exports to the EU (Table 1). Indeed, more than half of Russian exports to the EU consist of crude oil and natural gas. The Russia–CEEC trade structure is similar to that of Russia's trade with the EU: energy-related products account for more than 80% of Russian exports to CEECs – an even higher share than in exports to the EU-15 (*Revue Elargissement*, No. 61, March 2004, p. 1). Even within manufacturing industry trade, energy carriers (refined petroleum and nuclear fuel) as well as basic metals and fabricated metal products accounted each for more than 30% of Russian exports to the EU in 2002 (Table 1). The evolution of the Russian export structure to the EU over time has not been encouraging either (Appendix Table A1). Between 1995 and 2002, the highest gains in Russian manufacturing industry exports were achieved by refined petroleum, nuclear fuel, iron and steel, fish products and wood, i.e. products with relatively low value-added. Generally speaking, apart from energy carriers and metals, Russia's role as a trading partner for the EU is marginal.

Ukraine's export structure is somewhat more favorable: around three quarters of Ukrainian exports to the EU-15 represent manufacturing industry products, the most important items being basic metals (21.2% of total), fuels (15.8%), and textiles (11.2%; Table 1). Exports of oil products have surged particularly fast since 2001 (as have exports of crude oil and natural gas), partly reflecting the high world market prices, but also the lifting of the ban by Russia on its fuels re-exports. However, basic metals are still the principal area of Ukraine's specialization *vis-à-vis* the EU. This is largely due to basic iron and steel: Ukraine commands a share of 5% in total EU imports of these products. By contrast, chemical products, particularly basic chemicals, have been the major loser: their share in manufacturing industry exports to the EU contracted from 14% in 1995 to just 4.9% in 2002. Other products that have suffered a considerable decline are, for instance, dairy products and meat. Apart from the manufacturing industry, agricultural exports have been generally quite important as well, although their share has fluctuated widely, largely on account of the changing weather conditions for harvests. Similarly to the case of Russia, the structure of Ukraine's imports from the EU has remained relatively stable over time, with various types of machinery and equipment (including electrical, optical and transport equipment) accounting for nearly half of total manufactured imports from the EU in 2002.

The current structure of Russian and Ukrainian exports does not provide much room for growth and makes these countries highly vulnerable to volatile commodity prices. However, the current account surpluses enjoyed by both countries could, at least theoretically, allow for more imports of *investment* goods, badly needed for the modernization of their economies. As illustrated by the example of the CEECs, such imports and more FDI (foreign direct investment) inflows may also gradually form a basis for a subsequent upgrading of Russian and Ukrainian export structures. Thanks to successful industrial restructuring facilitated by the high inflow of FDI, during the period 1995-2002, the CEECs' manufacturing exports to the EU were growing at 16% per year, making strong inroads into the EU market in a wide range of manufactured products, such as motor vehicles, TV, radio and telecommunication equipment, office machinery and computers (Appendix Table A3).

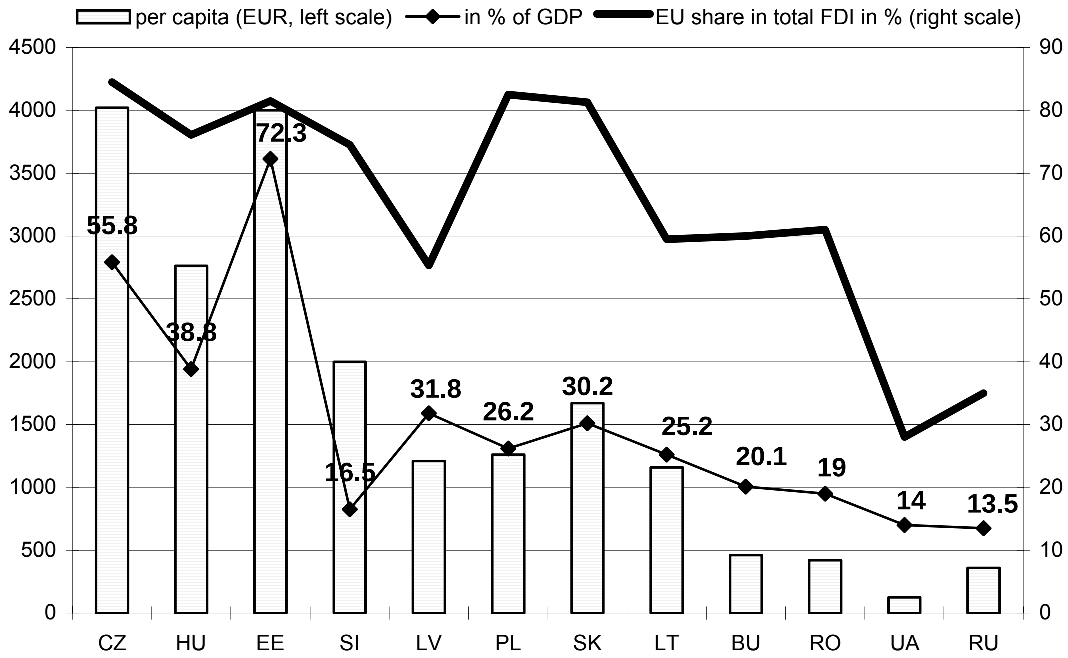
Needless to say, the precondition for such a development in Russia and Ukraine is an improvement in the domestic climate for investments and the curbing of capital flight. Despite a recent acceleration in domestic investment, particularly in Ukraine, both countries remain net capital exporters. So far, the inflows of FDI have been meager, and the level of FDI penetration remains much lower than in the CEECs (Figure 3). Besides, the share of the EU as a foreign direct investor in Russia and Ukraine is much below those observed in CEECs – another piece of evidence of the limited degree of integration, which is particularly alarming in the case of Ukraine.

Table1: Structure of EU-15 trade with Russia and Ukraine

		Russia				Ukraine			
		EU-15 exports		*EU-15 imports*		*EU-15 exports*		*EU-15 imports*	
NACE rev. 1 classification		1995	2002	1995	2002	1995	2002	1995	2002
	Total (EUR million)	15326	29102	17858	39130	2019	5236	1460	4029
	shares in total (%)								
A,B	Agriculture	2.3	2.6	3.2	3.0	2.0	2.2	7.1	16.1
CA	Extraction of crude petroleum and natural gas, coal	0.0	0.0	29.0	51.6	0.0	0.0	4.2	7.2
CB	Mining of metals	0.2	0.1	0.3	0.2	0.0	0.0	0.1	0.3
CB	Stone and clay	0.0	0.1	0.9	1.0	0.8	0.6	1.1	2.5
DA	Food products; beverages and tobacco	21.2	9.5	3.0	1.6	13.7	4.6	8.8	6.1
DB	Textiles and textile products	5.1	5.9	1.2	0.7	7.8	10.7	10.8	11.2
DC	Leather and leather products	3.0	1.9	0.5	0.3	1.8	2.2	3.2	3.1
DD	Wood and wood products	0.9	0.8	2.4	1.8	0.4	0.5	0.7	2.9
DE	Pulp, paper & paper products; publishing & printing	3.3	3.9	2.6	1.1	3.0	3.9	0.1	0.1
DF	Coke, refined petroleum products & nuclear fuel	0.5	0.5	11.3	17.1	3.4	0.8	7.5	15.8
DG	Chemicals, chemical products and man-made fibers	8.5	12.3	7.1	3.4	11.2	13.8	14.0	4.9
DH	Rubber and plastic products	2.2	3.3	0.1	0.0	2.2	3.8	0.2	0.3
DI	Other non-metallic mineral products	1.7	1.9	0.2	0.1	1.4	2.0	0.8	0.4
DJ	Basic metals and fabricated metal products	5.7	5.7	32.1	15.5	4.9	5.2	29.7	21.2
DK	Machinery and equipment n.e.c.	18.7	18.9	0.7	0.4	19.1	19.1	1.2	1.6
DL	Electrical and optical equipment	14.9	19.5	0.6	0.5	11.9	14.8	1.4	1.5
DM	Transport equipment	7.2	9.7	2.1	0.4	12.9	12.3	7.0	2.8
DN	Manufacturing n.e.c.	4.5	3.2	2.2	1.0	3.4	3.3	1.9	2.0
E	Electricity	0.0	0.0	0.4	0.4	0.0	0.0	0.0	0.0
	Others	0.3	0.4	0.1	0.0	0.2	0.1	0.0	0.0

Source: Own calculations based on Eurostat Comext Database

Figure 3: Stocks of inward FDI in CEECs, Ukraine and Russia, 2003



Source: Own calculations based on wiiw-WIFO (2004)

The EU, on the one hand, and Russia and Ukraine, on the other, are very unequal partners in nearly all respects, including the size of their economies, as well as the volume and composition of their trade. In terms of trade and investment, the degree of integration with the EU is low in the case of Russia, but even lower as concerns Ukraine.

Institutional relations

The EU's institutional relations with Russia and Ukraine largely reflect the above-mentioned economic asymmetries. The centerpiece of these relations over the past ten years or so have been the so-called *PCAs (Partnership and Cooperation Agreements),* which support the respective country's efforts towards democracy and the approximation of its legislations to EU standards. In the sphere of the economy, the agreements aim at fostering trade and investment by granting better access to each other's markets, creating a level playing field for investment, and promoting cooperation in a number of priority areas. In the area of *trade*, the PCAs contain the body of WTO (World Trade Organization) rules and norms, despite the fact that neither Russia nor Ukraine has become a WTO member so far. Most importantly, the agreements envisage the MFN (most-favored-nation) principle in merchandise trade, although many items of Russian and Ukrainian exports to the EU enjoy in fact even lower import tariffs provided by the so-called GSP (Generalized System of Preferences). The PCAs also mention the possibility of establishing free trade zones in the future and ensure the freedom of transit of goods destined for third countries. Any subsidies distorting free and fair competition between domestic and imported goods are unwelcome, except in the production of unprocessed agricultural and mineral products. Generally, the PCAs also forbid the application of quantitative restrictions in mutual trade, although they grant the EU the right to impose import quotas on textiles and steel products. Meanwhile the textiles quotas have been abolished, but those for steel are still in place.

Also, the PCAs aim to create a favorable and stable climate for *investment* by easing the establishment and the operating conditions for each other's companies. In particular, the EU grants 'national' (non-discriminating) treatment to Russian and Ukrainian companies operating on its territory, although certain 'sensitive' sectors (mining, fishing, real estate, audio-visual services, telecommunications, certain professional services, agriculture, and news agencies) are exempted. In turn, European companies wishing to establish themselves in Russia and Ukraine are given the choice between 'national treatment' (the rules applied to domestic companies) and 'MFN treatment' (the 'best' rules applied to foreign companies). However, in certain sectors (banking, insurance, real estate, natural resources, fishing, hunting, agriculture, lease of state property, telecommunications, mass media, certain professions, and operations affecting historical monuments) the MFN principle is applied uniformly.

The EU has also been assisting Russia and Ukraine within the framework of the *Tacis* (Technical Assistance to the Commonwealth of Independent States) program. The focus of the program has been on the support of institutional, legal and administrative reforms, as well as on addressing the social consequences of transition. However, its performance has so far been mixed.

Relations EU–Russia

The EU recognized Russia as the legal successor of the Soviet Union in December 1991. Negotiations on a PCA started in early 1992, and in December 1997 it took effect. Also, Russia was admitted to the Council of Europe on January 1, 1996, though there were serious reservations whether it qualified in view of, e.g., its observation of human rights and other democratic principles. However, the envisaged start (already for the year 1998) of negotiations regarding the possible establishment of a free trade area has not yet materialized. The *Common Strategy* of the EU on Russia from June 1999 stated that 'a stable, democratic and prosperous Russia, firmly anchored in a united Europe free of new dividing lines, is essential to lasting peace on the continent' (European Council, 1999a). Maintaining the PCA as the core of the mutual relationship, the strategy had three major economic dimensions: support of Russia's efforts to achieve WTO membership, the future establishment of an EU–Russia free trade area, and the creation of a Common European Economic Space.

At the end of December 2001, the EU Commission adopted the *'Country Strategy Paper 2002-2006'* for the Russian Federation (EU Commission, 2001a). (A similar 'strategy' has been elaborated by Russia as well.) The strategy reiterated the importance of the PCA and stressed the EU's important strategic and economic interest in Russia's development, *inter* *alia* as a bridge between the EU and Asia; it did however no longer mention free trade negotiations. The main EU concern is about the unbalanced trade (huge deficit in trade with Russia) and the EU's excessive dependence on energy imports from Russia; therefore, access restrictions to the Russian market (including trade in services) should be removed. According to the Strategy Paper, Russia's accession to the WTO would represent a major support to the reform process and ensure a framework and structure for continued economic growth and the attraction of investment.

In 2002 the EU announced (after the USA) its readiness to recognize Russia as a market economy. This important step made the application of various import restrictions somewhat more difficult, e.g. on steel, textiles, nuclear fuel, and space technologies, which allegedly cost Russia some USD 2.5 billion per year (President Putin's speech at the Stockholm EU Summit in March 2001, *Moscow Times*, March 26, 2001). In February 2004 the EU Commission called for measures to improve the effectiveness of EU–Russia relations, particularly in view of growing interdependencies and the forthcoming EU enlargement (EU Commission, 2004).

Apart from the above-mentioned numerous political declarations, the Tacis program, the Northern Dimension Action Plan, and the launching of an 'energy dialogue' in late 2000, EU–Russia economic cooperation has not progressed very far yet. In fact, in 2003 EU–Russia relations even deteriorated, as the positions of the two sides on several issues were increasingly diverging; more recently, however, the two sides have compromised on a number of issues. In particular, Russia has accepted the extension of the PCA to the new EU member countries (April 2004), agreed to double domestic natural gas prices until 2010 (May 2004), and ratified the Kyoto protocol on climate change (November 2004). In turn, the EU has given up its initial demands of gas market liberalization in Russia and signed the bilateral protocol within the framework of Russia's WTO accession. However, the divergent 'values' and especially the EU's criticism of Russia's policies in Chechnya remain serious stumbling blocks for a further rapprochement.

The Russian side complains that its statutory relations with the EU are not only weaker than those of the CEECs, but also below those of many EU associate countries from Africa and Latin America. However, some pragmatic Russian scholars point out that, in view of Russia's distorted export structure and the low competitiveness of its industry, the bulk of Russia–EU trade is *de facto* liberalized. The average EU tariff on Russian exports is just 1.5%, and nearly 90% of Russian exports face no tariffs at all. Moreover, Russian export quotas in the EU have not been fully used, and Russia's annual loss resulting from various EU import restrictions has only been around USD 200-300 million (Schmelyev, 2000). Besides, it may be argued that the EU requirement on meeting technical norms and standards, though initially associated with some costs, brings eventually benefits to exporters as well – especially in the context of Russia's accession to WTO and overall modernization efforts. The latter would provide the key impetus for an upgrading of the Russian export structure, including exports to the enlarged EU (Grinberg, 2003).

In view of the above-discussed economic asymmetries between Russia and the EU (not to mention political and institutional considerations), Russia's EU membership or even an association status is not on the agenda in the foreseeable future. Therefore, after the EU's recognition of Russia as a market economy, practical steps towards closer economic cooperation should include, first, the support of Russian regions bordering the EU (particularly Kaliningrad) and, second, the establishment of a free trade zone between Russia and the enlarged EU. Still, the idea of a *Common European Economic Space*, put forward by the EU and encompassing free movement of goods, services, capital and labor between the EU and Russia, is yet to be specified (see Samson and Greffe, 2002 for more details). As for the issue of border regions, it is to be tackled in the framework of the newly launched 'Wider Europe – Neighborhood' strategy, although the proposed financial instrument (less than EUR 1 billion for all neighborhood programs during the period 2004 to 2006) appears not very generous (EU Commission, 2003).

Largely because of the above-mentioned economic asymmetries, EU–Russia relations have not advanced very much, although the EU has meanwhile officially recognized Russia as a country with a market economy. However, the envisaged idea of a Common European Economic Space has yet to be specified.

Relations EU–Ukraine

The history of institutional relations between the EU and Ukraine goes back to December 1991, when the European Communities adopted a 'declaration on Ukraine' stressing *inter alia* the democratic character of Ukraine's referendum on independence. A PCA was signed in June 1994 and went into force in March 1998, although its trade provisions had taken effect already in February 1995 by way of an Interim Agreement. The agreement was concluded for ten years with an option of automatic prolongation. It also provided a framework for a political dialogue between the two sides, which has been conducted through yearly summits.

The subsequent years witnessed a further rapprochement between Ukraine and the EU. In June 1996, the EU gave Ukraine the status of a country with an economy in transition, and in June 1998, Ukraine announced its intention to become an EU associate member. In December 1999, the EU adopted a Common Strategy covering a four-year period (European Council, 1999b). The Strategy welcomed Ukraine's European choice and outlined a strategic partnership between the EU and Ukraine on the basis of the PCA. As far as the economic sphere was concerned, the Strategy's priorities included supporting economic transition in Ukraine; ensuring environmental protection, energy and nuclear safety; strengthening cooperation between the EU and Ukraine in the context of enlargement; and assisting Ukraine's integration into the European and world economy.

Ukraine has received substantial technical assistance from the EU, largely channeled through the Tacis program. In the energy sphere, it benefited from the EU's 'Fuel Gap' program, aimed to help the country cover its fuel imports after the Chernobyl nuclear plant had been closed at the end of 2000. In addition, Ukraine is receiving financial assistance from the EBRD (European Bank for Reconstruction and Development) to construct a shelter for the Chernobyl nuclear reactor (EUR 100 million was earmarked for this purpose in 2001-2004). Over the past ten years, total assistance from the EU to Ukraine amounted to about EUR 1 billion, notably in the form of technical (Tacis), macro-financial and humanitarian aid.

Despite the above positive developments, there are several stumbling blocks hampering the relations between Ukraine and the EU. Unlike Russia, Ukraine has not yet been officially recognized by the EU as a country with a market economy. Officially, the reasons for that has been the slow progress in economic reforms and the failure to improve Ukraine's human rights record, combat corruption and reform the judiciary system. Although EU officials sometimes hail Ukraine's aspirations to become an EU member in the future, no concrete dates have been specified so far. Instead, relations with Ukraine are now covered by the EU program *'Wider Europe – Neighborhood'* adopted in March 2003 and encompassing EU relations with the 'European periphery'. Within the framework of that program, the EU has launched the so-called New Neighborhood Programs (NNPs). These are aimed at avoiding new dividing lines in Europe after the EU enlargement by boosting cross-border cooperation with the 'left-out' countries. For Ukraine, four such NNPs are envisaged for 2004-2006. Finally, the EU visa regime for Ukrainians (just as for Russians and citizens of other CIS countries) remains highly restrictive, and at least a re-admission agreement will be indispensable to ease it.

Summarizing, EU–Ukraine institutional relations are even less advanced than those with Russia. So far, the EU has been hesitant to give Ukraine the 'carrot' of possible EU membership and has not even granted it the official status of a country with a market economy.

The impacts of EU enlargement

Impact on Russia

The political and economic changes in Central and Eastern Europe after 1991 have had extremely adverse effects on Russian trade with that region. Though comparisons are difficult, there is little doubt that Russian exports to the CEECs declined substantially already immediately after 1989[1]. However, the decline in (registered) Russian imports from the region was even more pronounced, and the Russian trade balance with the CEEC region has since been in surplus (more than EUR 10 billion in 2003). Another major trade setback occurred in

[1] In 1989, more than half of Soviet (largely Russian) trade was conducted with the CMEA countries. A number of statistical problems, in particular the application of unrealistic exchange rates in intra-CMEA trade, make these comparisons highly tentative (Havlik, 1991, 1995).

1993 when Russian imports from the region dropped by more than half as a result of the abolishment of special accounts linking the remaining centralized inter-state deliveries. In particular, trade with civilian machinery and equipment declined sharply. Russian exports of machinery and equipment to CEECs have essentially been limited to some spare parts for earlier machinery deliveries and some equipment for existing nuclear power plants. Nevertheless, Russian exports to the CEECs doubled between 1995 and 2003 (to a greater part as a consequence of rising energy prices), yet imports from the CEECs nearly stagnated (a mere 16% increase over the same period). In the year 2003, imports from CEECs accounted for just 7.5% of total (registered) Russian imports.

Russia's stance towards the enlargement of the European Union has been skeptical, though enlargement was officially welcomed and Russia was not explicitly opposed, as had been the case with the enlargement of NATO. Some Russian experts and officials feared a further deterioration of trade with the CEECs after the latter's accession to the EU. However, the above-quoted foreign trade figures suggest that there is not much scope for a further decline of trade – in particular not as a consequence of the CEECs' EU accession (and their adoption of EU external trade policies from May 1, 2004). In fact, as the CEECs adopted the EU's generally lower external import tariffs (4.4% on average instead of 6.5% previously, Table 2) upon accession, the effect on trade with Russia should on balance be rather *positive*. This effect should be particularly pronounced in the case of Poland, where the average tariff fell by 9.5 percentage points. In Hungary, the average tariff fell by 5.1, in Slovakia and the Czech Republic by 0.6 percentage points. In reality, the decline in tariffs is even stronger, since many Russian export goods qualify for the preferential GSP rates granted by the EU (aluminum being an important exception). Russia's major export commodities to these countries have a rather low value-added and are sold at world market prices, which Russia as a small supplier (except in the case of oil and gas) is not able to influence. Therefore, as a first approximation, it is safe to assume that the changes in tariff rates will not translate into changes in prices. This, in turn, implies that the full benefit of the tariff reduction is likely to be reaped by suppliers, i.e. Russian exporters.

Table 2: Applied import tariffs (on most-favored-nation basis), in %, by country

Import market	Year	Average	Agricultural products	Wood, pulp, paper and furniture	Textiles & clothing	Leather, rubber, footwear and travel goods	Metals	Chemicals & photographic supplies
Czech Republic	2001	5.0	10.0	5.1	6.5	4.1	3.7	3.8
Estonia	2002	1.7	12.2	0.0	0.0	0.0	0.0	0.0
Hungary	2001	9.5	25.8	5.4	8.2	6.6	5.0	5.2
Latvia	1999	4.1	11.9	2.2	6.9	3.6	0.8	1.0
Lithuania	2001	3.4	9.8	2.9	9.1	2.8	0.1	0.4
Poland	2001	13.9	41.9	7.9	13.1	11.5	9.7	8.6
Slovak Republic	2001	5.0	9.9	5.1	6.5	4.1	3.7	3.8
Slovenia	2002	9.6	11.3	9.5	12.7	10.6	7.5	7.7
CEEC-8 average		6.5	16.6	4.8	7.9	5.4	3.8	3.8
EU-15	2002	4.4	5.9	1.8	8.4	4.2	2.3	4.7
Russia	2001	9.9	8.9	13.1	10.8	8.0	9.5	7.0
Ukraine	2002	7.0	10.8	7.9	6.4	10.3	5.3	6.0

Import market	Year	Transport equipment	Non-electric machinery	Electric machinery	Mineral products, precious stones and metals	Manufactured articles not specified	Fish and fish products	Petroleum
Czech Republic	2001	6.1	3.6	3.5	3.4	3.2	0.1	2.4
Estonia	2002	0.0	0.0	0.0	0.0	0.0	3.1	0.0
Hungary	2001	10.8	8.3	9.7	4.8	7.7	16.7	0.8
Latvia	1999	3.1	0.0	1.0	4.6	3.9	8.4	0.0
Lithuania	2001	0.1	0.2	0.4	1.5	1.3	4.6	2.5
Poland	2001	16.7	8.1	7.6	6.9	10.7	19.9	9.9
Slovak Republic	2001	6.1	3.6	3.5	3.4	3.3	0.1	0.0
Slovenia	2002	11.5	9.2	9.5	5.7	10.6	7.1	2.4
CEEC-8 average		6.8	4.1	4.4	3.8	5.1	7.5	2.3
EU-15	2002	4.1	1.7	2.5	2.0	2.5	11.6	3.1
Russia	2001	10.5	9.1	12.2	12.0	13.4	10.5	5.0
Ukraine	2002	7.3	4.7	7.8	8.4	10.1	10.4	0.0

Note: All averages are calculated as simple averages of the *ad valorem* MFN applied Harmonized System 6-digit duties.
Source: Own calculations based on WTO

The Russian concern that new non-tariff barriers may emerge is not fully substantiated either, and an agreement on extending the EU import quota for Russian steel has already been signed. Also, accession to the EU is expected to lead to higher market growth in the CEECs, *inter alia* also for goods from Russia. In several other important respects, EU policies towards Russia have also been more favorable than those applied by several CEECs. For example, ethnic Russians living in the Baltics benefit from the EU pressure to respect minority rights (one of the Copenhagen criteria for EU accession).

At the same time, some Russian fears regarding adverse consequences of enlargement are definitely real. First, the new EU members have already introduced the restrictive 'Schengen' visa regime for Russian citizens, even though their accession to the Schengen zone will not take place before 2007-2008. Obviously, the border regions are affected the most. Although a simplified visa procedure for residents living near EU borders is currently under consideration, it remains to be seen whether and how it will be actually implemented. Second, Russian energy exports to the EU may suffer in the medium and long run due to the EU strategy of diversification of energy supplies. The strategy stipulates that not more than 30% of the EU's energy needs may come from one source, whereas most CEECs are heavily dependent on imports of Russian fuels. Finally, the new member states will affect EU voting procedures, and there is at least a possibility that they may twist EU policies towards Russia – and that not necessarily in a direction favorable for Russia.

Thus, in the short run, the effects of the EU enlargement on Russia should be positive, although losses are possible in the medium and long run given the EU energy security concerns. However, politically Russia may be disadvantaged due to new accents coming from the new member states.

Impact on Ukraine

Ukraine is directly affected by the EU enlargement, since three of the new EU member states – Poland, Slovakia and Hungary – are bordering Ukraine, whereas another three – Lithuania, Latvia and Estonia – used to have free trade agreements with it (excluding agricultural products in the case of Latvia and Lithuania), which had to be scrapped in the wake of enlargement. The new EU members are a quite important market for Ukrainian products. In 2003, the CEECs were the destination of 13% of Ukrainian exports and the source of 8.4% of its imports. Among the CEECs, Hungary and Poland are the most important trading partners, accounting for more than half of all Ukrainian exports to the region. Similarly to exports to the EU, Ukrainian exports to the CEECs are dominated by basic metals and mineral fuels.

Like Russia, Ukraine has recognized the benefits of EU enlargement for the country in the *medium and long run,* not least due to the average import tariff reduction in Poland, Hungary, Slovakia and the Czech Republic mentioned in section 3.1. Of course, in the case of the Baltic states, the average tariff applied to imports from Ukraine rose after the existing free trade agreements had been abandoned. (Obviously, exports of the Baltic countries to Ukraine now face higher tariffs as well. As far as exports from other new EU members are concerned, no changes in Ukrainian import tariffs applied to them have occurred.) However, due to the limited volume of trade between Ukraine and the Baltic countries, the net effect from tariff adjustments in the CEECs as a whole is expected to be marginally positive as well. Also, the quotas previously applied to selected Ukrainian goods by some accession countries (e.g. by Hungary on textile products and sugar, and by the Czech Republic on coal) have been abolished. Probably even more importantly, the EU enlargement has resulted in a single set of trade rules and administrative procedures applied across a market of some 450 million consumers. Together with accelerated economic growth in the new EU members, this will lead to rising demand for imports, also from Ukraine.

However, things might look different in the *short run*. First, it appears that Ukraine's exports of steel to the new EU members (some 800,000 tons annually) will fall under the previous (EU-15) quota. In 2001, the EU and Ukraine elaborated a new draft agreement on trade in steel envisaging, for instance, an expansion of the quota up to 355,000 tons. Yet the agreement was never signed (allegedly due to the failure of the Ukrainian government to refund VAT to metals exporters), and since then the EU quota has been set unilaterally and revised on an annual basis. In 2003, it stood at 117,944 tons, although Ukraine's actual steel exports amounted to only 102,066 tons, corresponding to 86.5% of the quota (*Recycling Today*, January 15, 2004). The reason for that might have been a favorable market situation in other countries, which made steel exports to the EU less attractive.

For 2004, the steel quota was initially set at 184,546 tons. Thus, a substantial upward revision is needed to accommodate Ukraine's steel exports to the new EU members. In summer 2004, a preliminary agreement between Ukraine and the EU was reached to raise the quota to 606,824 tons, and further negotiations on this issue are underway. However, the agreement has not been signed yet, resulting in possible losses for Ukraine's steel exporters of EUR 230 million per year in 2004-2005 (International Centre for Policy Studies, 2003b).

Second, the incidence of anti-dumping measures against exports of Ukrainian chemicals and metals to the CEECs may increase after the EU enlargement. For instance, prior to the enlargement, only Poland and Hungary were applying anti-dumping measures against Ukrainian metals, and these measures were softer than those applied by the EU. In addition, Ukraine's exports of machinery and equipment will be subject to new certification requirements of the EU, and those of agricultural products will face tougher SPS (sanitary and phyto-sanitary standards). As a result, the Ukrainian side estimates total losses of domestic producers in 2004-2005 at over EUR 300 million per year (International Centre for Policy Studies, 2003b), corresponding to some 1.5% of Ukraine's exports. If Ukraine were a WTO member, it would be automatically eligible for compensation of any trade losses. However, Ukraine is not expected to join the WTO before 2005, and that under the most optimistic scenario. In the medium run, losses are expected to be much smaller, as the steel quota will be re-negotiated, and other Ukrainian export products will increasingly correspond to the EU standards.

Finally, cross-border trade may suffer from the more restrictive ('Schengen') visa regime applied by the new EU members towards Ukrainian citizens. Of particular importance is the visa regime with Poland, which has a long border with Ukraine and a lot of unofficial ('shuttle') trade. Hungary and Poland introduced a visa regime in autumn 2003, whereas the Czech Republic and Slovakia did so already in 2000. According to the Ukrainian border offices, in the three months following the introduction of the visa regime by Slovakia, the number of Ukrainian tourists entering Slovakia fell by 76% against the three preceding months. The number of private trips (usually involving shuttle trade) plunged by 57%, and business trips by 64%. The number of Slovaks entering Ukraine dropped by 60% (International Centre for Policy Studies, 2003a).

Whereas the introduction of a visa requirement by Poland has reportedly already caused damage to the cross-border movement of labor between Poland and Belarus, the disruptions in the case of Ukraine are reportedly limited, since Polish visas are issued to Ukrainians free of charge, in exchange for visa-free entry of Polish citizens into Ukraine. A similar agreement has reportedly been reached between Ukraine and Lithuania as well. In addition, a special visa type (the so-called 'local visa') is now under consideration by the EU, which will be issued to the residents of border regions and will entitle them to multiple entry into neighboring regions on the other side of the border.

Last but not least, foreign direct investment inflows into Ukraine may accelerate somewhat following the EU enlargement, as the country now finds itself on the EU border, and also due to the very low initial base (Figure 3). However, we do not expect a marked turnaround in FDI inflows as long as the main impeding factors of a domestic nature – political uncertainty, bureaucratic hurdles, corruption, and the lack of the rule of law – persist. An acceleration of FDI from Ukraine into the CEECs is more likely, following the transfer of the production of 'sensitive goods' (e.g. metals) aimed at avoiding the restrictive EU import regime. Ukrainian investments into the metals industry of CEECs are already noticeable[2], although at present they represent acquisitions of privatized assets (rather than greenfield investment) and are driven by the good liquidity position of Ukrainian producers of metals (rather than by market access considerations).

It appears that Ukraine's fears of short-term economic losses from the EU enlargement, first of all in trade in steel, are not completely unfounded. However, in the medium and long term, economic losses are expected to be lower, and FDI inflows will probably increase. Besides, in political terms, Ukraine is likely to benefit from the determination of some of the new EU members, most notably Poland, to bring the country 'closer' to the EU.

Relations Russia–Ukraine

Despite the substantial decline in trade between Russia and Ukraine following the collapse of the Soviet Union, the economic interdependence between the two countries is still

[2] E.g., the Ukrainian Donbas Industrial Union Corporation has already acquired two steel mills in Hungary: Dunaffer in 2003 and DAM in 2004.

pronounced. For Ukraine, Russia is the biggest trading partner in terms of both exports (18.7% in 2003) and particularly imports (37.6%), reflecting the geographical and cultural proximity, but also the common history. In addition, Russia (together with Cyprus, which represents, at least partly, Russian capital that fled the country over the years of transformation) is an important investor in Ukraine. This is especially true for the oil industry, with four out of six refineries being already owned by Russian companies. Also, in autumn 2003, Ukraine allowed Russia's electricity monopoly RAO UES to participate in the partial privatization of its energy network.

Predictably, for Russia trade with Ukraine is not as important. In 2003, the latter accounted for only 5.7% of Russian exports and 7.7% of imports. However, Ukraine (along with Belarus) is important for Russia as a transit country, in particular for exports of oil and natural gas to Europe: some 90% of Russian natural gas exports is reportedly being shipped via Ukraine.

Over the post-Soviet years, Ukraine has invariably been running a huge deficit in its trade with Russia (reaching EUR 3.8 billion according to Ukrainian, and EUR 3 billion according to Russian sources in 2003), with the value of imports from Russia exceeding approximately two times the value of Ukrainian exports to Russia. This deficit is largely structural, as mineral fuels account for about two thirds of total imports from Russia. The structure of Ukrainian exports to Russia is more diversified, the biggest export items being machinery and equipment, ferrous metals and meat. Many of these products face high barriers to entering the Russian market. Both countries apply rather high import tariffs (in addition to a range of non-tariff measures), standing on average at 10% in Russia and 12.7% in Ukraine (Elborgh-Woytek, 2003). Ukraine's import tariffs on a number of agricultural commodities such as sugar, butter and potatoes are particularly high and stand at 50%. Tariffs apart, a major point of contention prior to mid-2001, was the Russian policy to charge VAT (value added tax) and excises on its exports to the CIS countries according to the 'country of origin' principle (Andrianov, 2003). Since Ukraine shifted to the 'country of destination' principle already in the mid-1990s, at some point Ukrainian exports to Russia were *de facto* exempted from any indirect taxation, leading to a number of problems in bilateral trade relations (UN ECE, 2003). By contrast, the problem nowadays appears to be rather the opposite: Ukrainian exporters often face considerable delays in the reimbursement of domestically charged VAT.

However, economic links between the two countries may strengthen as an (indirect) consequence of EU enlargement and as a result of the recent 'Agreement on the Formation of the Common Economic Space (CES)' between Ukraine, Russia, Belarus and Kazakhstan, which was signed on September 19, 2003 (Astrov, 2004). While there are serious doubts about how far the actual (re-)integration of the post-Soviet space may go, at least a free trade area between the participating countries may well be implemented. This relates to the objectives of Ukraine, which – unlike Russia – is reluctant to enter into more advanced stages of integration with Russia, not least given its EU membership aspirations. On the one hand, as a result of the CES agreement, Ukrainian producers may gain access to the formerly protected Russian market. Indeed, easier access to the Russian market for Ukraine's goods is already visible. For instance, in February 2004 Russia lifted import restrictions on most rolled steel products imported from Ukraine (*Zerkalo Nedeli*, February 21, 2004). With an average wage of just half the Russian level, Ukraine remains a potentially competitive supplier for the Russian market.

On the other hand, Ukraine will be able to benefit from the lower prices for oil and natural gas imported from Russia. So far, Russia has been applying the ‘country of origin’ principle of VAT taxation with respect to exported fuels, effectively making them 20% more expensive for Ukrainian importers. While the VAT is obviously levied on Russian domestic sales of fuels as well, the price paid by Ukraine is higher than the Russian domestic price – and that for a number of reasons, such as the discrimination of Russian transport tariffs between domestic and export shipments. The proposed unification of tariffs (including those for transportation), along with the universal application of the ‘country of destination’ principle of VAT taxation (envisaged for 2005), will bring about a convergence of prices for energy carriers between Russia and Ukraine. The reverse side of the coin is that cheaper energy may further aggravate the already high energy intensity of the Ukrainian economy inherited from Soviet times.

In the longer perspective, given the strong performance of Russia’s economy, access to the Russian market may prove crucial for Ukraine’s growth. In turn, Russia’s interest in the CES appears to be driven primarily by geo-strategic considerations, including the safety of its energy exports routes.

The trade relations between Russia and Ukraine, though extensive, are at the moment hindered by numerous trade barriers. However, they are likely to intensify following the formation of the Common Economic Space and the expected robust growth in both countries. Ukraine’s motives for participating are primarily economic and reflect the country’s disillusionment with respect to integration into the EU, while for Russia, strategic and energy transit considerations prevail.

Conclusions: regional cooperation prospects and policy challenges

The EU, on the one hand, and Russia and Ukraine, on the other, are very unequal partners in nearly all respects – a fact manifesting itself also in their trade relations. The EU is a relatively important trading partner for Russia and (although less so) also for Ukraine. However, apart from being suppliers of energy carriers and metals, the role of Russia and Ukraine as trading partners for the EU is marginal (in the case of Ukraine even negligible). This is partly due to the existence of numerous barriers in mutual trade, but, more generally, it reflects the slow progress achieved by both countries in restructuring their economies, attracting more FDI and upgrading their export structures in favor of goods with higher value-added.

Apart from the existence of PCAs and the programs of technical assistance (mainly Tacis), the EU’s institutional relations with Russia and Ukraine have not progressed much, and even a free trade area will most probably not be implemented in the short and medium run –

definitely not before both countries join the WTO. This proved to be a particular disappointment for Ukraine, which – unlike Russia – has so far considered integration into the EU structures as its ultimate goal. In fact, in a number of important respects, Ukraine's relations and economic integration with the EU are even less advanced than those of Russia (e.g. the absence of a market economy status granted by the EU, lower shares in trade and FDI). For the time being – and most likely in the future as well – Ukraine is, and will remain, more integrated with Russia than with the EU.

Prior to the EU enlargement, both countries were focusing their diplomatic efforts on the possibly negative impact on their economies, trying to negotiate concessions in PCAs with the accession countries (Russia) and demanding 'compensations' from the EU for the resulting trade losses (Ukraine). Our analysis shows that these claims are only partly justified, and in a number of ways both countries may even benefit from the enlargement.

Table 3 summarizes our findings on the possible impact of the EU enlargement and outlines the regional cooperation prospects and challenges. Politically, Russia may indeed face a somewhat harder EU line at the insistence of the new EU members, whereas Ukraine, which will find itself on the border of the enlarged Union, will most probably benefit. The same applies to the medium- and long-term economic impact. In the short run, however, Ukraine is likely to lose more from EU enlargement than will Russia, as long as uncertainty regarding the size of the EU import quota for Ukrainian steel persists. In turn, this will foster Ukraine's interest in strengthening economic ties with Russia even further, and signs of this are already visible as Russia is regaining economic strength.

While this partial 're-orientation' of Ukraine towards Russia has provoked some criticism from the EU, such stance may actually be counter-productive. The main challenge for the EU policy-makers is to foster a balanced economic integration with *both* Russia and Ukraine simultaneously, thus avoiding the potential costs of trade diversion between the two countries. Thus, on the one hand, the establishment of a free trade zone between Russia and the EU, e.g. within the framework of the proposed Common European Economic Space, has to be coordinated with simultaneous trade agreements with Ukraine (and possibly with other CIS countries, especially Belarus and Moldova, as well). On the other hand, an (unlikely) turnaround in EU policies with respect to Ukraine resulting in the country's EU integration should be accompanied by a simultaneous liberalization of EU trade with Russia. Finally, it is important that the border regions are not adversely affected by the enlargement and that no new 'Iron Curtain' emerges. Many of these border regions such as Kaliningrad in Russia and the whole Western Ukraine are underdeveloped even by the respective countries' standards. Hence the need for their effective support by the EU is crucial. Such an approach will be indispensable for preventing the emergence of new dividing lines in Europe and promoting new neighborhood relations.

Of course, much will depend on whether the latest (May 2004) EU enlargement will continue to proceed as smoothly as it is widely hoped and to what extent the new EU members will actually bring new accents to EU external policies. This suggests one possible vein of further research. Other interesting research areas are, first, the assessment of the actual economic effects of EU enlargement on Russia and Ukraine and, second, the likely economic consequences of the formation of the Common Economic Space between Russia and Ukraine on a detailed level. At the time of writing this report, research in this direction is already underway.

Table 3: EU, Russia and Ukraine: regional cooperation prospects and challenges

Dimension	Russia-EU	Ukraine-EU	Russia-Ukraine
Institutional relations	PCA, market economy status, WTO agreement, EU membership or association status out of question	PCA, no market economy status, Ukraine's EU membership aspirations so far not shared by the EU	both members of the Commonwealth of Independent States and Common Economic Space
Impact of EU enlargement on bilateral relations			
Political	may worsen (new accents from the new EU members), although Russian speakers in the Baltics likely to benefit	likely to improve (insistence from the new EU members, especially Poland)	may improve as Ukraine's EU accession prospects are fading
Economic (trade)			
short-term	marginally positive effect on Russia (small non-energy exports by Russia, average import tariff reduction in new EU members)	losses for Ukraine may be sizeable (in particular steel quota)	indirect consequence: Ukraine even more interested in trade liberalization with Russia (Common Economic Space)
medium- and long-term	some losses for Russia possible (EU strategy of energy diversification)	rather positive for Ukraine (uniform trade rules, quota re-negotiated, technical standards and SPS adjusted)	closer integration of the post-Soviet space
Border regions development	losses substantial (Schengen visa regime)		
Policy challenges	implementation of a free trade area involving all three parties (EU, Russia, Ukraine), in order to avoid potential trade diversion costs effective support of border regions development and reforms by the EU		

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APPENDIX

Table A1. Russia: gaining and losing industries in exports to the EU-15, 1995 to 2002

	NACE rev. 1	Exports 2002 EUR million	Average annual change in %	Absolute gain,1995-02 EUR million	Market share in the EU-15 2002 in %
30 biggest winners					
Refined petroleum and nuclear fuel	232	6025.7	20.3	3409.0	29.46
Other first processing of iron and steel	273	206.3	-6.6	431.4	17.83
Nuclear fuel	233	615.9	8.4	206.9	50.62
Fish and fish products	152	458.9	9.9	132.4	4.25
Sawmilling, planing and impregnation of wood	201	515.9	7.5	128.6	10.04
Textile weaving	172	102.3	17.1	62.6	1.96
Coke oven products	231	59.6	26.4	43.2	5.43
Cement, lime and plaster	265	30.6	34.8	25.6	4.32
TV, radio and recording apparatus	323	25.9	37.2	21.5	0.10
Other special purpose machinery	295	74.6	10.1	21.3	0.52
Ships and boats	351	33.7	24.8	21.2	0.42
Panels and boards of wood	202	149.4	4.2	19.0	6.47
Other products of wood; articles of cork, etc.	205	23.8	25.7	16.9	1.16
Vegetable and animal oils and fats	154	16.5	25.3	12.1	0.24
Cutlery, tools and general hardware	286	20.9	18.5	11.7	0.35
Basic iron and steel, ferro-alloys (ECSC)	271	1564.9	5.1	11.1	14.07
Instruments for measuring, checking, testing, navigating	332	22.6	14.5	9.8	0.15
TV, and radio transmitters, apparatus for line telephony	322	13.4	25.5	8.9	0.08
Electricity distribution and control apparatus	312	18.6	15.2	8.8	0.23
Office machinery and computers	300	13.8	16.1	6.8	0.02
Structural metal products	281	16.4	14.3	6.5	0.78
Weapons and ammunition	296	12.0	15.8	6.4	3.45
Man-made fibers	247	14.5	11.7	6.0	0.65
Detergents, cleaning and polishing, perfumes	245	21.6	10.5	5.4	0.71
Publishing	221	8.9	17.0	5.2	0.34
Other general purpose machinery	292	21.6	9.5	4.5	0.16
Electrical equipment n. e. c.	316	32.7	8.9	4.4	0.26
Other chemical products	246	38.1	6.3	4.2	0.36
Motorcycles and bicycles	354	4.9	18.6	2.9	0.11
Medical equipment	331	8.4	13.7	2.9	0.06
10 biggest losers					
Pharmaceuticals	244	6.3	-16.4	-31.0	0.02
Dairy products; ice cream	155	26.7	-11.8	-51.6	2.37
Other wearing apparel and accessories	182	121.2	-0.3	-53.6	0.28
Pulp, paper and paperboard	211	425.1	-1.1	-64.7	4.26
Motor vehicles	341	37.0	-13.4	-126.7	0.10
Meat products	151	64.5	-14.5	-166.6	1.15
Jewelry and related articles	362	316.7	-1.4	-199.8	3.13
Basic chemicals	241	1255.3	0.6	-316.5	3.65
Aircraft and spacecraft	353	29.2	-26.0	-338.2	0.08
Basic precious and non-ferrous metals	274	4148.5	-0.2	-1042.3	11.92
Manufacturing industry	Total	17159.6	5.5	2107.5	2.22
Exports	Total	39129.7	11.8	21272.0	4.42

Source: Eurostat Comext database, own calculations

Table A2. Ukraine: gaining and losing industries in exports to the EU-15, 1995 to 2002

	NACE rev. 1	Exports 2002 EUR million	Average annual change in %	Absolute gain,1995-02 EUR million	Market share in the EU-15 2002 in %
30 biggest winners					
Refined petroleum and nuclear fuel	232	623.1	28.4	451.3	3.05
Basic iron and steel, ferro-alloys (ECSC)	271	554.3	11.4	220.3	4.98
Other wearing apparel and accessories	182	379.4	16.4	194.6	0.88
Vegetable and animal oils and fats	154	120.6	98.3	119.3	1.73
Sawmilling, planing and impregnation of wood	201	82.5	47.9	75.7	1.61
Tubes	272	58.8	31.5	46.6	2.95
Basic precious and non-ferrous metals	274	147.3	7.4	32.0	0.42
Tanning and dressing of leather	191	68.1	13.3	29.0	2.33
Footwear	193	52.5	17.0	26.3	0.50
Structural metal products	281	27.9	54.5	25.9	1.33
Other chemical products	246	27.2	35.0	22.6	0.25
TV, radio and recording apparatus	323	22.6	48.2	20.4	0.09
Furniture	361	28.4	26.4	19.5	0.24
Domestic appliances n. e. c.	297	18.4	80.5	18.0	0.27
Fruits and vegetables	153	29.2	16.0	16.7	0.56
Made-up textile articles	174	17.8	53.3	16.4	0.33
Panels and boards of wood	202	20.6	24.9	15.4	0.89
Sports goods	364	20.4	27.0	14.8	0.80
Coke oven products	231	13.6	43.4	12.1	1.24
Other textiles	175	12.5	41.7	11.2	0.37
Ships and boats	351	23.0	18.1	10.7	0.29
Knitted and crocheted articles	177	17.4	21.1	10.4	0.22
Other special purpose machinery	295	14.0	27.0	10.2	0.10
Jewelry and related articles	362	30.3	10.3	7.9	0.30
Parts and accessories for motor vehicles	343	8.0	37.4	6.6	0.05
Other non-metallic mineral products	268	11.2	18.8	6.4	0.88
Leather clothes	181	6.3	109.0	6.2	0.45
Other general purpose machinery	292	10.0	18.5	5.3	0.08
Machinery for production, use of mech. power	291	15.5	11.6	4.8	0.08
Office machinery and computers	300	6.5	28.2	4.8	0.01
10 biggest losers					
Cement, lime and plaster	265	0.0	-66.4	-5.6	0.00
Other food products	158	9.0	-3.3	-5.8	0.16
Fish and fish products	152	0.2	-40.3	-7.8	0.00
Textile fibers	171	5.2	-10.9	-9.5	0.17
Man-made fibers	247	11.0	-5.6	-10.6	0.50
Dairy products; ice cream	155	37.3	-1.0	-16.5	3.32
Meat products	151	40.4	-3.8	-26.6	0.72
Other first processing of iron and steel	273	48.4	-4.2	-29.1	4.18
Aircraft and spacecraft	353	64.7	-3.6	-68.5	0.18
Basic chemicals	241	157.5	-2.0	-80.8	0.46
Manufacturing industry	Total	2975.4	12.9	1223.3	0.38
	Total	4029.4	15.6	2569.0	0.42

1.1.1 Exports

Source: Eurostat Comext database, own calculations

Table A3. CEEC-8: gaining and losing industries in exports to the EU-15, 1995 to 2002

	NACE rev. 1	Exports 2002 EUR million	Average annual change in %	Absolute gain 1995-02 EUR million	Market share in extra-EU imports '02 in %	Market share in total EU imports '02 in %
30 biggest winners						
Motor vehicles	341	13575.3	28.0	9674.8	35.57	6.98
Parts and accessories for motor vehicles	343	5767.4	34.2	4600.7	34.16	7.60
TV, radio and recording apparatus	323	4236.0	37.0	3504.3	16.66	9.60
Office machinery and computers	300	3689.3	45.0	3293.6	6.00	2.86
Furniture	361	5081.9	17.1	2327.8	42.98	19.33
TV and radio transmitters, apparatus for line telephony	322	2330.7	69.3	2234.1	13.63	5.33
Electrical equipment n. e. c.	316	2901.1	25.0	1944.9	23.45	12.23
Machinery for production, use of mech. power	291	2497.6	22.1	1578.5	13.33	5.12
Other general purpose machinery	292	1952.5	23.9	1301.4	14.88	4.59
Electricity distribution and control apparatus	312	1863.0	23.9	1270.3	23.46	9.38
Rubber products	251	1986.1	22.0	1262.2	28.28	9.29
Other special purpose machinery	295	2055.4	18.0	1151.6	14.31	5.04
Plastic products	252	1718.2	20.1	1030.6	15.19	4.12
Electric motors, generators and transformers	311	1877.2	17.8	991.9	22.26	10.22
Other fabricated metal products	287	2345.4	13.2	921.7	24.83	8.86
Electronic valves and tubes, other electronic comp.	321	1266.2	20.3	793.5	4.37	2.19
Domestic appliances n. e. c.	297	1594.2	16.3	704.3	23.45	7.70
Instruments for measuring, checking, testing, navigating	332	906.5	22.4	587.0	6.02	3.01
Other first processing of iron and steel	273	249.4	-9.3	581.5	21.55	4.22
Pulp, paper and paperboard	211	1270.5	10.1	579.2	12.74	3.03
Isolated wire and cable	313	1024.5	18.4	551.7	29.90	13.52
Refined petroleum and nuclear fuel	232	1882.3	12.2	551.5	9.20	3.97
Cutlery, tools and general hardware	286	877.8	20.4	533.7	14.50	5.08
Structural metal products	281	1246.5	13.4	448.7	59.30	19.17
Sawmilling, planing and impregnation of wood	201	1416.6	8.7	431.1	27.57	14.14
Machine-tools	294	784.2	13.0	387.0	9.48	4.23

Table A3 continues

Glass and glass products	261	1105.4	11.3	336.8	29.41	8.77
Other textiles	175	454.2	23.4	331.5	13.48	3.97
Printing	222	403.7	34.1	329.4	33.27	10.47
Railway locomotives and rolling stock	352	547.5	21.5	327.4	48.14	16.60
10 biggest losers						
Tubes	272	407.1	4.1	-1.7	20.42	4.94
Vegetable and animal oils and fats	154	62.1	2.0	-8.5	0.89	0.46
Watches and clocks	335	16.8	-2.9	-8.8	0.40	0.33
Coke oven products	231	412.8	4.7	-9.1	37.59	25.63
Cutting, shaping, finishing of stone	267	39.8	2.4	-17.5	7.23	2.56
Tanning and dressing of leather	191	201.4	2.7	-17.9	6.88	3.91
Footwear	193	989.5	5.6	-27.2	9.39	4.56
Basic iron and steel, ferro-alloys (ECSC)	271	2199.8	3.5	-220.9	19.78	4.77
Cement, lime and plaster	265	95.3	-16.6	-354.4	13.45	5.39
Other wearing apparel and accessories	182	4484.2	3.4	-531.6	10.35	6.66
Manufacturing industry	Total	100268.2	15.8	50081.1	12.95	4.80

Source: Eurostat Comext database, own calculations

Chapter 3

FROM RUSSIA WITH BUSINESS

THE LATE RISER TNC:

OUTWARD FDI FROM CENTRAL AND EASTERN EUROPE

Kálmán Kalotay*

In Central and Eastern Europe, outward foreign direct investment was not yet until recently a prominent factor in the region's reintegration into the world economy, especially when compared to trade liberalization in the early 1990s or inward foreign direct investment in the late 1990s. In the terminology of the investment-development path, with the notable exception of the Russian Federation, the region is in stage 2, whereby inward flows are still growing faster than outward flows. This article argues that a combination of the latecomer status of the region's transnational corporations and the transition shock can explain most of that laggard situation. It hypothesizes that the imminent enlargement of the European Union would give a major push to the outward foreign direct investment flows of Central and Eastern Europe, on condition that adequate government policies to promote those investments are put in place. The impact on the investment-development path, however, is uncertain, because accession to the European Union is often accompanied by a surge in foreign direct investment inflows, too. Finally, the article also looks at the options available to deal with the specific problems of the Russian Federation in relation to capital flight, including ways of regularization and potential return to the home economy.

Keywords: Central and Eastern Europe; investment-development path; outward FDI; transition; transnational corporations

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Introduction

This article looks at the reasons why, in Central and Eastern Europe (CEE), outward foreign direct investment (FDI) has not yet become as a prominent factor in the region's reintegration into the world economy as trade liberalization used to be in the early 1990s or inward FDI is currently. To put the question into an analytical context, it refers to the investment-development path (IDP) paradigm as originally suggested by John H. Dunning (1981 and 1986).

This article will start with a brief overview of the patterns of outward FDI from CEE, including its geographical destinations and industry composition. The subsequent section then briefly look on what international economic and business literature so far can indicate for us on the topic. That lays the ground for the next section dealing with outward FDI from CEE context of the IDP. It is then followed by a discussion on corporate strategies. Then follows a discussion on government policies, and their variations from country to country. In particular, the article will try to explore briefly how the Russian Federation could deal with its capital flight problem, and how other countries would rather need to promote outward FDI. The article will be completed with some forward-looking general conclusions.

Patterns of outward FDI from CEE

Trade, FDI and transition

Immediately after transition had started – or independence had been gained, in many cases – trade liberalization became the first vehicle of the reintegration of CEE into the world economy (EBRD, 1999). In most CEE countries, not only the degree of trade liberalization tended to be radical, but also it was accompanied by the elimination of the State monopoly of international trade. In retrospect, the latter alone could constitute an economic revolution alone in most countries. But coupled with the disappearance of import protection, it prompted a major reorientation of trade, both in terms of partners and in terms of products.

From the mid-1990s, inward FDI was gaining importance in an increasing number of CEE countries. It is not far-fetched to assume that, by the turn of the millennium, inward FDI became the sole most important engine of successful reintegration into the world economy (Kalotay, 2001). Data witness a major boom in inward FDI. From 1995 to 2001, the region's inward FDI stock quadrupled, from $40 billion to $160 billion (UNCTAD, 2002, p. 313). Back in 1995, the ratio of the inward FDI stock to the gross domestic product (GDP) (5.4%) was only half of the world average (9.9%). Within 5 years, by 2000, CEE had almost completely caught up with the rest of the word. Reaching 18.9%, its inward FDI stock per

GDP was only 1.1% below the world average (20%). Moreover, there are individual CEE countries where by 2000, that ratio had become very high even in global standards. In Estonia, for example, it exceeded 50% and in the Czech Republic and Hungary 40%. (In contrast, it was only 7.7% in the Russian Federation).

Outward FDI: How big it is?

Outward FDI until recently was not yet at a stage of playing a similar key role. In 2001, the region's *registered* outward FDI stock reached $24 billion (i.e. 15% of the inward stock) only (UNCTAD, 2002, p. 17), the Russian Federation alone accounting for more than $14 billion. The remaining 40%, too, was distributed very unevenly. Hungary was second, with a stock of more than $4 billion, far ahead of the others. It was followed by Poland ($ 1 billion), Slovenia, Croatia, the Czech Republic (with values over $800 million each) and Estonia (with more than $400 million). The remaining 12 countries together accounted for less than $1.2 billion (less than 5% of the region's outward FDI stock). Relative to the GDP, Estonia is the only country where the share of the outward stock exceeded 5% in 2000. Estonia was followed by the Russian Federation, Hungary and Slovenia, each of which displaying values over 4%.

A note of caution is to be added here, too. It seems that in various economies in transition, and in the Russian Federation in particular, official statistics have difficulties in reflecting the real size of outward FDI. In the Russian Federation, officially reported FDI may be ten times less than real outbound FDI. The registered outflows of the Russian Federation do not include that capital flight, estimated to exceed $20 billion per year in the 1990s (UNCTAD, 2002, p. 84).

The outward FDI stock of the Russian Federation reported on a balance-of-payments basis ($3 billion in 1995, $14 billion in 2001) is much less than the estimated assets of Russian firms abroad. An in-depth study has suggested that a figure of $20 to $30 billion would have been more realistic estimate for Russian FDI outward stocks already in 1997 (Bulatov, 1998). There are other calculations suggesting even higher FDI outward stock figures. In 1995, two studies suggested that the stock of Russian investment abroad – direct, portfolio and other – was of the order of $130 billion at the beginning of 1995 (Rybkin, 1995; Gorshenin, 1995). In 1996, another study concluded that the volume of Russian investment abroad was more than $300 billion, of which direct and portfolio investments each represented $30 to $40 billion, while the 'other ' category accounted for roughly $230 billion (Khaldin and Andrianov, 1996).

Why did such big differences exist between balance-of-payments data and other estimates? There may be various reasons:

- The balance-of-payments data did not capture fully the value of assets accumulated by the Soviet Union abroad. The book value of Soviet companies abroad was considered to be $2 billion at the beginning of the 1990s (Sokolov, 1991) and the market value $10 billion (Gorshenin, 1995). Moreover, the market value of outward FDI may have increased over time, as compared with its original book value. Given decline of the rouble against the dollar in the 1990s, the market value may now be significantly higher when expressed in roubles.

- The balance-of-payments data did not account either for the assets that the Russian Federation inherited in other former Soviet Republics. These investments had in fact been registered as domestic investment by the Union of Soviet Socialist Republics and became foreign assets once these republics gained independence.
- Some part of Russian assets was financed through outflows registered under other flows (such as portfolio flows, trade finance or service payments), increasing the whole outward FDI stock substantially (Bulatov, 1998).
- Finally, at least a part of the outward flows went completely unregistered. The above-mentioned studies suggest that the registration of FDI and other outflows was far less advanced than the reporting of FDI inflows.

Some part of Russian assets abroad may be financed through outflows registered under other flows (such as portfolio flows, trade finance or service payments), or not officially reported at all (see also the discussion below), increasing the whole outward FDI stock substantially. In this respect, Russian "capital flight" is not "classical" in the sense that it cannot be proxied by the usual methods focussing on the "errors and omissions" item of the balance of payments (Claessens and Naude, 1993). If that amount is taken into consideration, the Russian Federation turns out to be a major net capital exporter – in fact the only net capital exporter of the region.

Recently, the Central Bank of the Russian Federation has sought to estimate officially the net outflow of private-sector capital from the country (annex table 1). For the decade of 1994-2003, that calculation resulted in $154 billion. In an effort to come up with a more realistic picture on the extent of capital exports, it also concluded that by the end of 2002, the outward FDI stock of the country reached $48 billion.[1] These data revisions put, for the first time, the Russian Federation, into the world top league of outward investors (table 1). If all private-sector outflows were counted, the county would be in 2002 number 12 on a global scale, ahead of such major outward investing economies as Sweden, Singapore, Taiwan Province of China or Brazil. And even if only the outward FDI stock is counted, the Russian Federation is now number 19 on a global scale, ahead of the Republic of Korea.

[1] http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=iip_rf_e.htm, updated on 11 February 2004.

Table 1: The new world league table of outward FDI stock, 2002 (Billion dollars)

Rank	Economy	Value
1	United States	1 501.4
2	United Kingdom	1 033.0
3	France	652.1
4	Germany	577.8
5	Hong Kong, China	370.3
6	Netherlands	355.7
7	Japan	331.6
8	Switzerland	297.6
9	Canada	273.7
10	Spain	216.1
11	Italy	194.5
…	*Russian Federation (all outflows)*	*153.6*
12	Sweden	145.4
13	Australia	91.2
14	Denmark	74.6
15	Singapore	71.3
16	Finland	69.5
17	Taiwan Province of China	59.6
18	Brazil	53.2
19	Russian Federation (outward FDI stock)	47.6
20	Korea, Republic of	43.5
⋮		
40	Hungary	4.6
⋮		
51	Czech Republic	1.5
⋮		
56	Poland	1.3
⋮		
59	Slovenia	1.1
60	Croatia	1.1

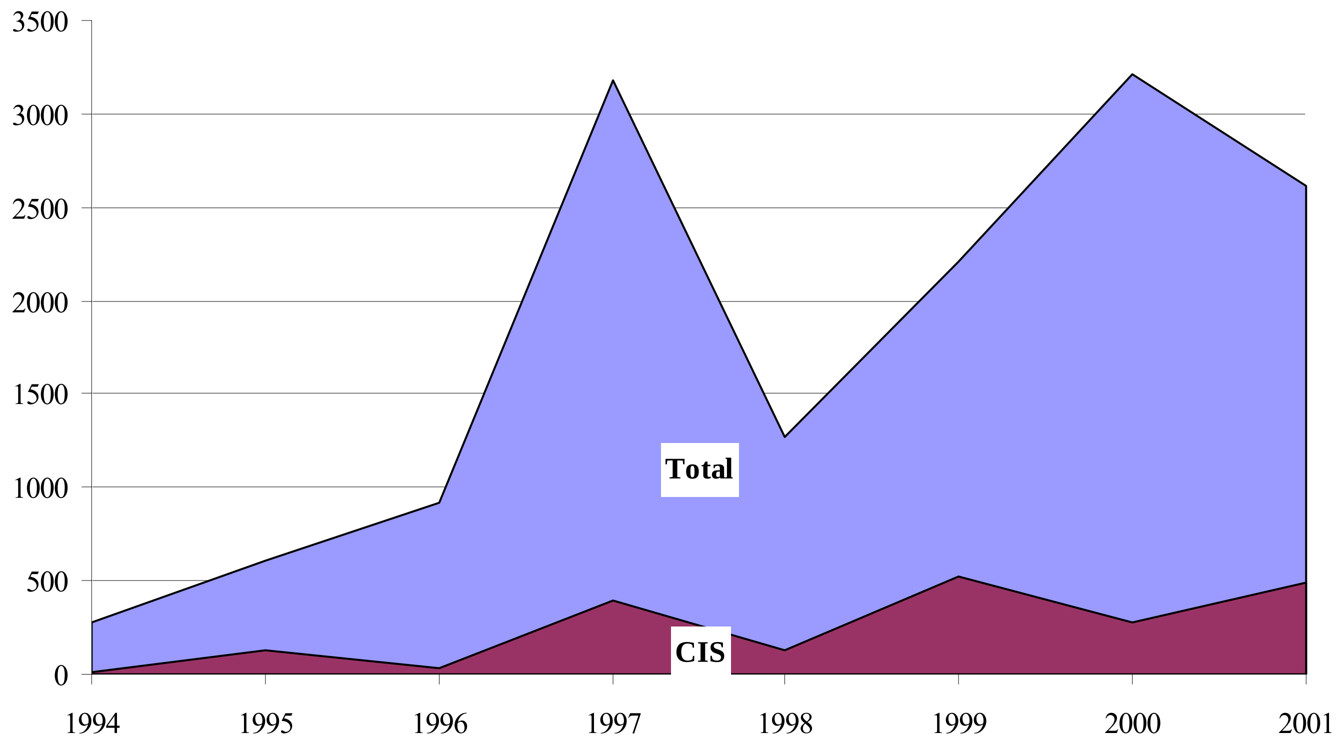
Sources: UNCTAD, FDI/TNC database and the Central Bank of the Russian Federation

Some features of outward FDI from CEE

Information on the structural patterns (industries, countries of destination) of outward FDI from CEE is quite scattered. What is available usually confirms the nascent status of those investments. In terms of countries of destination, while developed countries still figure prominently among the recipients of outward FDI, more recent data show a changing geographical pattern, especially regarding FDI from various countries envisaged to enter the EU in 2004. Nevertheless, given the bad quality and lack of data, these findings remain to be confirmed. Moreover, the Russian Federation is still a major exception to those trends. While

Russian firms have non-negligible investments in CEE (especially in Poland), too, they mostly target developed economies. The share of the Commonwealth of Independent States (CIS) in Russian outward FDI *flows* (figure 1) has been consistently low since 1994. It reached its highest share in 1999 (23.5%) – still less than a quarter of outflows. In contrast, in 1994, 1996 and 2000, that share remained under 10%.

Figure 1: Russian Federation: total FDI outflows and FDI outflows to CIS, 1994-2001 *(Million dollar)*



Source: Based on the balance-of-payments data of the Bank of Russia.

The firms from the other countries more often target other CEE economies, especially with which they have traditionally close business links (for example, Slovenian firms target former Yugoslavia). Within that general pattern, there are major country-by-country differences: an overwhelming majority of outflows and outward stocks in Croatia, Estonia and Slovenia are intra-regional. CEE is also a dominant destination for Slovakia and the Czech Republic, and is sizeable (though only in second position) in the case of Hungary. On the other hand, Latvia is an exception, with minimal outward FDI stock in CEE in 1999.

What does the literature tell us on outward FDI?

If there is a need to indicate a single most important reason for dealing in detail with corporate strategies as the key to explaining, it should be without doubt the incapacity of classical economic theories to explain the current phenomenon of FDI and its patterns. On the basis of the classical theory of international trade only, based on the comparative advantages, and extended into the movement of the factors of production by Eli Heckscher (1919) and Bertil Ohlin (1933), even the world of inward FDI would be difficult to theoretize. If those flows followed the classical theory, the developing economies and the countries in transition should be the main recipients of FDI, and not the developed economies. And probably outward FDI from economies in transition should not exist at all.

International business theory, especially the eclectic paradigm of John H. Dunning (1977, 1993, 1999) is better equipped to cover the outward FDI of economies in transition. The internalization aspect (I advantages) of the eclectic paradigm, drawing on Ronald H. Coase's work (Coase, 1937) can be used as a point of reference to explain the behaviour of outward investing firms anywhere, including the economies in transition. As for the ownership (O) advantages, originating in Stephen Hymer's (1960) and Raymond Vernon's (1966) contributions, their application is less straightforward. In principle, it should be the firms of the most advanced countries that possess those advantages and exploit them through international expansion. No wonder that, back in the 1960s, Vernon described those advantages as typical for United States firms. However, the fact that there are transnational corporations (TNCs) originated form developing countries was already observed by Louis Wells in the late 1970s (Wells, 1977, 1983). An original explanation talking about reverse motives and eventual ownership *dis*advantages is more recent (Sachwald, 2001). These theories can already somewhat better be adapted to the CEE context.

In-depth analysis on outward FDI from post-transition CEE has only recently started. Without being comprehensive, one can mention various efforts. In the Czech Republic, it has been Alena Zemplinerova (2001) who has been among the first to investigate the main motivations and features of outward FDI. In Estonia, a similar effort was undertaken by a team led by Urmas Varblane (Varblane *et al.*, 2001). In Hungary, most of the research in this area has been done by Katalin Antalóczy and Andrea Éltetö (Antalóczy, 2001; and Antalóczy and Éltetö, 2002). In the Russian Federation, there have been a number of studies undertaken. Notable are the results of Alexander Bulatov (1998, 2001), based on, among other things, a first-hand company survey. Slovenian research is probably among the most advanced ones, with various authors – Andreja Jaklič, Matija Rojec, Metka Stare, Marjan Svetličič, Andreja Trtnik, for example – analyzing various aspects of outward FDI (see, for example, Jaklič and Svetličič, 2001 and 2003; Stare 2002a and b, Svetličič, Rojec and Trtnik, 2001).

A caveat to this enumeration is imperfect information. This list may have overlooked research efforts, for example, in Croatia, because those findings – due to language constraints (most international scientific exchange takes place in English) or the limits of international funding (the European Union usually prefers funding research in the accession countries) –

are very probably much less communicated to the channels of international scientific discussion.

The research activities mentioned above cannot really take off without coordinators and synthesizers. In this respect, one has to mention efforts by Marjan Svetličič from the University of Ljubljana, Slovenia, to bring together experts from various CEE countries (Czech Republic, Estonia, Hungary, Poland and Slovenia). That project became the starting point of various original studies. Another main focal point in stimulating and coordinating research in the area is at the Turku School of Economics (Finland; and before at the Lappeenranta University of Technology), where Kari Liuhto has not just undertaken a series of case studies and analyses, especially on the outward expansion of Russian firms (see Liuhto, 2001), but has organized events and publications around this and other transition-related topics.

All in all, the topic of outward FDI and TNCs from CEE has not yet entered the mainstream of international business studies and international economic literature. There are signs however that the topic is from time to time selected by researchers outside the CEE or the immediate neighbouring countries such as Austria and Finland. For example, there are manuscripts emanating from the *Université Paris I Panthéon-Sorbonne* (Andreff, 2003).

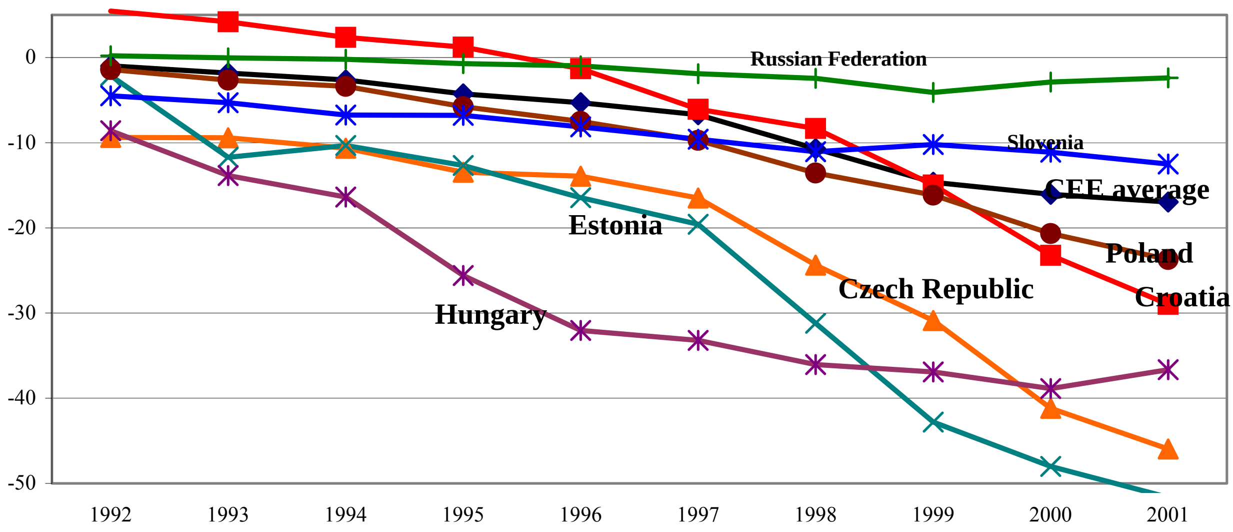
It is also notable that international institutions such as the United Nations Conference on Trade and Development, and its *World Investment Report* team, in particular, have for years picked up the topic of outward FDI from CEE with the aim of reflecting, synthesizing and further developing the results of current research. With the list of the top 25 TNCs, it has added first-hand survey-based information, too. That could stimulate new directions, and present original results in neglected aspects such as the implications of such outward FDI for policy (see also Kalotay, 2002). The author of this article has been pleased to be part of those efforts since 1997.

The IDP of CEE

Measuring the IDP of CEE

The net outward investment position of the seven CEE countries with already measurable outward FDI stocks (Croatia, Czech Republic, Estonia, Hungary, Poland, Russian Federation, Slovenia), although the period of possible observation (1992-2001) is very short, seem to fit, in most cases, into a scenario of countries in the second stage of the IDP (figure 2). In most cases, the starting value of the net outward investment position is close to zero. Some of the countries that inherited assets abroad after the break-up of larger units (such as Croatia,[2] the Russian Federation and Estonia) started from positive (or almost positive) values. With the exception of the Russian Federation, as time passed, the net outward investment position of countries became increasingly negative, with Estonia and the Czech Republic moving the fastest towards a major surplus in *inward* FDI.

Figure 2: The IDP of selected CEE countries, 1992-2001 (Net outward investment position as a% of GDP)



Source: Author's calculations, based on data derived from UNCTAD's FDI/TNC database, UNCTAD's Statistical handbook online and World Bank tapes.

With the exception of the Russian Federation, the net outward investment position of year 2001 correlates relatively well (0.68) with GDP per capita, derived from World Bank tapes. While all countries are "in the negative", richer countries show less pronounced values. In turn, if the data for the Russian Federation are added, the correlation practically disappears (0.05).

Even with that relatively nice fit into the IDP, the case of CEE again seems to confirm the idiosyncratic character of the IDP. In other words, the evolution of a given country in a given period of time is always unique. It can be well compared with the previous and subsequent periods of the same country. In turn, once a cross-country comparison is attempted, the results start to weaken substantially. If nothing else, each of them has a unique corporate strategy inside, or other individual circumstances. And when it comes to comparing different countries in different periods, especially with countries from different regions, the task becomes almost

[2] Croatia inherited large assets in the Krsko nuclear plant in Slovenia. That had a major impact on the initial IDP position of both countries.

impossible. No wonder, no exact range of GDP per capita is attached to the specific stages of the IDP.

Measuring oligarchy: an additional method

One of the relative weaknesses of the IDP may be due to the fact that, on the side of GDP per capita, it does not consider differences in income distribution. In other words, it is tacitly assumed either that national income is evenly distributed among population; or at least at a given level of development, the income distribution of countries is fairly the same.

Measuring outward FDI through oligarchy helps overcome that weakness of the IDP. As a proxy for wealth, the *Forbes* magazine list of the world's richest people (27 February 2003; referring to the situation of year 2002) has been used. It is quite notable that, of the 476 billionaires of the world in 2002, 17 came from the Russian Federation, and *none from any of the other CEE countries*. With this representation, the Russian Federation is the fourth billionaire country of the world, behind only the United States (222), Germany (43) and Japan (19), and ahead of, for example, Canada (15), the United Kingdom (14) and France (13). If the estimates are correct, billionaires control almost 15% of the GDP in the Russian Federation, compared with 7% in the United States and 8% in Germany.

A global comparison between the total worth of billionaires in 2002 and outward FDI stock in 2001 reveals a strong correlation between the two (0.774). And if the data for the Russian Federation are complemented by the unpublished estimates of Alexander Bulatov (annex table 2), correlation further increases to 0.777.

In explaining the above results, one has to assume two different worlds: one of the "small" countries where there are signs of the applicability of the IDP and other standard analysis; and another for the Russian Federation, where a combination of "system-escape" factors (capital flight) and global corporate strategic aspirations result in a major capital exporting world, without having the necessary GDO per capita usually assumed for that. This issue is picked up in detail in the next session.

The role of corporate strategies

What the largest TNCs of CEE look like

Information on what and how individual TNCs is one of the most important parts of the analysis of FDI in all regions of the world. To do so, it is also essential to evaluate, which of these TNCs are the most important players.

For the purposes of analyzing outward FDI from CEE, such an exercise was undertaken, for the first time, in the *World Investment Report 1999* (UNCTAD, 1999), which published a list of the top 25 non-financial TNCs headquartered in Central Europe, ranked on the basis of foreign assets. In *World Investment Report 2001* (UNCTAD, 2001) for the first time, the largest TNCs of the Russian Federation were shown together with those from the rest of CEE. With the exception of Gazprom, most of the leading outward investors of the Russian Federation were included in that list. With its annual sales above $ 10 billion in 1999 (as reported in the top 500 list of the *Financial Times*, <http://specials.ft.com/ft500/may2001/eastern.html>) and its extensive international network, Gazprom would likely have been to be one of the top CEE TNCs. However, consolidated information on its international activities could not be obtained. In turn, that description of the network without additional comments is already a clear-cut proof of the global reach of Russian firms.[3]

For the rest of the TNC universe in CEE, according to the most recent data published in the *World Investment Report 2002* (UNCTAD, 2002) most of the non-financial TNCs on the top 25 list (annex table 3) continued to grow in 2000, expanding more abroad than at home. They achieved double-digit growth rates of their foreign assets, foreign sales and foreign employment. However, their domestic assets and domestic sales increased only moderately (confirming previous trends), while their domestic employment contracted.

Data for the top 25 for 2000 also confirm that Russian TNCs for which data are available are much larger and more globally spread than their non-Russian counterparts. Lukoil Oil Company, the largest with foreign assets of more than $4 billion, compares with the largest 10 TNCs from developing countries. In foreign assets, foreign sales and foreign employment, the average for Russian firms on the list is more than 10 times higher than the average for other firms. They are also more transnationalized and have a wider geographical reach. These large differences may partly be due to differences in the industry composition as all Russian firms in the sample are involved either in natural resources or in transport, activities that are more capital-intensive than most manufacturing activities.

However, not all top TNCs in the region are on a growth path. While most Russian and Slovene firms, for example, do so, some Czech, Slovak and Polish firms are undergoing major restructuring, which often involves withdrawal from foreign activities. As a result of these changes, four firms left this list in 2000: Motokov (Czech Republic), Slovnaft (Slovakia), Croatian Airlines (Croatia) and Elektrim (Poland) – the latter one was also obliged to file bankruptcy in 2002.

The industry composition of the list remained stable over the years, despite the departure and arrival of firms. In 2000, transport (7 firms), petroleum and natural gas (4 firms) and pharmaceuticals (3 firms) kept their prominence. Trade caught up with 3 companies on this list.

[3] On this issue, see, in particular, UNCTAD, 2001, p. 116; Gazprom, 1999, pp. 86-102; Heinrich, 2001, p. 78; Liuhto, 2001, p. 27.; and Westphal, 2000, pp. 61-63.

The Network Spread Index (NSI) of the 25 largest TNCs of CEE is significantly lower than that of the world's largest TNCs. This index compares the number of countries in which a firm is present with the number of countries that are potentially open for inward FDI. The latter is usually proxied by the number of countries that have a positive inward FDI stock. At the end of 2001, there were 187 such countries.

In 2001, the Network Spread Index of the 25 largest TNCs of CEE stood at less than 4%, indicating that most of the leading TNCs in CEE are at an early stage of transnational expansion (table 2). There are, however, some differences by origin and industry. The index of Russian, Croatian and Slovene firms, for example, is above average. In machinery and pharmaceuticals as well, the network spread is relatively wide.

Table 2: The Network Spread Index of the 25 largest non-financial TNCs based in CEE
(Percentage)

By country of origin	NSI	By industry	NSI
Russian Federation	5.08	Petroleum and natural gas	5.21
Slovenia	4.55	Transport	2.22
Croatia	4.68	Pharmaceuticals	7.31
Hungary	2.54	Machinery	8.82
Other countries	1.82	Trade	2.85
Average NSI	*3.79*	Other industries	1.52

Source: UNCTAD, 2002.

Even for Russian TNCs, on average, the index values (5.08) are only a third of those for the top exporters of the country. While the average Russian TNC is present in less than 10 foreign markets, the average lead exporter sells in 27 countries. (For data on the top exporters, see *Expert* (Moscow), No. 27 (287), 16 July 2001.) In petroleum and natural gas, the spread of markets through exports (NSI=8.57) is twice as frequent as the spread of firms through outward FDI. It should be noted, however, that some of the top Russian oil and gas exporters are also leading outward investors. In such cases, the differences in the network spreads reflect corporate choices between serving markets through trade or through FDI.

The list of the top 25 TNCs is not exempt of weaknesses. Perhaps the most important one is a lack of comprehensive lists of potential respondents that could ensure that 100% of the potential sample is covered. Moreover, the list cannot include financial firms (banking, insurance etc.) because its methodology (listing based on foreign assets) cannot handle the problems of comparisons between financial and non-financial firms. Nor can it cover foreign affiliates investing abroad referred to above as its method follows the principles of final ownership and consolidation of reports. Finally, of the various methods of outward expansion and activity, it can deal with documented equity investment only. This may leave out firms that follow less orthodox ways of internationalization. This may be a major handicap, for example, when dealing with outward FDI by Russian firms where even the mechanisms of control and management over foreign activities – whether through equity participation or other contractual arrangement – are impossible to determine.

The representativeness of the results depends on the responsiveness of firms because of an almost complete lack of secondary sources that would provide the missing parts of information. Finally, because of the use of consolidated and audited accounts as a main source, there is an important time lag between the actual year covered in the data and the year of publication. In CEE where the map of outward investment changes fast, it is a major problem that can be mitigate only through anecdotal evidence on recent developments.

The way forward of the top 25 list should be through the fine-tuning of the method and improving the responsiveness of firms, which may become more and more used to this survey. On a more conceptual level, the challenge is to broaden the current narrow definition of foreign presence (foreign assets only) to a more encompassing one (exports, licensing, management contract or any other form of international involvement), without losing the practicality of the survey. While the narrow approach may be criticized as a “straightjacket”, limiting more real-life approaches, the latter one may be criticized as a too “shoreless” method. A commonly agreed new definition could probably strike a compromise between the two by introducing one or two new variables into the now three-legged (assets, sales, employment) transnationality index.

Are CEE firms different?

It may be argued that a specificity of CEE in the area of outward FDI is relative the discontinuity of past factors influencing the behaviour of such investment. In fact, the accumulation of historical experience and expertise in this area was interrupted twice: once when communist parties took over power, and again when they lost it. Hence the patterns of outward FDI are determined more by present-day and future-oriented considerations that in other regions.

The collapse of the former trading, supply and management systems following the demise of the Council for Mutual Economic Assistance necessitated the emergence of new structures for CEE companies formerly dependent on markets in (and inputs originating from) other CEE countries. This fact, combined with newly found possibilities for investing, led these companies to undertake new investments abroad as soon as the political climate changed.

The cases of Hungary, Estonia and Slovenia prove that, when transition is sufficiently advanced, some basic firm-specific ownership advantages tend to develop. This improves the chances of investing abroad, especially in order to overcome the profit constraints of small domestic markets and to maintain corporate competitiveness.

Russian TNCs

The case of the Russian Federation seems to be different from all the rest of the region, whether EU accession countries or others. First of all, outward investors from the Russian Federation immediately aim at establishing global presence. It is to be recalled that the share of other CIS countries, where Russian enterprises might have been expected to be in the best position to use their ownership advantages, is low in registered outward FDI flows (figure 1). As evidenced by the widespread phenomenon of capital flight, an important part of FDI outflows appear to be motivated by the desire of investors to diversify assets as a safeguard against domestic instability. This is then linked with the phenomenon of "round tripping". (Round tripping refers to the transfer of funds abroad in order to bring some or all of the investment back as FDI and claim the tax and other benefits offered to foreign investors; see UNCTAD, 1998, p. 290). One indication of the existence of round tripping in the Russian Federation, especially before the financial crisis of 1998 was a fast parallel increase of inflows and outflows itself. Another proof was the persistent high share of offshore Cyprus in both inflows and outflows – a small island that otherwise has no ownership advantages at its local firms (UNCTAD, 2000, p. 65). Finally, the discrepancy of home and host country statistics is also pointing towards the existence of round tripping. A large part of Russian investment into developed countries is not reflected in host country statistics either because the individual transactions are too small to be registered, or are transferred through third countries, typically outside the area of the Organisation for Economic Co-operation and Development (Sheets, 1996).

In the case of the Russian Federation, the question of ownership advantages has been presented in contradictory ways. On the one hand, Detelin Elenkov (1995a and b), based on the experience of Russian aerospace industry, claimed that firms in transition were typically possessing high-technology advantages and thus in their expansion they should build their strategy on ownership advantages – just like firms from developed countries do and from developing countries can not do. It turns out however, that the author has been generalizing from the experience of a rather exceptional industry. The spacecraft industry represents 0.02% of Russian exports only (UNCTAD TRAINS database). Of the largest 10 Russian exporting firms (accounting for close to one-third of total national exports), 8 are oil and gas companies, and two of them are engaged in non-ferrous metallurgy (see on *Expert*, No. 27 (287), 16 July 2001). This situation should the prevalence of natural resource-based firms in the Russian economy – a far shot from the optimism about the importance of high-technology activities.

Alexander Bulatov (1998), following and adapting the reasoning of Marjan Svetličič and his co-authors (1994) on system-escape FDI elaborated on the case of pre-transition former Yugoslavia, thought that it was not high-technology advantages but rather escaping a difficult business environment the prompted Russian firms today to invest abroad. If the first push really came from these motivations, then the region should be closer to the situation of ownership *dis*advantages, or rather say, ownership advantages in terms of coping with difficult business conditions. The lack of high-technology ownership advantages is also evident form the list of the top 25 TNCs, where some natural resource based firms dominate.

As mentioned, the patterns of outward FDI from the Russian Federation are largely determined by the behaviour of leading firms, such as Gazprom and Lukoil. (Finally, all corporate strategies are individual and corporation-specific.) *Lukoil*'s strategy is well documented both in its own corporate communications and through the list of the largest 25 TNCs of CEE, where it is the biggest reporting firm. It is a firm that has maintained its growth even in the middle of the Russian financial crisis. It may be hypothesized that, indeed, assets abroad have acted as an effective cushion against the shocks coming from upheaval in the domestic economy. Indeed, in 1998, in sharp contrast with the decline in domestic activities, the overseas activities of Lukoil soared, seemingly unaffected by the Russian crisis. While the 71% devaluation of the rouble caused a 53% drop in the dollar value of total assets, foreign assets rose by almost 50% in 1998, to $2.3 billion. A similar contrast prevailed in sales and employment: total sales declined by 10%, while foreign sales swelled by no less than 400%; total employment decreased by 2% while foreign employment soared by 400%. As a result, Lukoil leads over all Central European firms in terms of foreign sales and foreign employment, and its transnationality index bounced from less than 6% to more than 23%.

The development of Lukoil may also indicate the capacity of some Russian firms to switch from domestic to foreign markets – a trend not reflected in statistics on total outward FDI, which showed a sharp contraction in 1998 FDI outflows.

The expansion of Lukoil abroad is not just fast but is it efficient in terms of entering competitive developed markets such as the United States. This is once again a proof of the global strategies of outward investing Russian firms. The expansion into the United States took place through the acquisition of Getty Petroleum Marketing Inc. for $71 million at the end of 2000. Given the important costs of establishing greenfield presence, and the informal barriers to such entry by the structure of the United States market for the distribution of petroleum products, that was the only possible avenue for Lukoil's effective entry there. The First Vice President of Lukoil stressed in this respect that "This is the first acquisition of a publicly held American company by a Russian corporation, and it is the first step in our expected expansion into the U.S. market. It is an excellent opportunity for LUKOIL because it gives us entree into the vast American market in partnership with a highly regarded brand. In the future, we may seek to supply the Getty stations with our own petroleum products" (Lukoil, 2000, p. 1).

The acquired firm owns a chain of 1,260 retail outlets in 13 states. It also markets heating oil and other petroleum products. The principal shareholders of Getty (which collectively owned approximately 40% of Getty's common stock) agreed to the transaction, subject to certain conditions. First, Getty's headquarters were to remain in Jericho, Long Island, New York. Second, Lukoil had to make a best-effort promise to avoid laying off employees and to retain the majority (if not all) of the pre-acquisition management. Lukoil also intended to keep the Getty brand, considered as one of the premier and best-known retail brands of petroleum products in the United States.

The managers of both Lukoil and Getty argued that the transaction created major synergies. “The combination of Getty’s strong presence in the American market with LUKOIL’s capabilities as a world class integrated oil company is going to create a formidable new company,” said the chairperson and chief executive officer of Getty Petroleum Marketing (Lukoil, 2000, p. 2).

Government policies

General issues

For policy makers dealing with outward FDI issues, the most important stakes are the same as in the case of inward FDI, i.e. where and how locational decisions are taken and where jobs, especially higher quality, management-type jobs are created. In this respect, Governments face the dilemma that if they help the creation of better jobs at home by giving a hand to their firm’s international competitiveness, they let out financial resources that in principle could be used productively at home, too. However, they have to understand that outward FDI is not a zero-sum game, under which money and jobs are transferred from the home to the host economy, for at least three reasons. First of all, for many outward investing firms, the alternative of going abroad is going out of business. In this sense, outward FDI is a job saver at home. Secondly, when some simple jobs are created abroad, there is a need to create additional, higher-quality jobs at home, especially in “upstream” coordinating functions (management, logistics, information technology etc). Thirdly, the establishment of an affiliate abroad usually boosts the sales of the parent firm in the host economy, indirectly creating jobs at home.

These considerations are also valid in the context of transition in CEE countries. Indeed, if Governments wish to meet the aspirations of the population for fast improving standards of living, especially in countries where the fact of negotiating accession to the EU in itself raises expectations, the promotion of outward FDI can be seen as a major toll to reach that goal..

It is also to be understood from a more macroeconomic point of view that OFDI is a sine qua non in any middle- or high-income economy for its successful participation in the global context. The lack of OFDI may lead to the disappearing of firms that were stopped from investing abroad, due to intensive international competition.

While the motivations for outward FDI may be somewhat different between accession countries, where there is a growing search for more cost-efficient locations, and the non-accession countries, which typically need to get a foothold in the enlarged EU area, in both cases, Government policies and instruments may play a major role, especially in reducing the market entry barriers in areas and countries where in an initial phase, private institutions would be reluctant to be involved. In perspective, however, the promotion of OFDI may be based on public-private partnerships.

Policies on outward FDI have three levels. The first one is capital account liberalization. The second one is passive promotion, usually through bilateral investment treaties and double taxation treaties. The third level is active promotion. In the latter area it is to be emphasized that even in the largest developed home countries (United States, United Kingdom, Japan, Germany etc.) outward FDI requires and receives active public assistance, going beyond a simple liberalization of capital account transactions (UNCTAD, 1999). The institutional setting comes either in the form of an outward investment promotion agency, a development finance institution, or an investment guarantee scheme. Their services cover a wide range of areas, including information and promotional services, feasibility studies, project development, financing and guarantees.

If this is the case with the leading outward investing countries, probably the nascent outward investors of the countries in transition, too, would require help. Some countries in transition already do it. In 1999, the Czech Export Import Bank reported having an investment guarantee scheme (UNCTAD; 1999). In Hungary, it is the Hungarian Export Credit Guarantee Corporation (MEHIB) that has developed a political risk insurance scheme for Hungarian outward investors. Investment locations are ranked on the basis of four risk categories that are revised twice a year. A fifth category applies to countries on an ad hoc basis (UNCTAD, 1997, p. 99). In Slovenia, the Slovene Export Corporation provides long-term (3-15 year) investment insurance (up to 90%) against both commercial and non-commercial risks (including war and civil disturbances, expropriation including regulatory expropriation, currency conversion and transfer restrictions, denial of justice and natural catastrophes).

However, so far, there has been only one scheme, Corvinus International Ltd. in Hungary, which provides a menu a services including finance (in the form of participation in the share capital, loans or guarantees) and advisory services (consulting on firm strategy, matchmaking and partner search, and valuation and credit rating) to potential outward investors. The typical clients of Corvinus are medium-sized Hungarian manufacturing enterprises, although the scheme is open, in principle, to all firms and industries. That is an important characteristic making sure that not just the largest firms of the countries go the international way.

In other countries active outward investment promotion does not exists either because local firms have not yet reached the stage of feeling the need to expand abroad, or, in the case of Poland, because the relatively large domestic market and important slack of labour force apparently provide sufficient opportunities for private firms envisaging to expand. It remains to be seen, however, whether Polish firms will be able to cope with increased international competition if their expansion is limited to the Polish market, once the country joins the EU.

Russian policy dilemmas

It may also be argued that the Russian Federation should be treated as a special case. Given the scope of capital flight, at first sight, policies discouraging outward FDI should be on the policy agenda. That, however, does not seem to be a realistic option for two reasons. On the one had, constraining policies may harm the global strategic aspirations of Russian firms, which, at the end, could hurt economic development at home as well. On the other had, it can be argued that in fact policies have been quite restrictive in terms of constraining capital account convertibility and subjecting outward FDI to authorization. The problem of the latter has been that it had an effect on the contrary, prompting, rather than retaining, capital flight.

A more realistic avenue would be to adopt measures to transform and regularize, through tax and other measures, the unreported investments into officially registered ones (AFX, 2001). Some of these measures can be taken from the classical weaponry of the fight against capital flight such as more stringent financial information and reporting rules. Sometimes, improvement can come from exercising the Government's shareholder rights in firms in which it ahs a majority or even minority stake, as happened in the case of Gazprom, where the management failing to report transparently on the firm's transactions was replaced. Consideration can also be given to include an "incentive" in the tax system for up front transactions, at the expense of unreported investment.

Finally, it is a generally improving business environment that can stimulate the reduction of outward assets to a "normal" level, without harming welfare at home and strategic economic interests abroad.

Conclusions

Given the limits of time and length, this article has not – could not – provide fully researched answers to the questions raised. Rather, it has indicated the width and depth of issues and hypotheses that future research has to prove or refute in a thorough scientific manner. That really provides a dense research agenda for the academic community.

This article has attempted to find preliminary – or even more definitive – answers to some of the questions raised about outward FDI from CEE. Although heavily influenced by the specific circumstances of transition, this outward FDI nevertheless seems to follow the footsteps of "normal" outward FDI from other regions of the world. Reflecting the relatively latecomer status of CEE on the global outward FDI scene and the impact of the ruptures with the past caused by the transition shock, the outward FDI of most of the CEE countries has been so far fairly small.

It has also been highlighted that the Russian Federation is a special outlier, where quite important amounts of unregistered FDI are prompted by a combination of system-escape motives and global corporate aspirations in natural resources (especially oil and gas). It is hence more difficult to provide policy answers to the dilemmas of the Russian Federation than to those of other countries, where the promotion of outward FDI may be entering on the government policy agenda.

In this article, the issue of outward FDI was put, among other things, into the context of the IPD. It has been argued that most countries of CEE still in phase 2, under which outward FDI grows faster than inward FDI. There are some cross-country differences in this respect. Most importantly, the Russian federation does not seem to fit at all into that theoretical framework. It requires further analysis why it is so. But more importantly, this article has looked at the problem of capital flight from the Russian Federation from the practical point of view of what that problem represents for policy makers and how they try to tackle it.

It has finally been recognized that the next important event bearing a major impact on outward FDI from CEE will be the potential enlargement of the EU to include 10 CEE countries beginning with 2004. It has been stressed that such an event would probably prompt a major increase of outward FDI not just by the countries that are about to join the EU but also the ones that wish to gain footholds in that enlarged area. The rest is hypothesis, to be tested again after 2004.

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Annex table 1. Net outflow of private-sector capital from the Russian Federation,[a] 1994-2002
(Billion dollars)

Item/year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003[b]	Total
Net capital outflow by banks	2.0	-6.8	-1.3	-7.6	6.0	4.3	2.1	-1.3	-2.5	-9.6	-14.7
Foreign assets	3.0	-4.0	2.9	1.3	-0.3	3.4	3.5	1.4	1.1	1.1	13.4
Foreign liabilities	-1.0	-2.9	-4.2	-8.9	6.3	0.9	-1.4	-2.7	-3.6	-10.7	-28.2
Net outflow by non-financial enterprises and households	12.4	10.7	25.1	25.9	15.7	16.5	22.8	16.2	10.6	12.5	168.4
Foreign assets	13.6	5.4	25.5	29.8	14.2	10.1	15.5	10.5	18.4	16.8	159.8
Foreign liabilities	-1.2	-3.8	-8.1	-12.7	-8.3	-2.1	-1.8	-3.7	-14.3	-10.3	-66.3
“Net errors and omissions” in the balance of payments[c]	-	9.1	7.7	8.8	9.8	8.6	9.2	9.5	6.5	5.9	75.1
Total net outflow of private-sector capital	14.4	3.9	23.8	18.2	21.7	20.8	24.8	15.0	8.1	2.9	153.6

Source: the Central Bank of the Russian Federation, http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=capital_e.htm (updated on 22 January 2004).

[a] Based on the balance of payments of the Russian Federation, flow data. The sign "+" denotes an outflow of capital, "-" denotes an inflow.

[b] Preliminary data.

[c] “Net errors and omissions” entirely relate to non-financial enterprises and households. Recording their capital transactions in the balance of payments is very difficult, given the nature of their activities.

Annex table 2. Worth of billionaires and outward FDI in selected countries, 2001-2002

(Billion $)

Economy	Total worth of billionaires (2002)	Outward FDI stock (2001)
United States	703.4	1 381.7
United Kingdom	29.8	942.8
France	45.2	515.5
Germany	140.5	513.8
Belgium	1.0	449.0
Hong Kong (China)	33.2	374.8
Mexico	24.0	328.4
Japan	48.9	300.1
Canada	44.9	244.5
Switzerland/Liechtenstein	25.1	236.4
Spain	19.3	186.0
Italy	29.6	182.4
Russian Federation	*36.6*	*153.6*
Sweden	43.9	122.6
Australia	5.4	88.0
Denmark	5.3	64.0
Singapore	8.9	63.2
Taiwan Pr. China	10.4	54.7
Netherlands	7.2	42.8
Portugal	1.4	40.8
South Africa	4.2	29.0
Austria	1.0	26.3
Philippines	3.1	24.9
Ireland	3.3	23.9
Chile	4.4	22.1
Argentina	1.6	20.7
Lebanon	3.8	19.0
Malaysia	8.4	12.0
Brazil	8.5	11.0
Israel	5.0	9.8
Venezuela	8.3	6.1
Greece	3.3	5.1
Colombia	1.0	3.0
Turkey	8.9	3.0
Thailand	2.4	2.6
Indonesia	1.4	2.5
Norway	1.0	2.1
India	17.4	2.1
Korea, Republic	5.0	1.8
Saudi Arabia	40.2	1.7
United Arab Emirates	2.0	0.3
Kuwait	5.1	0.1
Rest of the world	-	176.9
Total	1 403.3	6 552.0

Source: *Forbes* magazine list of the world's richest people (27 February 2003; http://www.forbes.com/2003/02/26/billionaireland.html;for data on billionaires) and UNCTAD FDI/TNC database (for other data)

Annex table 3. The top 25 non-financial TNCs based in CEE [a], ranked by foreign assets, 2000
(Million dollars and number of employees)

Ranking by foreign assets	TNI [b]	Corporation	Country	Industry	Foreign assets	TNI [b] (Per cent)
1	11	Lukoil	Russian Federation	Petroleum and natural gas	4 189.0	34.7
2	6	Novoship	Russian Federation	Transport	963.8	53.7
3	1	Latvian Shipping [c]	Latvia	Transport	459.0	87.3
4	5	Primorsk Shipping	Russian Federation	Transport	256.4	59.4
5	24	Hrvatska Elektroprivreda	Croatia	Energy	296.0	4.3
6	7	Gorenje Group	Slovenia	Domestic appliances	236.3	46.9
7	10	Far Eastern Shipping	Russian Federation	Transport	236.0	38.8
8	13	Podravka Group	Croatia	Food and beverages/ pharmaceuticals	.. [e]	31.6
9	9	Pliva Group	Croatia	Pharmaceuticals	181.9	39.7
10	3	Atlantska Plovidba [c]	Croatia	Transport	138.0	63.2
11	8	Krka	Slovenia	Pharmaceuticals	129.2	40.0
12	20	MOL Hungarian Oil and Gas	Hungary	Petroleum and natural gas	102.7	9.6
13	14	Tiszai Vegyi Kombinát	Hungary	Chemicals	101.2	25.4
14	2	Adria Airways [c]	Slovenia	Transport	116.3	64.0
15	19	Petrol Group	Slovenia	Petroleum and natural gas	98.8	10.6
16	22	Mercator	Slovenia	Retail trade	65.1	4.5
17	4	Zalakerámia	Hungary	Clay product and refractory	60.0	60.8
18	15	Skoda Group Plzen	Czech Republic	Diversified	.. [e]	26.2
19	12	Malév Hungarian Airlines	Hungary	Transport	41.4	33.9
20	18	Matador	Slovakia	Rubber and plastics	.. [e]	13.1
21	21	Merkur	Slovenia	Trade	37.3	7.5
22	25	KGHM Polska Miedz	Poland	Mining and quarrying	32.3	2.7
23	23	Petrom	Romania	Petroleum and natural gas	28.0	4.5
24	16	Iskraemeco	Slovenia	Electrical machinery	25.8	24.4
25	17	Intereuropa	Slovenia	Trade	23.0	16.7

Source: UNCTAD, 2002.

[a] Based on survey responses.

[b] The Transnationality Index (TNI) is calculated as the average of three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[c] 1999 data.

[d] Including export sales by the parent firm.

[e] Data not revealed by the firm; estimates have been made using secondary sources of information.

Note: In some companies foreign investors may hold a minority share of more than 10%.

RUSSIAN CORPORATIONS ABROAD – SEEKING PROFITS, LEVERAGE, OR REFUGE?[1]

Peeter Vahtra and Kari Liuhto

Abstract

Russian outward foreign direct investments have grown rapidly during the past decade. The existing data on Russian markets suggest several particularities in the country's organisational settings, including relatively low level of transparency of the operations of Russian companies both on domestic markets and abroad. Additionally, high level of concentration characterises the Russian economy, making several industries politically sensitive, especially what comes to the international operations of the largest corporations. Emphasising these specific features, four typological groups of Russian large industrial corporations are formed. The created typology serves as simplifying tool in explaining the organisational settings and outcomes related to internationalisation of Russian companies. The cross-border operations of both the Russian and EU firms strengthen the linkage between the Union and Russia and aid in building the Common European Economic Space between the EU and Russia even if Russia would not become a member of the Union in the foreseeable future.

Keywords: Russian companies, internationalisation, FDI, typology

[1] The revised version of the paper has been submitted for publishing in Transnational Corporations, forthcoming.

Introduction

The most efficient way to bring Russia closer to the world economy is to support the integration of Russian firms into the global business. The trade rapprochement – for instance via Russia's WTO membership – is an outmost necessary but not a sufficient condition in this process, and hence, more emphasis should be placed on the investment integration.

The most integrative bridges are those, which do not only support foreign direct investment (FDI) flows to Russia but also aid the Russian investors to participate in the international business. The expansion of the Russian corporations out off their domestic market is perhaps the fastest means to improve the international competitiveness of Russian firms, since increasing international competition inside the Russian market via attracting foreign companies into the country has led to a slow modification of old practices, as foreign firms adapt to the Russian business culture rather than push Russian firms to modernise their practices.

Scholars have so far conducted a relatively small number of academic researches on the Russian business expansion abroad. The number of the scientific studies on the internationalisation of the Russian companies remains small despite the increasing economic and political importance of the phenomenon. The phenomenon is particularly important in the eastern parts of the EU25 and the CIS.

Earlier studies related to the internationalisation strategies of the Russian companies stress the limited applicability of the internationalisation theories produced in the developed West to the understanding on the foreign expansion of the Russian companies (e.g. Bulatov 1996; Efimova et al. 1996; Pchountelev 2000; Heinrich 2001a).

Earlier researches also describe the activities of the Russian corporations in some individual countries, such as in Cyprus (Pelto et al. 2003), Finland (Jumpponen 2001; Vahtra & Lorentz 2004), Lithuania (Zashev 2004), and Poland (Liuhto 2002). Even a larger number of the studies deals with individual companies (e.g. Heinrich 2001b; Kobyzev 2001; Liuhto 2001a/b; Peregudov 2001; Rybakov & Kapustin 2001; Survillo & Sutyrin 2001; Trofimenko 2001).

In addition, scholars have investigated reasons why the Russian companies go abroad. Economic motives have been found insufficient for explaining alone all the international activities of the Russian corporations. Therefore, the political dimension of the foreign operations should be taken into account, when the internationalisation of the Russian firms is discussed. The non-economic motives of the internationalisation become emphasised particularly in the strategic sectors of the economy, including the oil business, natural gas sector, and the metal and mining industry (e.g. Heinrich 2003; Liuhto & Jumpponen 2003 a/b; Vahtra & Liuhto 2004). Due to the dominating role of the energy sector in the Russian economy, several academics have focused the outward expansion of companies operating in the energy sector (e.g. Väätänen & Liuhto 2000, Liuhto 2001a/b; Peregudov 2001; Trofimenko 2001; Heinrich 2003).

Since the United Nations Conference on Trade and Development (UNCTAD) provides an excellent macroeconomic view on the Russian outward foreign direct investment (OFDI), the authors approach the phenomenon from the microeconomic perspective i.e. the writers deal with the international operations of Russia's largest industrial corporations[2]. The main objective of this research is to build a typology related to the foreign operations of Russia's largest industrial corporations.

The article is structured as follows: firstly, the methodological basis of the research is given. Thereafter, the authors provide an overview on the historic development of the Russian OFDI and describe the activities of the Russia's largest companies abroad. In Chapters 4 and 5, the literature review is conducted in order to create a typology concerning the foreign operations of the Russian largest companies. The final chapter provides some policy recommendations related to the Russian companies' internationalisation both from the home and the host countries' perspective.

Methodology

During the past five years, the authors have systematically gathered a great amount first-hand and second-hand material on the foreign operations of Russia's 100 largest corporations. The first-hand data is mainly based on one enterprise survey, several case studies (management interviews), and company reports. Correspondingly, the second-hand data has been collected for instance, from statistics, numerous business reviews and Internet sources.

The authors have noticed that the first-hand data is not always the best way to receive reliable data, since the Russian companies are not extremely willing to provide information for researchers. The reluctance to give information to outsiders may stem from a fear of data ending in the hands of their competitors, tax authorities or even organised crime.

As the authors have observed in their earlier research projects that the companies have provided either deliberately or non-deliberately misleading information to researchers, the writers have collected information from several second-hand sources. By combining both the first-hand and the second-hand sources, the authors aim at drawing a more comprehensive picture of the foreign activities of the Russian companies.

In order to build the typology on the foreign operations of the Russian firms, the authors have reviewed earlier literature on organisation typologies relevant for this study.

[2] The data of Expert Rating Agency (2004) was used to select the companies for the investigation. The 100 largest industrial companies were defined on the basis of their net sales in 2003. The banks were excluded from this study (see Appendix).

The Russian Business Operations Abroad

The Historic Development of the Russian Outward Foreign Direct Investment

According to Bulatov (1998, 69-70), *"Russian firms started to invest abroad in the last decades of the 19th century. Capital was exported primarily to China and Persia, as well as to Mongolia. During the period 1886-1914, Russian capital exports amounted to about 2.3 billion roubles (equivalent to $ 33 billion at 1996 prices). Between the two World Wars, the Union of Soviet Socialist Republics did not withdraw all outward investment, although it radically diminished it. To support trade with Turkey, Iran, Afghanistan and Mongolia, a whole net of trading companies was established and operated in those traditional partner countries. Trading affiliates in Western Europe were added later. Also, various banks, transport, insurance and other types of firms were established abroad with Soviet capital. In the post-war period, the number of companies abroad increased somewhat".*

Even after the World War II, the foreign operations of the Soviet firms remained rare. The USSR firms had around 30 subsidiaries in developing countries and 116 subsidiaries in the OECD countries at the end of 1983. The Soviet companies were not particularly active in their operations even within the CMEA. By 1990, only some 175 Soviet-owned joint ventures were registered in the European CMEA countries (Zaleski, 1986; McMillan, 1987; Matejka, 1988; Cheklina, 1991).

The overwhelming majority of the Soviet subsidiaries abroad carried out marketing of oil, metals, timber, chemicals, machinery, and vehicles. In addition to the intermediary activities, Soviet units abroad serviced the foreign trade activities of the USSR, as they operated in transportation, the insurance business, and international banking. Moreover, Soviet organisations operated in tourism and travelling (Hill, 1986).

Despite the small number of Soviet firms abroad, their importance in supporting Soviet exports cannot be neglected. Sokolov (1991a/b) argues that the Soviet units overseas were selling about 40% of Soviet oil and oil product supplies abroad, more than 50% of the exports of civilian-use manufactured goods, and 60% of the timber, paper, and cellulose exports. However, when evaluating the role of Soviet enterprises abroad, one should not forget that the foreign operations of these Soviet firms were not motivated by business logic alone, but that Soviet firms abroad also served the goals of the USSR's foreign policy (Hamilton, 1986).

On the eve of the USSR's disintegration, the OFDI stock of the Soviet Union was modest; less than $ 1 billion in 1990. The transformation from the centrally planned system towards a market economy has resulted in considerable increase in OFDI. In the beginning of 2004, Russia's OFDI stock amounted already to $ 52 billion, and with this sum Russia ranks as the 21st among the world's largest investor countries. With the aforementioned figure, Russia covers 0.6% of the world's OFDI stock.

Even if Russia's share is minimal, one should keep in mind that the OFDI stock forms only a fraction of the Russian capital abroad. In order to estimate the total amount of the Russian capital outside Russia, one should not forget the capital flight from the country. According to the European Commission (2004), $ 245 billion is estimated to have flown from Russia during 1992-2002 i.e. Russia’s OFDI stock is approximately a fifth of the capital flight.

Kalotay (2003) suggests that the EU25 is the main destination for the Russian firms. The member states of the EU has attracted a half of all the Russian OFDI. Besides Germany, the eastern part of the EU is a particularly attractive investment target for the Russian firms. In absolute terms, Poland is the leading country in Central Eastern Europe (CEE) with nearly $ 1.3-billion investment from Russia. Correspondingly, Latvia and Lithuania are the leading countries measured in relative terms. In both the aforementioned countries, Russia accounts for 5% of the total inward FDI stock (see Table 1).

According to Kalotay (2003), the USA is the second largest destination of the Russian OFDI after the enlarged EU. The USA has attracted more Russian FDI than any other single country. The USA represents a quarter of the Russian OFDI stock.

Table 1 Russia's FDI Stock in the New European Union

Country	Russia's FDI stock ($ mn)	Russia's share of recipient country's total FDI stock (%)	Russia's ranking among foreign investor countries	Russian FDI per host country's citizen ($)
Cyprus (1.1. 97-31.12.2002)	284.69	…	…	…
Czech Republic (31.6.2003)	28.50	0.07	…	3
Estonia (31.3.2003)	69.73	1.40	10	50
Hungary (1.1.2003)	71.00	0.23	…	8
Latvia (1.1.2003)	157.31	5.28	…	68
Lithuania (1.1.2003)	235.56	5.21	8	65
Malta (1.1.2003)	0.00	0.00	…	0
Poland (1.1.2003)	1291.90	1.89	12	33
Slovakia (30.6.2003)[3]	less than 10.00	less than 0.10	…	…
Slovenia (1.1.2003)	2.10	0.00	…	0

Source: Central banks, authors' calculations.

The authors are convinced that the Russian corporations have a strong foothold in the CIS, even if the Russian FDI does not necessarily appear in the FDI statistics of CIS countries. One reason for the absence of Russia in these statistics, besides statistical deficiencies, is simply the fact that Russian corporations have invested indirectly i.e. via another country. To put it differently, Russian corporations can sometimes be detected behind investments from the Bahamas, Panama, the Virgin Islands, or even some EU countries, in particular Cyprus. Russia's OFDI stock presented in Table 1 covers only a minority of the overall Russian capital in Cyprus, as Cyprus was prior to her EU accession perhaps the most significant transit point for Russian capital targeting to CEE (see Table 2).

Table 2: Cyprus' FDI Stock in the New and Future EU Member States

[3] In this context, one has to take into account that Yukos has acquired a Slovak pipeline operator with over $ 70 million (perhaps indirectly via its foreign unit) and Gazprom may have already conducted $ 1-billion investment in the Slovakian natural gas company, SPP.

	Cyprus' FDI stock ($ mn)	Cyprus' share of recipient's total FDI stock (%)	Cyprus' ranking among investor countries
Czech Republic (31.6.2003)	469.19	1.21	…
Estonia (31.3.2003)	9.02	0.20	…
Hungary (1.1.2003)	315.13	1.00	14
Latvia (1.1.2003)	5.95	0.20	31
Lithuania (2.6.2003)	74.70	3.30	29
Malta (1.1.2003)	0.00	0.00	…
Poland (1.1.2003)	998.90	1.46	16
Slovakia (30.6.2003)	194.00	2.20	10
Slovenia (1.1.2003)	8.91	0.22	…
Bulgaria (1.1.2003)	274.50	5.16	8
Romania (30.9.2002)	422.43	4.90	8

Source: Pelto et al. (2003).

The main targets for the Cypriot investments among the new and two future EU member states are Poland, the Czech Republic, Romania, Hungary, and Bulgaria. A significant amount of the Cypriot FDI in these countries (amounting to nearly $ 2.5 billion) is generally considered to be Russian by origin.

An Overview of the Russian Corporations' Foreign Operations

UNCTAD (2004) provides a list of the 25 largest non-financial transnational companies based in CEE. Five Russian companies, namely Lukoil, Novoship, Norilsk Nickel, Primorsk Shipping, and Far Eastern Shipping, are on that list. In terms of foreign assets, Lukoil ranked as the largest transnational corporation based in ex-socialist countries with its foreign assets totalling to nearly $ 6 billion. With its 6-billion-foreign investment, however, Lukoil did not qualify among the world's 100 most transnational corporations. Here one should keep in mind the company list provided by the UNCTAD is not a fully comprehensive as it is based on an enterprise survey. In order to fulfil the obvious gaps of the list, the authors describe the foreign operations of the largest corporations in Russia's most outward-oriented industries.

Oil and Natural Gas Industry

Russia's most significant outward-expanded corporations can undoubtedly be found in the oil and natural gas sector. Russia's three most transnational oil companies are privately-owned

Lukoil and **Yukos**, and the state-owned **Rosneft**. The majority of Russia’s other oil producing firms can be regarded as regional players rather than global actors.

Although the international activities of Russian oil companies practically cover practically the whole globe, the main production targets are the resource-rich Middle-East and the CIS, particularly the Caspian Sea region. Another important location for the Russian oil companies is Eastern Europe, where they control several refining units and distribution outlets. As a consequence of Lukoil’s acquisition of the USA-based Getty Petroleum Marketing in 2001, the geographical scope of Russian oil companies have expanded out off Europe.

Gazprom is practically Russia’s natural gas industry. It covers over 80% of Russia’s gas production and a similar stake of the country's gas exports. Gazprom has equity investments in over 20 countries, including several EU member states. Besides the EU25, Gazprom has investments in the future members of the EU i.e. Bulgaria, Romania and Turkey, and in some CIS countries. With its foreign expansion, Gazprom supports its gas exports. Due to its outward expansion, Gazprom receives revenues directly (via sales to its foreign subsidiaries) and indirectly (via the profit distribution of its foreign subsidiaries). Gazprom's investments in the EU prove that the Russian corporations may benefit directly from the enlargement even if Russia is not a member of the EU. On the other hand, Gazprom's investments in the foreign gas companies may increase the predictability of the gas supply from Russia to the EU, which is to grow significantly in the next decade.

Itera is the largest private producer of natural gas in Russia. Itera holding company has its headquarters in the USA but it can nevertheless be regarded as a Russian firm, since its owners and management board are closely related to Gazprom's former directors and shareholders. Itera has emerged as the major supplier to the CIS and the Baltic States, being the largest independent producer and supplier of natural gas in the region. Itera has mainly founded distribution units abroad (see Table 3).

Box 1 Some Foreign Operations of Russia's Leading Transnational Corporations in Oil and Natural Gas Industry

Lukoil, Russia's largest oil producer, has purchased foreign oil fields, production facilities and retail property. Nearly a fifth of the corporation's reserves are located abroad. Its major foreign fields are in Iraq, the Azeri and Kazakh sectors of the Caspian Sea, and Egypt. Three quarters of the company's proven foreign reserves lie in the Iraqi field, West Qurna. This oil field, with the estimated reserves of some 20 billion barrels, is one of the largest in the world. Due to the unsettled ownership of West Qurna, the Kazakh, Azeri and Egyptian fields are currently responsible for practically all of the company's foreign production. Even if Lukoil has considerable stakes in oil fields abroad, foreign production accounted for less than five per cent of the group's total oil and gas condensate production in 2002.

Besides participating in the development of foreign oil fields, Lukoil has acquired refineries in Bulgaria, Romania, and Ukraine. The company also possesses an extensive retail network; altogether over 4700 stations, of which nearly 900 stations are located in other former Soviet republics and Eastern Europe. In the end of 2003, Lukoil won a tender allowing it to acquire 80% of the Serbian Beopetrol, which operate some 200 petroleum stations and several oil storages in Serbia. In addition to the ex-socialist countries, Lukoil has expanded to the developed West. In 2000, along with the takeover of Getty Petroleum Marketing, Lukoil acquired some 1300 filling stations in the USA. Recently, Lukoil acquired almost 800 stations from ConocoPhillips for the price of $ 266 million.

Yukos, the country's second largest oil producer, has during the past few years emerged as a notable actor in the global oil business. In the beginning of 2002, the company acquired 78% of the Federovsky exploration block in Kazakhstan, being the company's first production outlet outside Russia. Almost simultaneously, Yukos bought a 49%-stake in a Slovak pipeline company, Transpetrol, in a $ 74-million deal. Through Transpetrol, Yukos controls the Slovakian sector of one of Russia's main pipeline export outlets, the Druzhba pipeline. In mid-2002, the company managed to obtain a controlling stake in a Lithuanian refinery, Mazeikiu Nafta, with $ 160 million. Though Yukos' international activities are minor compared to those of Lukoil, Yukos is probably Russia's second most transnational <u>oil</u> company.

Gazprom is the world's largest natural gas producer. Gazprom has equity investments in over 20 countries. Besides the current EU, Gazprom has investments in the future members of the EU and some CIS countries. Gazprom is most probably Russia's largest transnational corporation in terms of foreign assets.

A handful of major companies is responsible for the lion's share of the oil and gas industry's foreign assets. These giant corporations have a considerable presence in foreign markets, and they rapidly expand the scale and the scope of their foreign activities. So far, smaller companies in the Russian oil and natural gas sector have concentrated on exporting rather than establishing units abroad. However, it is probable, that the smaller units increase their presence in Russia's close-by regions in the near future. The regional internationalisation is the only option for smaller companies if they do not decide to merge either with larger Russian corporations or foreign firms.

Metal and Mining Industry

As the metal and mining industry accounts for a fifth of Russia's total exports, it does not come as a surprise that this sector is Russia's second most outward-oriented industry after the oil and natural gas business.

The leading metallurgical conglomerates can be classified as global actors. The Russian metal companies have acquired production sites mainly in the resource-rich developing countries. As an example, one can take a bauxite mining complex in Africa, which was acquired by Russia's leading aluminium company, **Russky Aljumini (RusAl)**. Besides mining abroad, RusAl owns refineries in former socialist countries.

In addition to RusAl, some other metal majors have extended their presence abroad. Russia's leading metal corporations have not only founded marketing units but also production outlets outside Russia. **Norilsk Nickel's** acquisition of Stillwater Mining and **Severstal's** acquisition of Rouge Industries in the USA can be mentioned as examples of significant investments in production outlets outside Europe.

Alrosa is one of the world's leading diamond mining companies responsible for almost 25% of the world's raw diamond production. Although Alrosa's domestic units cover the majority of the corporation's diamond output, the company also mines diamonds abroad. Besides foreign production, Alrosa has opened several representative offices and trading companies overseas.

In conclusion, the Russian metal and mining companies are still on their way to reach a place on the global market, but it is likely that the Russian metal giants increase considerably their presence on the world market already in the mid-term both via establishing marketing units and buying production outlets abroad (see Table 4).

Box 2 Some Foreign Operations of Russia's Leading Transnational Corporations in the Metal Industry

Russky Aljumini (RusAl) is the second largest aluminium company in the world after the US Alcoa. RusAl produces a tenth of the world's aluminium and three quarters of Russia's output. The company exports to over 30 countries. RusAl's foreign sales account for 80% of its turnover. Europe is the largest external market, representing almost 60% of the company's export revenues. Asia accounts for over 30% and the USA practically the remaining 10%. In order to facilitate its exports, RusAl has founded representative offices at least in four countries: China, Germany, the UK, and the USA. The corporation's bauxite deficit inside Russia has pushed the company to start production abroad. In Guinea, the company manages a bauxite mining complex, Compagnie des Bauxites de Kindia. According to non-confirmed information, RusAl's investments in Guinea total $ 2 billion. In April 2004, the company submitted a bid to obtain a majority share in a Jamaican bauxite mining company, Alpart, earlier controlled by the bankrupt Kaiser Aluminium. The stake is estimated to value $ 150-200 million. Besides mining, RusAl owns the Oradea aluminium refinery in Romania and the Nikolayev aluminium refinery in Ukraine. The company also holds a 74% stake in Armenal foil mill in Armenia.

Norilsk Nickel is the world's largest producer of several strategic metals. Its market share is around 60% of palladium, 20% of platinum and nickel, 10% of cobalt, and 3% of copper production worldwide. In order to support its foreign sales, the company has acquired a London-based metal trading company, Norimet Ltd. In 2003, Norilsk Nickel bought a 51%-stake in a US company, Stillwater Mining, in a $ 257-million deal. Stillwater Mining is the sole producer of platinum-group metals in the USA and the fifth largest producer in the world.

Severstal ranks among the world's top 20 steel companies. The company's exports are targeted to over 100 destinations worldwide. Severstal's foreign sales amounted to approximately $ 1.1 billion in 2003. In the end of 2003, Severstal won the auction to buy Rouge Industries, the fifth largest steel producer in the USA. The acquisition would provide means to circumvent the US steel import restrictions and increase the Severstal's global recognition. For managing its US assets, Severstal has established an affiliate, Severstal North America Inc, in the country. Apart from its acquisition in the USA, Severstal has made an offer to buy the largest Czech steel producer, Vitkovice. In addition to participating in the Czech tender, Severstal is eyeing another giant target in the CIS, the Ukraine's largest steel producer, Kryvorizhstal. Besides, Severstal has also established a joint venture with a European group, Arcelor, for the manufacturing of hot galvanised rolled products for the European market. Severstal holds 75% of the shares in this venture.

Non-Natural Resource-Based Industries

Although several non-natural resource-based companies have started their internationalisation, the authors believe that only one non-natural resource-based company, namely **OMZ**, ought to be placed among the ten most transnational industrial corporations in Russia.

Box 3 Foreign Subsidiaries of OMZ

Country	**Company**	**Activities**	**OMZ' stake, %**
Armenia	OOO OMZAR	Investing activities	100
British Virgin Islands	UHM Investments Ltd.	Investing activities	100
	Shipley Trading Ltd. BVI	Investing activities	100
Czech Republic	Skoda Steel	Castings production	100
	Skoda JS	Nuclear equipment production	100
Netherlands	Friede Goldman Marketing	Sales of engineering services	75
	United Heavy B.V.	Investing activities	100
	UHM Investments NV	Investing activities	100
Romania	UPET S.A.	Production of metal valves, mobile rings and offshore rigs' components	66
Tunis	UHM Tunissia	Representative office	95
Ukraine	OAO CBK Korall	Design and R&D for shipbuilding industry and drilling platforms	30
USA	BioLink Technologies Inc.	Development, manufacturing and marketing of fingerprint biometric products	39
	FGL Buyer LLC	Naval architecture and marine engineering in the offshore drilling	75
	OMZ Investments Co.	Investing activities	100
	Friede Goldman United Ltd.	Royalties and license fees from FGL Buyer LLC	75

OMZ (Uralmash-Izhora Group) is the largest heavy engineering corporation in Russia. OMZ controls 70% of the Russian market for oil and gas drilling equipment, 60% of the special steels market, 80% of the metallurgical equipment market, 50% of the nuclear power plant equipment market, and more than 90% of the mining equipment market. OMZ' products are exported to over 30 countries. Altogether Asia accounts for 60%, the CIS 21%, and Europe 19% of the consortium's exports. The company possesses production, marketing, and investment units overseas. Box 3 outlines the main foreign subsidiaries of OMZ (see Table 5).

The second example of the outward-oriented non-natural resource-based branch is the foodstuffs industry. **Wimm-Bill-Dann** (WBD) is the market leader in Russia in its product segments of wide range of juices, yoghurt, and baby food products. Even if Wimm-Bill-Dann is primarily focusing on the domestic market, it additionally has a strong position in the CIS region. The company also sells its products to Canada, Germany, Israel, the Netherlands, the UK and the USA through both its own distribution network and independent distributors.

Wimm-Bill-Dann has production units in Kyrgyzstan and Ukraine. In 2000, the company acquired an 84%-stake in a Kyrgyz dairy plant, Bishkeksut, for a modest $ 450 000. A year later, WBD acquired a 60%-stake in a Ukrainian plant, Kiev Dairy No 3, in a $ 4-million deal. In 2002, WBD strengthened its presence in Ukraine by acquiring an 82%-stake in the Ukrainian Kharkovsky dairy plant for $ 5 million, followed by the acquisition of a 76%-stake in the Burynsky Dairy Powder Factory for $ 2 million.

Despite the WBD's foreign production facilities, the bulk of the company's production is carried out inside Russia. Since the company's business is continuously growing, its future acquisitions may include the companies from CEE. Likely, the CIS will, nevertheless, hold the largest potential for WBD's foreign operations in a short term (see Box 4).

Box 4 Foreign Units of Wimm-Bill-Dann

Country	**Company**	**Activities**	**WBD's share,** %
Canada, Germany, Israel, Netherlands, UK, USA	Distribution centres	Sales, marketing	100
Kyrgyzstan	Bishkeksut	Dairy plant	84
Ukraine	Kiev Dairy	Dairy plant	58
	Kharovsky	Dairy plant	82
	Burynsky	Dairy powder factory	76

The third example of the outward-oriented non-natural resource-based industry is the mobile telecommunication. The mobile telecommunications is currently the fastest-growing

Russian industry. The number of mobile phone users has more than doubled during the past year, and the current amount of some 60 million mobile customers is not even near the market saturation. The three dominant companies in the mobile communication market account for close to 90% of the market.

MTS' market share in Russia was around 40% in 2003. Besides its leading position in the Russian markets, MTS has expanded its activities abroad. In 2003, MTS acquired the controlling stake in the largest mobile operator in Ukraine, UMC. The price of the purchase was $ 194 million. In 2003, MTS further invested over $ 60 million in Ukraine. In Belarus, MTS holds a 49%-stake in Mobile TeleSystems LLC. In addition to its operations on the Ukrainian and Belarus markets, MTS is reported to have interest in Bulgaria and Moldova (see Box 5).

Box 5 Foreign Units of Mobile TeleSystems

Country	**Company**	**Number of subscribers,** *mn*	**MTS's market share,** *%*
Ukraine	UMC	4.1	60
Belarus	Mobile TeleSystems LLC	0.6	50

Summa summarum, UNCTAD indicates that Lukoil, along with Norilsk Nickel and three Russian shipping companies, ranks among the 10 most transnational companies based in the ex-CMEA. The authors consider that the shipping companies should be excluded from the list since the outward expansion of these companies reminds one more of a technical exercise rather than genuine internationalisation, because the foreign-flagging ships does not mean that the firm would have become more committed to foreign operations or that the business practices would have changed. Sea transportation is an international business by definition and hence, those shipping companies dealing with international trade do not become global as such, but rather they are born global.

The researchers believe that Russia's ten largest industrial companies, having established the strongest international presence are Gazprom, Lukoil, Russky Aljumini, Norilsk Nickel, Itera, Yukos, OMZ, Rosneft, Alrosa, and Severstal (see Table 3).

Table 3 A Summary of Russia's 10 Most Transnational Industrial Corporations Based on the Foreign Assets

Company	Main countries / regions abroad	Type of activity abroad	Estimated value of foreign assets
Gazprom	Several countries in the CIS, CEE and EU plus South-East Europe	Trading, distribution, and marketing of gas, manufacturing of petrochemicals and gas, pipeline construction	…
Lukoil	Azerbaijan, (Iraq), Kazakhstan, Egypt, Columbia, Iran, Saudi-Arabia, Bulgaria, Ukraine, Romania, Baltic States, USA	Production and exploration of oil and gas, oil refining, retailing and marketing of petroleum	~ $ 6-9 billion
RusAl	Armenia, Romania, Ukraine, Guinea, Germany, USA, China, UK	Refining, processing and production of aluminium, bauxite mining, sales and marketing units overseas	~ $ 2-3 billion
Norilsk Nickel	UK, USA, Switzerland, Belgium, South Africa	Sales, marketing, and production of platinum-group metals, production of cobalt, mining and production of gold	~ $ 2 billion
Itera	USA, Armenia, Belarus, Estonia, Georgia, Latvia, Moldova, Turkmenistan, Uzbekistan	Headquarters (USA), gas distribution, plastic manufacturing, fertiliser production, metal production, pipeline construction	…
Yukos	UK, Slovakia, Kazakhstan, Lithuania, Austria, China	Oil exploration, process technology, pipeline construction, oil transportation, oil refining	~ $ 1 billion
OMZ	Romania, Netherlands, USA, Armenia, British Virgin Islands, Tunisia, Ukraine	Production of metal devices, investing and sales activities, technology development, engineering services	…
Rosneft	Kazakhstan, Algeria, Columbia, Afghanistan	Oil and gas production, field development, reconstruction of oil and gas infrastructure	~ $ 0.5 billion
Alrosa	Angola, Belgium, Israel, UK	Diamond mining, sales and marketing, product development	~ $ 0.5 billion
Severstal	USA	Metal production	~ $ 0.5 billion

Earlier Literature on Organisational Typologies

Organisational typologies often provide an appropriate framework for describing organisational settings and explaining their outcomes (e.g. Doty & Click 1994). Rich (1992) argues that organisational typologies provide effective data storage system and means for theory development by classifying the complex field of organisations into discrete categories. In earlier literature, the term *typology* often refers to conceptually derived classification of data. Typologies are developed theoretically with the organisational groups identified and conceptualised prior to the placement of organisations into these groups (Rich 1992; Miller 1996). As it thus appears from the very nature of typologies, they are essentially well informed by underlying (theoretical) concepts, and as such, capable of drawing *"distinctions and relationships of conceptual importance"* (Miller 1996). This view is backed by Doty and Click (1994), arguing for the typologies as complex theoretical statements capable of being subjected to empirical testing, when properly developed.

Whereas the context of each individual study ultimately defines the selection of data collection methods and its classification schemes, several problems of oversimplification related to typologies have been presented in the literature. Typologies have often been criticised for the limited number of dimensions they have included, squeezing the organisations into few categories based on considerations of only few aspects of organisational life (e.g. Carper & Snizek 1980; Rich 1992; Doty & Click 1994).

Acknowledging these restrictions, the simplifying nature of typologies, however, largely explains their attractiveness among scholars. Permitting the breaking of organisational world into collective categories, typologies are viewed suitable even for detailed analysis of variations between the typological groups (e.g. Rich 1992; Harzing 2000). Gaining from comprehensive theoretical and conceptual insight and being mostly intuitive in nature, typologies are at their best *"memorable, neat and evocative"* (Miller 1996). These conceptual typologies can thus serve as a useful classification of the complex organisational reality, combining information content with simplified information retrieval. Mills & Margulies (1980) further argue for typologies to provide a *"general set of principles for scientifically classifying things or events"*, and serve as analytical tools to stimulate understanding on the underlying phenomenon.

There is an endless count of variables serving as the basis for configurations. In the current study, the authors categorise the companies along two basic dimensions (also referred to in literature as character, attribute, variable or parameter). The dimension has been defined by Rich (1992), as a feature by which organisations can be compared against another, thus serving as "*source for comparison between the organisations"*. While it appears obvious that the selection of appropriate dimensions for the basis of typology development should serve the particular needs of each individual study, it has been acknowledged that the dimensions should be based on the theories underlying the configuration (see e.g. Aldenderfer & Blashfield 1984).

In developing the conceptual typologies, the relevant amount of variables considered is arguably limited to just a few (Rich 1992). Not to forget the possibility of oversimplification, the employment of only few variables can, however, arguably clarify the phenomenon under classification. The approach to typology formation accommodated in the current study can be identified as nominal theoretical*,* including the selection of two dimensions in fit with the existing literature. In grouping the organisations, a monothetic selection of membership criteria is adopted, meaning that the possession of a unique set of characters is both sufficient and necessary for group inclusion (Mills & Margulies 1980; Rich 1992).

An extensive set of typologies can be found in academic literature. In following, a brief overview is provided on the most prominent typologies. Subsequently, the argumentation is made for the typology creation in the Russian context.

Miles and Snow (1978) differentiate among the types of organisational strategies and identify three ideal types of organisations (prospector, analyzer, defender) that are hypothesised to result in maximal organisational effectiveness. Similarly, Mintzberg (1983) identified five types of organisations that are maximally effective under defined circumstances. Also the Porter's (1980, 1985) identification of ideal-type organisational strategies hypothesised to maximise competitive advantage, ranks among the most prominent typologies. All the above-mentioned configurations take the view of typologies as *"conceptually derived interrelated sets of ideal types"* of organisations (Doty & Glick 1994).

One of the most extensive typologies of TNCs is provided by Bartlett and Ghoshal (1989). Based on their case studies of nine TNCs, the authors derive four types of firms operating internationally – *Multinational, International, Global,* and *Transnational*. Several empirical studies have been carried out subsequently, developing and revising this original typology. For example, Leong and Tan (1993), Ghoshal and Nohria (1993), Harzing (2000) have based their studies on Bartlett and Ghoshal typology. The results suggest varying support to the original configuration (i.e. systematic differentiation on several important characteristics between the groups), but clear-cut support for the typology has not been discovered.

Creating a Typology for Russian Companies Operating Abroad

The aim of the current study is to put forward a feasible typology based on the specifics of the Russian companies' foreign operations. Thus far, the academic contribution to this specific subject has been negligible. Given the specifics of the Russian economy, the authors consider the traditional variables found in internationalisation and strategic management literature, inapplicable for explaining the Russian companies' operations abroad. The definition of typological dimensions for the purpose of this study, thus, mainly relies on the secondary data on Russian economy. The combination of data is used to illustrate the characteristics of the Russian economic structure and the specifics of the country's organisational field, leading the authors to conclude on the particular dimensions of Russian companies' business operations abroad.

The authors have studied a comprehensive set of first-hand and second-hand data sources for classification of the international operations of the largest Russian industrial corporations. Assessing two dimensions characterising the internationalisation of the Russian companies – organisational transparency and the political embeddedness of their operations – some motives and operational logic behind the internationalisation of the Russian companies are eventually identified. In the following, we provide argumentation for the selected dimensions in explaining the implications of the Russian companies' foreign operations.

When composing the typology, the ultimate goal of the authors has been to provide some implications on the particularities of the Russian companies' foreign operations, hence addressing the specific features connected to this internationalisation process. When it was already concluded above that the internationalisation of Russian companies does not follow the pattern offered by traditional internationalisation literature, the authors base the diversification of the companies on the specific features connected to foreign operations of the Russian enterprise sector. In following, these features are discussed and the typological dimensions proposed accordingly.

The vast amount of capital flight from Russia since beginning of her transition period has drawn widespread domestic and international attention to the phenomenon. The reasons lie in the detrimental effects of the phenomenon on the Russian economy, including loss of productive capacity and its growth, tax and budget revenues, missing control over monetary aggregates and access to international financing, among others (e.g. Mulino 2002). According to various estimations, from the beginning of the 1990s, some $ 250 billion have left the country in a form of illegal capital transfers.

Capital flight can take various forms, and the origins of capital can be perfectly legal, making the phenomena difficult to fight. The situation is further complicated in the case of Russia, where the transition process has left the relationships between economic agents and the state unclear and subject to arbitrary changes (Mulino 2002). The schemes of illegal capital transfers are highly diversified, making the creation of exhaustive classification impossible. Characterised broadly, they include misrepresentation of export earnings, overstatement of import payments or fake deals and a variety of capital account transactions through non-resident banks and offshore locations. Particularly, along with the growing importance of the energy sector in Russian exports the problem of non-repatriation of the energy export earnings becomes has been highlighted (e.g. Tikhomirov 1997; Loungani & Mauro 2000). The claim is supported by the association between the world market price for oil and estimated levels of capital flight from Russia.

Apart from to intransparent capital flows from Russia, the constantly high share of the unofficial economy further adds to the problem of transparency in the operations of Russian corporations abroad. According to the World Bank, as much as 46% of the Russian GNP in 2000 was generated by the unofficial sector of economy. Although some improvement in the practices can be assumed, the problem is widely recognised to continuously burden the Russian enterprise sector.

The results for Standard & Poor's 2004 Transparency and Disclosure Survey[4] suggest the organisational transparency of Russian companies to remain low in international comparison. Although the survey shows improvement in transparency performance for 2004, most of the Russian companies constantly under perform in comparison to the Western counterparts[5]. Only some top Russian performers for 2004, approach the disclosure standards of respectable international level.

Based on the above reasoning, we identify the *operational transparency* as one of the two dimensions for explaining the nature of Russian companies' foreign operations. We further argue transparency to have a profound impact on policy decisions and host country attitudes towards the Russian investments. The higher levels of organisational and operational transparency are assumed to have a profound impact in developing the trustworthiness in host-country policy-makers towards the Russian companies operating in the country.

As elaborated above, the internationalisation of the Russian economy is inevitably dominated by the natural resource-based groups (NRGs). Raw materials account for two thirds of Russian exports and the Russian energy and metal companies hold strong international positions on several strategic markets. The natural resource-based industries form the backbone of the Russian economy, causing them to gain on significant political leverage and ambitions. Faltering business environment, characterised by the lack of transparency, weak financial systems and imperfect legal institutions, support the emergence and survival of large industrial conglomerates exploiting the absence of functioning financial and legal institutions. Although often being far from superior in organisational practices, these financial-industrial conglomerates tend to outperform small private firms simply due to their ability to better cope with imperfect economic environment. Examination of the ownership structures of Russian NRGs reveals notably high degree of such ownership concentration, with the largest groups of private owners[6] controlling 35% of the Russian industry when measured by sales (World Bank 2004). Economist Intelligence Unit (2004) provides related data on concentration in industrial assets – 10 largest industrial groups control some 38% of the Russian industrial assets. The resulting combination of Russia's critical dependency on its natural resources and the concentrated ownership of the productive assets in hands of relatively few groups of private owners, inevitably gives rise to political interests in the economic sphere.

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[4] The Standard & Poor's annual Transparency and Disclosure Survey analyses disclosure from international investor's perspective. The checklist method of the survey consists of 89 items relating to ownership structure and investor relations, financial and operational information, and board and management structure and processes.

[5] In 2004, Standard & Poor's Governance Services index of transparency among the largest Russian companies increased to 46% from respective 36% in 2003. The composite transparency score for UK companies for 2004 was 71%

[6] In the survey, a large owner was defined as an owner or alliance controlling either 0.25% of the total sales or 0.5% of total employment of the survey sample.

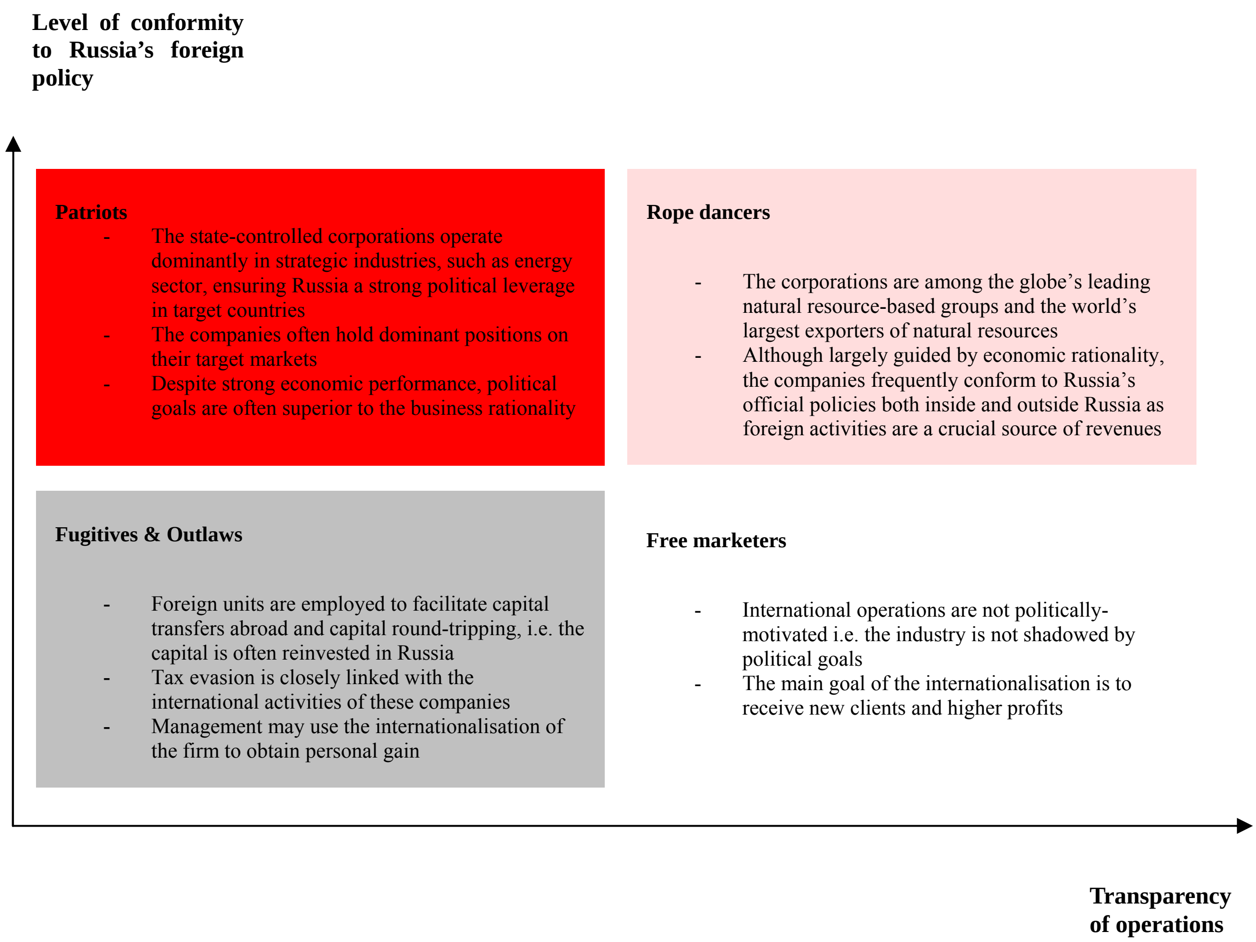
Considering the international operations of the Russian companies, the relation between business and foreign policy emerge even more complex than in domestic context. Controlling extensive reserves of strategic energy resources, Russia holds substantial political leverage not only in the CIS region but also throughout Europe. In 2003, over an half of Russia's export revenues originated from the strategic commodities – the share of oil, fuel and natural gas exports was 54% in the country's total exports and the substantially increased world market prices for oil are likely to scale up this share to around 60% in 2004. Such an export structure is inevitably resulting in mounting political ambitions, and the energy deliveries are essentially coupled with the measures of Russian foreign policy. The recent plans of the Russian government include creating a gigantic, government-owned energy conglomerate by merging several primary energy producers under the structure of Gazprom. The current restructuring of the energy sector and much-debated probe against the country's leading oil producer, Yukos, serve as indicators of the increasing state grip over the strategic sectors of economy.

The *level of conformity to the Russian foreign policy* is identified as a second dimension for classifying the Russian companies abroad. In one extreme of this continuum, one finds state-controlled conglomerates operating in strategic industries, while the other extreme is represented by smaller companies in strategically non-significant manufacturing sectors.

A Typology for the Foreign Operations of the Russia's Largest Industrial Corporations

Based on considerations on two dimensions of the foreign operations of Russian companies presented above, the authors propose the following typology on Russian companies abroad (see Figure 1). In developing the current typology, the authors have stressed the specific features of Russian business environment and policies having an effect on the Russian corporations' foreign operations. To rationalise the typology-creation, two specific dimensions of Russian companies' business operations abroad were identified from the existing literature and data on Russian markets. This consideration led the authors to identify four typological groups for the foreign operations of the Russia's largest industrial corporations. In the following, the dominant characteristics of each group are discussed with subsequent policy implications.

Figure 1: A Typology for the Foreign Operations of the Russian Largest Industrial Corporations



Patriots refer to the companies that are controlled by the Russian government, comprising mainly the industrial majors in the strategic natural resource-based industries. The purpose of the international operations of the companies such as Gazprom and Rosneft, is to serve the Russian foreign policy at least as much as it is to enhance their own economic performance. Whereas it can undoubtedly be argued that the political interventions are inseparable part of the activities of these state-controlled companies, the political power of Russian authorities over the private corporations, especially in the strategic natural resource-based sector, should not be forgotten either. The researchers further argue that until the oil and gas industry, for instance, is not operating on the basis of free market for the exploration licenses and transportation quotas, the companies in the sector continue to carry out the political ambitions of the Russian government, be it in the international business matters or domestic operations.

Rope dancers include the companies active in seeking international business opportunities and establishing foreign presence to enhance their performance. The size and strategic nature of these companies' business, however, forces them to balance between the business rationality and the governmental interests, i.e. the companies act according to the government policies when their business interests require them to do so. Since the level of political conformity is additionally highly dependent on the strategic significance of an industry, especially the companies in the strategic oil, gas and metals sectors are often obliged to play according to the state goals to remain in business. Due to the fact that the size of a company largely defines its political leverage, this category dominantly includes the major natural resource-based corporations that have gained a strong foothold on the international markets. Adapting to the official policy lines often secures these companies the access to vital assets, such as the exploration licences of natural resource sites and the pipeline infrastructure.

Fugitives & outlaws include the companies purposefully established for money transfers abroad and capital round tripping or, under the worst scenario, are engaged in 'direct' money laundering and illegal activities (e.g. shadow sales of armaments abroad). Also the viable companies that are turned into money transferring units behind their facades fall into this category. Transferring capital abroad and then moving it back home through various transfer regions, used to be a common practice throughout the 1990s, but the recent measures taken by the state indicate a radical change in the *laissez-faire* policy of the Yeltsin era. Particularly the recent scandalous events around some oligarchs in Russian oil and metals sector indicate the tightening state policy in the matter. The internationalisation of these companies can be seen as a double-edged sword for the Russian economy. Whereas these companies can be significant players both domestically and internationally, their foreign expansion boosts Russian economic well-being. On the other hand, massive capital transfers abroad seriously harm the Russian economy inhibiting the vital domestic investments.

Free marketers comprise the companies, whose overseas activities are not considerably shadowed by political ambitions. The companies are operating either in the less strategic business sectors or are smaller in size, thus remaining relatively irrelevant from a political perspective. These companies are often profitable and employ westernised business practices, seeking strategic growth through their foreign expansion.

Conclusions and Policy Recommendations

One of the main objectives to create a typology concerning the foreign operations of the Russian firms is to aid the policymakers to deal with the outward expansion of the Russian firms both in Russia and in the host countries receiving these investments. Rather negative attitudes prevail towards the outward expansion of the Russian firms both in Russia and abroad, since at home they are often regarded as non-patriotic fugitives and abroad as dangerous tools of the Russian foreign policy.

From the Russian perspective, the outward expansion of the Russian firms is essential for both the individual companies and the Russian economy as a whole. The companies must become more international in order to survive in the global competition, which will become fiercer even on the domestic market when Russia gains a membership in the WTO. Correspondingly, the Russian economy requires a structural reform and competitiveness improvement to transform the country from the natural resource-based economy towards a modern service and innovation-oriented society. The outward expansion is perhaps the most efficient way to force companies to change their old patterns.

The Russian government's policy towards the Russian companies' internationalisation is currently not supportive enough. The government should encourage firms particularly in non-natural resource-based industries to expand their operations particularly in the developed West, since the expansion towards the developing countries and the CIS does not force the Russian companies to transform their business practices as fast as the developed West. The encouragement could occur for instance in a form of providing risk finance, know-how and networks. By promoting transparent non-politically motivated investment abroad, the Russian firms would face a completely different attitude milieu in the recipient countries. Given the deep-rooted history-based resistance towards Russia's political and economic dominance in the former socialist bloc, the ultimate goal behind the internationalisation of the Russian companies play a significant role, how these companies are perceived in the host countries.

From the host countries' point of view, the Russian firms conducting legal and non-politically-motivated business are most welcomed i.e. the companies belonging to the group of *free marketers*. The host countries' attitudes towards the category called *rope dancers* depend to which extent they execute Russia's foreign policy. *Fugitives and outlaws* are generally unwanted due to the black and grey business they bring with them. *Patriots*, companies serving the Russian foreign policy, are particularly unwanted in those host countries, which struggle against the Russian dominance.

It needs to be remembered that the Russian companies may have a Janus-face i.e. they may play simultaneously different strategies in different regions. They may act as patriots in the CIS, whereas elsewhere they may play as free marketers. It is not completely unheard of that the same company could even have a third face i.e. it may also have be involved in non-legal activities in some developing country. Involvement in an illegal armament trade can be taken as an example of the aforementioned.

The outward expansion of Russian companies will be dominated by the strategic industries for years to come, and hence, the extensive expansion of free marketers could thus remain wishful thinking in the near future. However in longer run, it is possible that the number of the free marketers increases, especially if the Russian economy becomes less dependent on the exports of the strategic natural resources and the Russian government policies towards the internationalisation become less politically-oriented. If this is to happen, it seems evident that the host country policies, particularly in the ex-CMEA, towards the Russian business entry will become more neutral.

There is a slogan in Eastern Europe saying that "*Before Russians came to Europe with tanks, nowadays with enterprises and banks*". A negative interpretation of the slogan would mean that Russia is using her enterprises and banks to gain more influence in the host countries. On the other hand, a positive interpretation considers enterprises and banks as an excluding alternative for the tanks.

Here, one should not forget that the transnational economic co-operation laid the foundation for the European peace process, called as the European Union, almost five decades ago. In a similar manner, the operations of the Russian firms in the EU, and vice versa, the activities of the EU-based companies in Russia strengthen the linkage between the EU and

Russia, even if Russia would not become a member in the Union in the foreseeable future. Furthermore, the Russian companies' investments in the EU aid in building the Common European Economic Space between the Union and Russia.

In this paper, we took what can be considered as initial steps towards systematic organisational classification of Russian companies abroad. Theoretically sound classifications in the field are practically non-existent, and future areas of study could emphasise further development of classification tools of Russian OFDI for the use of both academic circles and policy makers. The strategic management and institutional literature may prove useful in developing such typological schemes that would aid us to discuss the future of Russian business expansion abroad.

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Appendix 1 Russia's 100 Largest Industrial Companies by Sales in 2003

Rank	**Company**	**Industry**	**Sales** *($ mn)*	**Annual growth rate** *(%)*	**Market capitalisation as of 1.9.04** *($ mn)*
1.	Gazprom	Oil and gas	26710.8	27.2	46660.5
2.	Russian Railways	Transportation	19371.5	n.d	n.d.
3.	Lukoil	Oil and gas	19345.0	40.8	24967.1
4.	RAO UES	Electricity	19327.1	17.8	10884.3
5.	Yukos	Oil and gas	13349.0	32.8	9114.7
6.	TNK-BP	Oil and gas	10379.0	26.1	6105.1
7.	Surgutneftegaz	Oil and gas	7662.0	17.0	24815.3
8.	Sibneft	Oil and gas	6205.2	35.0	12738.4
9.	Norilsk Nickel	Non-ferrous metals	4938.0	64.0	11962.1
10.	RusAl	Non-ferrous metals	4509.0	11.5	n.d.
11.	Svyazinvest	ICT	4329.3	27.1	n.d.
12.	AvtoVAZ	Machine building	4261.1	9.5	641.9
13.	Tatneft	Oil and gas	3800.3	7.3	2860.4
14.	Sistema	ICT	3759.9	313.8	n.d.
15.	Transneft	Oil and gas	3719.8	16.6	n.d.
16.	Rosneft	Oil and gas	3205.4	17.1	n.d.
17.	Magnitogorsk Metal	Ferrous metals	3047.0	44.4	n.d.
18.	Severstal	Ferrous metals	2663.3	35.4	3860.3
19.	Novolipetski Metal	Ferrous metals	2468.0	41.2	3925.6
20.	Evraz Holding	Ferrous metals	2308.7	49.7	n.d.
21.	Alrosa	Precious metals and diamonds	1955.2	1.5	n.d.
22.	RosEnergoAtom	Electricity	1944.3	12.8	n.d.
23.	Aeroflot	Transportation	1716.0	7.5	n.d.
24.	SUAL Holding	Non-ferrous metals	1700.0	28.0	1098.0
25.	UGMK Holding	Non-ferrous metals	1513.2	16.4	n.d.
26.	Trubnaja Metal	Ferrous metals	1346.6	37.3	n.d.
27.	VimpelCom	ICT	1335.6	70.1	5419.7
28.	Stroitransgaz	Construction	1327.4	-7.7	n.d.
29.	Bashneft	Oil and gas	1289.4	-4.2	663.6
30.	GAZ	Machine building	1195.4	11.2	129.5
31.	Ilim Pulp	Wood and paper	1144.0	14.9	n.d.
32.	TVEL	Nuclear energy	1113.3	24.2	n.d.
33.	Slavneft	Oil and gas	974.4	36.6	2076.6
34.	Severstaltrans	Transportation	966.0	36.6	n.d.

35.	KamAZ	Machine building	955.6	25.8	259.1
36.	Vimm-Bill-Dann	Foodstuffs	938.5	11.4	580.9
37.	Tseljabinsk Metals (Mechel)	Ferrous metals	836.7	37.4	396.0
38.	Megafon	ICT	814.6	98.6	n.d.
39.	Niznekamskneftehim	(Petro)chemical	813.3	20.8	652.9
40.	Fosagro	(Petro)chemical	768.2	n.d.	n.d.
41.	Phillip Morris Izora	Tobacco	751.2	25.8	n.d.
42.	Baltika	Beverages	737.2	5.6	1542.6
43.	Uralvagonozavod	Machine building	716.9	47.8	n.d.
44.	Razguljai-Ukrros	Beverages	677.2	21.7	n.d.
45.	Karavai Plus	Beverages	667.7	n.d.	n.d.
46.	Suhoi	Machine building	644.0	n.d.	n.d.
47.	Severstal-Avto	Machine building	631.6	26.2	n.d.
48.	Vyksunsk Metal Works	Ferrous metals	612.5	54.5	296.4
49.	Sun Interbrew	Beverages	607.2	45.2	n.d.
50.	Salavatnefteorgsyntez	(Petro)chemicals	604.2	13.9	216.1
51.	Aerospace Equipment	Machine building	581.7	7.4	n.d.
52.	Bashkirenergo	Electricity	577.8	10.1	311.9
53.	Tatenergo	Electricity	561.2	8.9	n.d.
54.	Novatek	Oil and gas	559.7	203.8	n.d.
Appendix 1 continues					
55.	OMZ	Machine building	546.2	21.5	148.3
56.	Saljut	Machine building	531.6	43.0	n.d.
57.	Rosgosstrah	Construction	515.0	311.8	n.d.
58.	Oskolsky Electrometals	Ferrous metal	507.2	33.8	n.d.
59.	Irkut	Machine building	522.0	-8.4	419.6
60.	Mosstroimehanisatsija-5	Construction	490.8	56.5	n.d.
61.	Ford Motor Company	Machine building	485.0	n.d.	n.d.
62.	Itera	Oil and gas	480.0	342.4	n.d.
63.	Irkutskenergo	Electrical energy	478.5	20.1	n.d.
64.	National Computer Corp.	ICT	469.0	41.4	n.d.
65.	Akron	(Petro)chemical	466.7	-0.9	180.9
66.	Mosinshstroi	Construction	452.0	-7.6	n.d.
67.	Chelyabinsk Rolled Pipe Plant	Ferrous metals	451.1	81.8	107.9
68.	Uralalkaly	(Petro)chemicals	445.3	15.2	n.d.
69.	Transstroi	Construction	440.2	-31.3	n.d.
70.	Ural Steel	Ferrous metals	438.8	25.5	n.d.
71.	Promishlenno Metal Holding	Ferrous metals	434.1	35.5	n.d.
72.	Mars	Foodstuffs	428.5	24.8	n.d.
73.	Tserkisovskyi	Foodstuffs	425.2	8.6	151.2

74.	Energomash	Machine building	423.5	35.8	72.9
75.	Titan	Pulp and paper	412.3	6.0	n.d.
76.	Ufimski Motors	Machine building	406.7	16.6	n.d.
77.	Mihailovskyi GOK	Ferrous metals	404.8	56.9	390.1
78.	IBS	ICT	399.3	66.3	n.d.
79.	Transmashholding	Machine building	396.5	72.0	n.d.
80.	Izmash	Machine building	389.2	3.7	n.d.
81.	Amtel	(Petro)chemicals	383.0	16.1	n.d.
82.	Golden Telecom	ICT	360.3	77.4	n.d.
83.	Mospromstroi	Construction	359.6	25.0	n.d.
84.	Tsaritsyno	Foodstuffs	353.6	91.7	n.d.
85.	Power Machines	Machine building	352.3	24.7	n.d.
86.	Petro	Tobacco	352.3	-32.9	n.d.
87.	Transnefteprodukt	Oil and gas	346.8	25.1	n.d.
88.	Novosibirskenergo	Electrical energy	343.0	26.3	179.4
89.	Syktyvkarski LPT	Pulp and paper	341.3	10.3	n.d.
90.	Glavmosstroi	Construction	340.4	136.3	n.d.
91.	Niznekamskshina	(Petro)chemicals	334.3	23.6	51.0
92.	Stinol	Machine building	319.7	28.1	n.d.
93.	Lebedinskyi GOK	Ferrous metals	313.8	24.5	579.7
94.	Novoufimski NPZ	Oil and gas	309.5	51.3	108.5
95.	Baltiskyi Zavod	Machine building	309.4	271.0	54.5
96.	VSMPO-Avisma	Non-ferrous metals	307.3	-6.7	923.1
97.	Sevmash	Machine building	307.1	167.7	n.d.
98.	Inteko	Construction	304.9	82.0	n.d.
99.	Vanjeganneft	Oil and gas	297.6	8.0	n.d.
100.	Ufaneftehim	Oil and gas	291.9	11.2	123.9

Source: Expert (2004)

BRIDGING THE CULTURAL GAP

COMPARISON OF BUSINESS NORMS IN FINNISH-RUSSIAN OPERATIONS

Olga Mashkina, Riitta Kosonen and Piia Heliste

Abstract

International partnerships and alliances are continuously growing in number. Especially many Western firms enter the Central and Eastern European (CEE) markets through strategic alliances. They do this to avoid and overcome some of the local constraints. However, previous studies show that international alliances fail very often. The reasons for the failure are often related to differences in business norms, institutional and cultural differences, partners' expectations and consequent economic behavior. These issues are particularly relevant in alliances between Western and CEE firms, where the difference in business norms is remarkable.

The aim of this study is to compare Finnish and Russian companies' business behavior, to describe and illustrate the "cultural gap" between the partners, and to provide possible solutions to bridge the gap. The theoretical framework of the study is based on the governance approach. Governance is used to study the gap in business norms between partners, and to focus on solutions used in coping with uncertainty. The data of the study is collected with questionnaires and semi-structured interviews with Russian managers, participants of the JIPROFIN-Management Training Program and their Finnish partners.

This paper presents a pilot study of a project "Business norms in the Baltic Sea Area".

Keywords**:** business practices, international alliances, partnerships, governance, social relations of enterprises, Russia

Introduction

During the last decade there has been a major socioeconomic and political transformation in Russia. In addition to the economic and institutional changes, business behavior, norms and values have gone through profound restructuring. Russia's natural resources, relatively cheap and skilled labor, and huge consumer markets have attracted an inflow of foreign investments. However, the stock of foreign investments has remained relatively low compared to other European transition economies. This is e.g. due to a range of Russia-specific risks, such as political instability, deficient infrastructure, rapidly changing legislation, and cultural differences (see e.g. Karhunen et al. 2004, 2003a&b, Hirvensalo & Heliste 2003).

Partnerships and alliances are the forms of economic cooperation, which reduce some of the risks of entering a foreign market. Previous studies show that many Western firms have entered Central and Eastern European markets through strategic alliances (e.g. Hyder & Abraha 2003). The local partner is seen to be better able to operate in the business environment that is unfamiliar to the Western firm. However, international alliances fail very often (Bleeke & Ernst 1995; Klein & Zif 1994). Problems are in large due to differences in business norms, institutional and cultural differences, partners' expectations and consequent economic behavior. Thus, understanding norms that govern business behavior in the companies and between partners can be essential for the successful realization of an alliance.

Business norms include both formal and informal rules that the company/manager/ employee use in the relations to their business. There are a number of studies elaborating and pointing out differences in the values and attitudes of Russian and western businessmen (Elenkov 1997, Arino et al. 1997). Such studies tend to underline that the choice of partner is more important than e.g. the funding of the venture (Arino et al. 1997). Managing the partner relationship becomes then the key issue in joint operation.

This paper explores differences and similarities in Finnish and Russian companies' business practices. This is achieved by comparing Finnish and Russian managers' ways of integrating their businesses in the surrounding society. Here, an analysis is made about companies' relations within a company, to their business partners, to the public sector, and to their labor force. The analysis is based on a questionnaire survey and semi-structured interviews. The paper concludes with suggestions about how the diverse business cultures could be bridged by moderating problems caused by cultural differences and by taking advantage of each partner's cultural characteristics.

The approach of this paper is descriptive. The aim is to point out and illustrate with examples a range of general similarities and differences between Finnish and Russian business practices.

Theoretical framework

This study uses an institutional approach to the analysis of business practices. Integrating the "cultural" and "social" into institutional analysis has been recognized by many researchers in economics, sociology, and political science. (e.g. Ayres 1952; North 1990; Williamson 2000; Winiecki 1994) With the transition to the market a lot of institutions (formal and informal) are changing in Russia, which allows talking about transition in norms as well. Partnerships and alliances become mechanisms for business norms' evolution, coping with the differences and stereotypes. Since Russian and Finnish partner companies have different historical and cultural backgrounds, they may have different ways of interpreting situations and problems, and thus, they resort to different practices in governing those (including self-enforcing institutions (Greif 1994, 2004)).

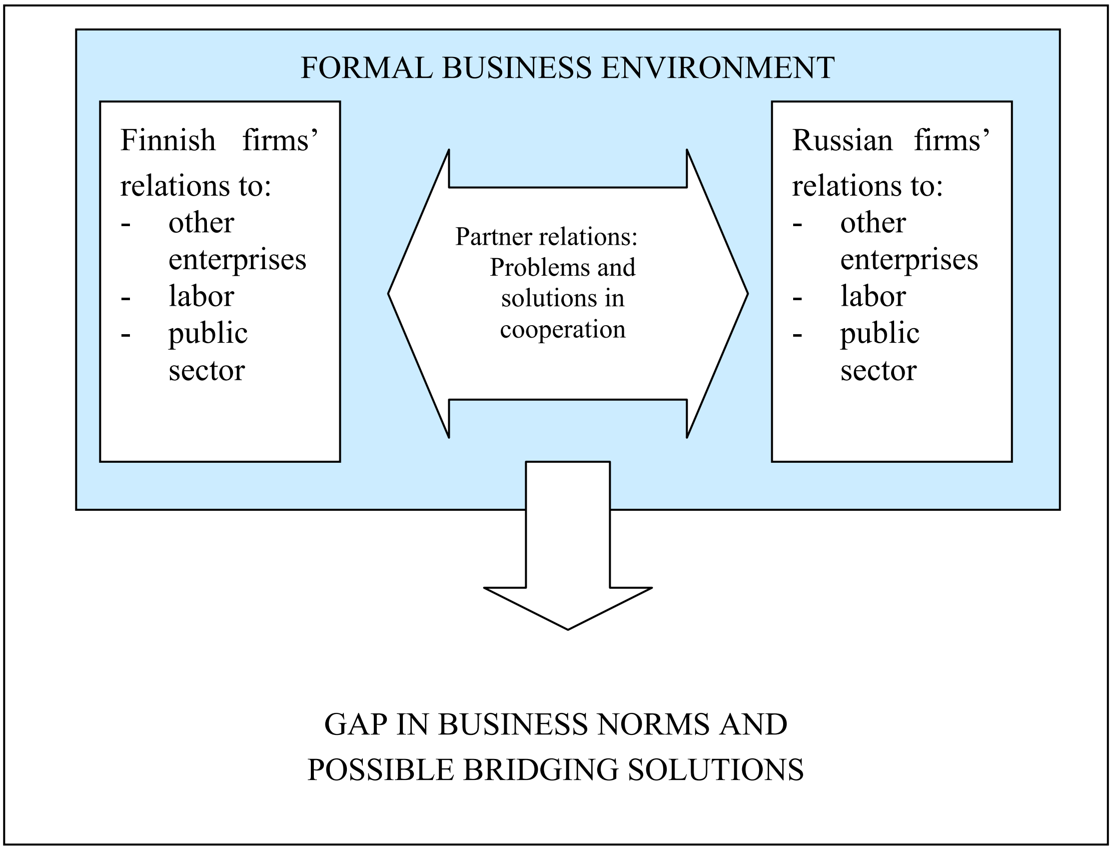
This study focuses on analyzing the mechanisms that contribute to the change in the contracting between Finnish and Russian companies. For the purpose, the governance approach is chosen as a theoretical framework of the study. Governance approach examines the mechanisms of coping with uncertainty, which has increased e.g. when market mechanisms have entered to replace state planning. These mechanisms include, for example, formal networks of interaction between enterprises (Granovetter 1985; Grabher 1993; Storper 1993, Kosonen 2002; 2004), such as clan markets, different enterprise unions, and sector related associations (Jessop 1995; 1997). Using this approach we study the gap in existing business norms between partners, and focus on solutions, which they use to cope with uncertainty.

The theoretical framework of the study focuses on the governance of business alliances. It comprises of two parts (see Figure 1):

1) formal business environment, which consists of e.g. legislation, taxation and property rights (i.e. formal institutions), that governs the operations of all companies and is in principle the same to all actors.

2) informal institutions that are based on physical environment, common beliefs and concepts of right and wrong, history, and the level of economic development of the society. From the perspective of business cultures, informal institutions are particularly related to enterprises' diverse views about how the daily operation is integrated into the local society: relationship between enterprises and the public sector (e.g. formal rules and their actual enforcement), relations between enterprises and the labor (e.g. the cost of labor vs. its productivity), and relations of enterprises to other enterprises (e.g. the quality of subcontractors and suppliers). This is done by comparing the views of the partners on problems that the alliances face between partners and in relation to the public sector, other companies and employees. Also, the solutions used to overcome these problems are studied.

Figure 1: Process model of business norms in Finnish-Russian partnerships



First, the functioning of the formal business environment in Finland and Russia is investigated based on questionnaire data. The norms and practices governing the company's relations in three levels of interaction (public sector, labor, and other companies) are examined. This allows for pointing out the practices that create problems in cooperation. These are, in turn, studied more in-depth with the help of the semi-structured interviews to define and explain the gap in the business norms and to provide possible solutions.

Research design and data collection

The research was based on empirical data collected in two phases. In the first phase, an attitudinal questionnaire was developed in order to capture the managers' views of business norms in Russian and Finnish enterprises. The questionnaire focused on social relations of companies that influence company performance and decisions that managers make everyday. The arguments covered five perspectives: 1) politics, 2) competition, 3) legislation and bureaucracy, 4) inter-organizational relations, and 5) business development and personnel management. Finnish managers were asked about their perceptions concerning Finland, and Russian managers about Russia. In addition, the questionnaire included a section with questions about the personal information of the respondent. The survey was conducted among 26 Russian managers participating in JIPROFIN management training program in 2001, and

22 Russian JIPROFIN participants in 2003-2004. The majority of the respondents were young (early middle-aged) managers from various regions of Russia, including Moscow and St. Petersburg, with some experience of working in international partnerships. The Finnish respondents comprised of 25 Finnish managers (2003-04) who were the mentors of the Russian participants in JIPROFIN training. Thus, all the respondents were involved in a business partnership of some kind between Russian and Finnish firms.

Based on the survey, it was possible to draw some general conclusions of how business norms differ between Finland and Russia. As the goal of this study was to provide a comprehensive view of the perception of business norms by selected company managers, rather than to get statistically verifiable information on a large sample of respondents, a more qualitative, interpretive methodological approach was applied in the study. Yin (1994) acknowledges the benefit of combining survey data with qualitative case studies as " [case studies] allow some insight into the causal processes, whereas survey can provide some indication of the prevalence of the phenomenon" (Yin 1994, 86).

In the second phase of the study, semi-structured, face-to-face and in-depth interviews were carried out with 22 Russian and 15 Finnish managers in 2003-2004. The interviews were carried out mostly in the native language of the interviewee, i.e. in Russian or Finnish.

Thus, the data collection included multiple sources of evidence: questionnaire data, relevant documents, and semi-structured interviews. This improves the validity of the study (Yin 1994). In addition, the interviews were carefully transcribed and cross-analyzed by the research team. The analysis included multiple reading of the transcripts in order to find out the common themes and topics.

On the whole, even if the sample under study is relatively small, we believe that the suggestions of this study can be used to illustrate the basic differences between Finnish and Russian managers. This is because the sample included a wide variety of actors operating in diverse sectors and regions in Russia. Also, the fact that all respondents were linked to each other through joint business, improves the respondents ability to raise up central questions in international cooperation.

Analysis of the results

The analysis of the results is divided in two parts: 1) the analysis of the survey data of the Finnish and Russian respondents and 2) the analysis of the semi-structured interviews. Based on the survey, an analysis is made about Finnish and Russian enterprises' relations to their labor force, to their business partners, and to the public sector – including enterprises' attitude towards the state regulation. Then, a detailed analysis is made based on in-depth interviews about how the differences and similarities in Finnish and Russian business norms affect joint business efforts.

Analysis of the survey data

The survey data of Finnish and Russian respondents points out a range of issues, where Finnish and Russian views are relatively similar. Also, the issues of disagreement and different viewpoints are quite clear. Differences and similarities in the opinions can be found in all aspects of enterprise operation. These issues are now discussed one at a time.

The Finnish and the Russian managers are unanimously of the opinion that **personal relations are essential** in conducting business. They both emphasize the importance of knowing one's partner very well and resort to recommendations from their personal network when searching for a new partner. However, the deciding factors in partner selection are the quality and price of the product, not the relationships. Also the importance of customers to the company strategy is emphasized by both Finns and Russians. Nevertheless, there is a clear difference in the perception of separating personal and commercial ties. The Finns do not have any problem in this regard, while the Russians prefer to separate personal relations from commercial ties. This may be explained by the fact that the Russians also consider it difficult to break up business relations characterized by strong personal relationships.

Personal relations with the public sector are also important in both countries. What is different, is that in Finland personal relations with authorities may speed up the decision making process, but they do not influence decisions as such. In Russia, they can both speed up the process and have an impact on the decision (level of taxes, granting licenses and permits etc.). Reflecting this, the Russians also acknowledge the hindrances that the corruption of the authorities causes for the companies. The majority of the Russian respondents find it impossible to avoid corruption in their business operations. Also management corruption is still considered a problem by almost a half of the Russian respondents.

Another obvious difference can be found in perceptions on the legal system. In Finland, legislation does not cause any significant problems, while in Russia, the legal system is considered a big impediment for company operations. In addition, the impartiality of the judicial system is a great concern for the Russian managers: less than 10% of them trust the Russian judicial system. Simultaneously, almost 70% of the Russian respondents find crime and disorder restraining the development of business operations. Also, the Russian respondents lack trust in the decisions of the federal government.

As regards labor relations, there are clear differences in delegation of authority. The Russian managers are very reluctant to delegate authority and they still fulfill paternalistic duties. Despite the differences in delegation, both the Russians and the Finns value initiative workers.

Importantly, most opinions shared by the Russians and the Finns are related to ***partner relations***. It seems that trust and recommendations are very important when working with partners for both Finns and Russian. It is important to know and trust partners and negotiate if things are not working (see Table 1.).

Table 1: Similarities in views between Finnish and Russian managers, %

Similarities	Finnish managers, %	Russian managers, %
Building of personal network is a prerequisite for a successful business in my country.	90.9	84
The business partner's technical competence is more important than his image.	48	54.5
The main goal of business is to improve the national economy, not to make profit to the shareholders.	8	4.5
If you have personal relations to the official you are dealing with, it speeds up the procedure.	72	100
In case of conflict with a supplier it is best to negotiate.	88	81.8
In search of a reliable partner recommendations are necessary.	76	77.3
In business it is necessary to know your partner well.	96	100
When choosing a supplier, the quality and the price of the product are more important factors than existing relations with a supplier.	76	72.7
Managers value initiative workers.	84	71.4
Customers are not very important for our company strategy.	4	13.6
Legal agreements are considered obligatory.	100	81.8
The main goal of business is growth.	66.7	48

The majority of differences between Russian and Finnish managers lie in the area of public sector and labor relations. Table 2 summarizes the main differences between partners. Even though issues such as corruption and crime, and legal system are not considered to be problems in Finland, they are still quite vital in Russia. Other issues, like personal connections in business, are also viewed differently by Finns than by Russians. However, the difference is not as drastic as in the issues of public sector.

Table 2: Differences in views between Finnish and Russian managers, %

Differences	Finnish manages %	Russian managers, %
It is possible to avoid corruption when doing business in my country.	80	13.6
The judicial system is impartial and just for all in my country.	88	9.1
It is better to work on the basis of personal relations than on purely commercial grounds.	60	27.3
Personal relations should be separated from commercial ties.	32	81.8
Russian/Finnish businessmen prefer to do business with domestic companies rather than with foreign companies.	52	9.1
Russian/Finnish managers do not like to transfer authorities to their subordinates.	20	61.9
When maintaining personal and friendly relations with a partner, it's impossible to break up the business partnership.	0	50
The legal system impedes companies' activities and growth in my country.	4	77.3
Crime and disorder impede companies' activities and growth in my country.	4	68.2
Corruption of the authorities impedes companies' activities and growth in my country.	0	77.3
Corruption of the management impedes companies' activities and growth in my country.	8	45.5
1.1.2 If you have personal relations to the official you are dealing with, it will influence the decision (level of taxes, granting licenses etc.).	8	77.3

The above mentioned differences and similarities were examined in more detail in the semi-structured interviews.

Analysis of the interviews

The analysis of the semi-structured interviews allows us to improve our understanding of the differences in Finnish and Russian business practices and norms. When interviewed, both partners gave illustrative examples of situations were problems emerge in Russian operations.

To start with, the two nationalities seemed to have very differing views about the specificity of business in their countries. In the survey, the majority of the Finns (67%) were of the opinion that there is nothing exceptional in Finnish business practices for a foreigner to understand: *"Finland is such a stable country that there are no special issues here…", "the business is so straightforward and based on regulations in Finland."*

This is in vast contrast to the Russian managers' opinions of their home country. In 2003-04, as many as 72% of Russian respondents believed that Russian business is something specific and unique (in 2001 it was 61.5%). Also the Finnish managers acknowledged the specificity of Russia. According to the Finns, the formal and informal institutions and their reinforcement in Russia are different from elsewhere in the world, especially Finland. *"The instability of the public sector is very challenging for us. This is something very different from Finland. Rules do not change so unexpectedly in Finland".*

During the interviews, the specificity of business in Russia was unpacked. Understanding the specificity would point out the factors underlying the gap in business norms. In what follows, the specificity of Russia is discussed on three levels of interaction: in relation to the public sector, to other companies and in relation to intra-company actors (labor and partners).

Finnish and Russian companies' relations to the public sector

The specificity of formal and informal rules in Russia has its roots first of all in the socialist past. During socialism, the Finnish and Russian public sector institutions were dramatically different. The economic and political reforms have not entirely balanced differences. As a consequence, both Russian and Finnish managers witness many problems due to the **Russian legislative framework**. According to Finnish partners *"The biggest obstacle is legislation, its transparency – or rather the lack of it. You never know what tomorrow brings."* Also the unpredictable implementation of legislation worries foreign investors. *"Legislation is changing rapidly and the changes are pretty random. Their implementation is even more random. It is a big barrier for foreign investment."*

The Russian managers share the Finns' view of unclear legislation. However, their reaction to the instability is less strict than that of the Finns. *"The Finns respect laws in more detail than we Russians do. Also, the Finns in Russia seem to be much more sensitive to laws and formal rules than to connections".* As a result: *"...they (Finns) are really afraid that they will not be transparent and they will be kicked out of Russia".*

In some cases, the Finnish desire to be honest and legal actually comes at a high cost: "I really respect Finnish honesty. But at our customs everything goes through gray areas, a lot of illegal operations, otherwise the customs fees and taxes can kill the company. In the previous Finnish company I worked with, this is exactly what happened – they wanted to be legal and pay all the fees and taxes, and the company went bankrupt".

In addition to the unstable formal operative environment (especially legislation) the informal environment – the Russian business culture – is different from the Finnish one. The specificity of Russian state-enterprise – relations manifests itself above all in the form of exceptionally **important role of personal relations.** The Finns underline that:

"In Russia, personal relations between enterprises and the public sector matter more than in Finland or the West, in general."

"Personal relations are very important. They are more important than money. For example, every now and then you need to visit some authority that gives permissions or denies them. You should really meet this person, but you often cannot meet him/her if someone cannot recommend you."

In general, the Russian respondents agree and explain: “Since the laws don’t really work, one should rely on personal connections and ties”. “I believe that personal contact helps in any country. It is very important. Many questions are much easier to solve if you have a personal contact”.

Also, concluding from the comments of the Finnish respondents, the modernization process of the public sector is heterogeneous and **regionally differentiated.** Western managers feel more acquainted and “at home” dealing with public sector issues in big market areas, such as Moscow and St Petersburg, than in many smaller agglomerations.

“Things have not really changed so much in the Russian countryside. One just adds new labels such as ’glasnost’ or ’perestroika’, but this is not enough to change things in practice...”

The Russians agree with the regional differences in legislation. “The politics are made in Moscow but the regional laws and interests may be totally controversial to it.” “As soon as the regional administration has noticed that there is some extra money, they invent new laws to get it. It really slows down the development in these regions.”

Reasons for differing formal and informal public sector procedures are manifold and include issues such as regional state authorities lacking experience in foreign business, the legacy of paternalistic enterprise behavior in some local societies, attempts to balance regional budget deficits with foreign income, low personal income level of state authorities (impulse for corruption), and the legacy of ‘*blat*” (mutual trust-based exchange of goods and services between persons).

Virtually all the Finnish respondents point to the importance of creating and maintaining personal contact with state authorities. The importance of personal relations has roots in socialism and (in the form of *blat*) perhaps dates even back in Russian history. The *blat* system refers to the use of personal trust-based relations that were created to exchange goods and services between citizens. During socialism, *blat* became extremely important in everyday life due to the failures of the socialist economic planning which resulted in chronic shortage of goods and services (see Ledeneva 1998, Lonkila 1999, Kosonen 2002 for more details on the role of *blat* in the Soviet Union). During socialism, *blat* contacts were used both in personal life (to receive goods and services, such as jeans, special hospital care, vacations, university scholarships etc.) and in enterprises. Enterprises created personal contacts to public sector officials to reduce production targets, to increase allocated inputs, and to negotiate more reasonable social obligations in the local economy. Socialist enterprises maintained housing, medical care, children day care, cultural facilities and the like.

The tradition of personal negotiation and **exchange of services** between enterprises and the state actors continues to be important in the present day Russia.

“Public authorities always need to have some direct use of our projects... this leads to exchange of services.”

The *blat* system has somewhat biased the Russian society in terms of lacking neutrality and increased corruption. It seems that the tradition of personal persuasion has obscured some public sector actors' neutrality and **created a system of favorites**. Finnish respondents argue that the only way to guarantee unproblematic business operations in Russia is to include oneself in authorities' circle of favorite companies. The operation of the favorites is eased by providing information, help in problem solving, more simple bureaucracy, more rapid dealing of red tape etc. (this correlates with Salmi and Bäckman 1999 notion of inner and outer circle of public sector relations). Becoming authorities "favorite" was very important especially during the 1990s, when the formal rules were very complex and rapidly changing. This was true especially regarding tax and customs rules. Personal consultation is needed to **receive information and advice, to secure uninterrupted running of business, and favorable interpretation of unclear formal rules**.

"We need good contacts with the public authorities in order to run business fluently. Local authorities may give us sanctions for being late of for producing too much...it costs a lot of money...it is very important to have good relations with them."

Most Finnish respondents complain that foreign companies are often used as contributors to fill in budget deficits. Resorting to foreign investors is understandable if one bears in mind the socialist time when enterprises were the main contributors of local social infrastructure. Due to the industrial collapse and the bankruptcy wave that swept over Russia in the 1990s, many local socioeconomic systems were left with mass unemployment and huge budget deficits. This is the case especially in localities that resorted to one or two big employers. Taking the local and regional budget deficits and the tradition of company paternalism, good personal contacts are nowadays needed to guarantee good-will of authorities and this way to possibly **avoid being milked**.

"Many of our Russian clients are the main employer of the city or village. They therefore have close contact with the authorities and may still for example take care of the local hospital"
"The local tax authorities seem to think that is perfectly ok to milk foreign businesses as long as they are kicking."
"The legislation changes frequently. Also, even if the rules are made in Moscow, it seems that at the local level regulations are in controversy with the ones in Moscow. As soon as the regional authorities notice increasing income in the foreign investor's operation, they create some new rules to milk the extra money. I'd say it is corruption, whatever you call it. Also, it slows down development on the regional level."

The involvement in personal relations has created a **seedbed for corruption**. Combined with the low public sector wages (in addition to the considerable delays of public sector wages in the 1990s), the reliance on personal negotiation is often accompanied with corruption in the form of money and goods. However, most Finnish respondents stress that they personally do not bribe authorities. Instead, they suspect that their Russian partners solve problems with money.

"We never could tell what tomorrow brings and who claims money and for what. This is how it was and I believe it still is so in Russia."
"*It is the national way of doing business in Russia. We Finns do not bribe but we suspect that our Russian clients boost their business with bribes."*
"Let's put it this way that if I had to be in court in Russia, I would not believe it's unbiased – due to personal relations and money."

Practically all the Russian respondents acknowledged the existence of corruption. However, the majority of the Russians actually denied paying bribes themselves. Rather, they became familiar with the issue from the press and stories of their friends and colleagues. According to several respondents, corruption occurs in the places "*where people receive low salary, and they are in their 50s and they don't want to change their job and they just take "fees"*. Also, the majority of the respondents suggest that corruption mainly takes place in customs, police and authorities, not between the companies. One Russian respondent even noted that: "*when it comes to the Finns and corruption in Russia, Finns should just close their eyes from it and pay the sums that are required. This way everything goes smoother"*. The Finns have a somewhat different viewpoint here: *"If you [pay and] get caught, they can blackmail more. This does not suit us."*

Usually Finnish companies solve the dilemma by finding a local representative to deal with public sector. "All these customs orders, certificates, health certificates that frequently change in Russia… but the Russians are masters in circumventing them... they find loop holes. Bureaucracy slows down business for a moment but then everything continues as previously."

According to Russian managers, friendly relations to administration may even help to avoid corruption. For example, "…do some small voluntary jobs for administration, municipality, so you will be known from a good side. Then the bureaucratic problems will be less of a problem. If you go to an administration officer with whom you have good relations, he will help you with the documents and help you to avoid all the bureaucracy".

According to a Russian respondent, the problem of corruption is decreasing: "the state authorities don't take bribes due to better salaries and working circumstances, the standard of living is getting higher, the taxes are collected in a more efficient way".

The majority of Russian respondents think that their Finnish partners understand the situation. "Our Finnish partners have worked with Russia for more than 50 years. They are very used to it. They really rely on us, on our experience, that we can solve our problems. Their only criterion is that everything should be legal and honest".

Personal contacts are needed also to **ease the complex and unclear bureaucracy**. The Finnish respondents point out that it has been very difficult to follow the complex red tape and even to distinguished which authorities' permissions are needed to carry out business. Here, personal contacts are needed to clear the bureaucratic mess.

"It is very difficult to find the right public authority to discuss with. Sometimes some official declares to be the one to negotiate with, and you do just that. But when you think that everything is ok, it turns out that you still need to negotiate with someone else."
"And then some other public organization comes to claim that our business is not legal because they have not given some kind of permission."
"In the West one knows the role of each public sector organization, but in Russia it is not clear who gives permissions. Instead, there are a lot of authorities who can start preventing your business."

Overall, there seems to be consensus among the Finns about the specificity of the Russian formal and informal public sector relations compared to Finland. However, **opinions vary as to how persistent the specific features are**. Parts of the Finnish respondents remind that the differences were most prominent during the 1990s, and that Russia has modernized rapidly since then. "*But anyway the situation is improving. It's becoming more stable, also at the level of local business cultures. Earlier it was like stepping in the dark, but not so much anymore".*

This holds also as regards corruption. "It was quite open previously. Now it is much more sophisticated. Not anymore like "give us some money". "It was massive, previously, the sums requested were very big. But now that Putin is in power, corruption is diminishing".

In contrast, some Finns are skeptical about improvements and believe in the continuously specific organization of state relations in Russia. This, they argue, is largely due to historical reasons.

Finnish respondents refer to the Russian history as a source of extensive bureaucracy. These companies doubt that due to the long term hegemony of authorities that dates to the Czarist Russia, the heavy bureaucracy might not ease even due to political and economic reforms.

"Corruption? It is increasing. Both in Finland and in Russia – especially in Russia"
"*They have the traditions of public sector hegemony… just read the Russian classics... it's all there..."*
"It was already during to socialist times. In difficult moments people got used to helping each other "scratch my back and I'll scratch yours". They are all the time making small services to other people. So that they knew that if they'll have problems, they will receive help from other people."

Part of the Finnish respondents acknowledge the positive trend of modernization in Russia, but bear in mind the enormous scale of socio-economic and political restructuring. Therefore, they do not expect any rapid improvements.

“Legislation is improving. It is becoming more clear. It is still quite strange and duplicated, but the last five years have shown slight improvement. The trend is right. But it is a big task and takes time.”
“We’ve noticed that it is very difficult to improve the Russian legislation.”
“I think Russia has understood the need to modernize the business environment. I’d say things are developing, but there are always problems in developing and changing things. It’s normal.”

Also, the majority of Russian respondents believe that the formal institutional situation is somewhat improving in Russia. It seems, that this is motivated also by the pressure coming from outside Russia. “*With joining WTO – they said that you have chaos with your laws – they fixed it, and now the laws stopped overlapping each other every 2 months”.*

From the Russian viewpoint, at the bottom of the problems with legislation is the way they are developed: “When laws are developed they have loopholes built into them from the beginning. But I have a feeling that it is really changing and we are going the right way”.

“The laws are being worked out in more detail and more carefully now. Before, in the 1990s, many laws were accepted, but they didn’t have any financial base for fulfillment. Now, when a law is being accepted in Russia, its financial grounds are more clearly specified.”

To conclude, it seems that the Finnish and Russian managers largely share opinions about the characteristics of the Russian legislative environment and the public sector. Both complain about unstable legislation, extensive bureaucracy, opportunism and corruption. Also, both underline the need to create personal relations to public sector authorities. However, it seems that Russian managers are more willing and capable of using personal relations in lobbying and negotiation. This often comes close to corruption. Finnish businesses in Russia in contrast, may suffer from poor negotiation skills and reluctance to resort to heavy lobbying. Both Finns and Russians emphasize that the formal Russian business environment is improving, especially during the past few years.

Finnish and Russian companies’ relations to other enterprises

During the Soviet times, relations between Finnish and Russian (Soviet) enterprises were relatively weak as enterprises often did not have direct contact to each other. Rather, foreign operations of socialist enterprises were organized through Moscow- and Leningrad-based foreign trade organizations. Along with the entry of the market reforms in Russia, the Finnish and Russian enterprises have been able to create normal horizontal relations. Here, too – concluding from the Finnish respondents’ comments – establishing personal connections seems to be critical in Russia. At least **personal negotiation and trust seem to be more important in Russia than in the Finnish business community**.

"You can do absolutely nothing in Russia without personal contacts."
"Words on paper have different importance to us than to the Russians."

"This is different from Finland. In Finland you can do business with unknown people. In Russia you cannot."

Here, again, underlying personal networking between managers is the tradition of *blat*. During socialism, *blat* between managers was used to exchange inputs and this way ease the chronic shortage of goods typical of the planned economy. Also, during the difficult years of restructuring in the 1990s barter trade was still relatively prominent. In those years, some Finns, also, resorted to barter with their Russian clients to secure business. Even if the role of barter has now dramatically reduced, Russian managers still use personal contacts in inter-enterprise relations. For example, companies may finance partner's investments in exchange for goods.

"It takes time to become a friend in Russia. But business relation always bases on some kind of friendship. Deep friendship or a little less, it does not matter. But it's there. And it helps to solve problems."
"It is absolutely rewarding to know your partner personally in Russia. And especially in Russia. I've known our biggest client for ten years. It is so easy to carry out business with him because we can talk things over."
"*Regarding relations to other enterprises, we really try to avoid the court because it is biased. We try to create as good relations as possible with our Russian partner. So that both partners are definitely happy and there is no need to go to the court."*

The decisive role of personal relations has had both positive and negative implications. First, Russians seem to **value personal agreements and promises over formal written agreements.** Therefore, problems have emerged when a Russian manager has been replaced with a new one that does not agree with his/her predecessor's formal agreements. Finnish companies have in some cases lost deals this way.

"There are cases when the new manager does not respect the agreements made by the previous manager."
*"In Finland, the new staff respects old agreements. But this is not necessarily so in Russia***"**

Second, established personal relations help to continue business and **mitigate competition**. On the one hand, this creates stability between business partners. On the other hand, newcomers find this disturbing, because it complicates the entry of competitors.

"Russian people cannot really distinguish between healthy friendship and unethical favoring of certain people. Take getting a job or making an agreement. Russians hire a friend and buy

equipment from a friend even if one could get a better one from elsewhere. On the other hand, this can be a richness of culture…"

Even between established partners there are **divergent views about how carefully the agreements should be followed.** Finns claim that Russians do not follow agreements as seriously as the Finns do. This shows in delivery delays and changes in the contents of goods. Finnish managers make detailed agreements on every business action. But their Russian partners do not respect agreements the same way: *"for them it is perfectly normal to deliver material a week late or so".* So, to avoid these problems, Finns demand prepayment. However, as they noted in the interviews: *"even then, after having paid to us, the Russians may call and want to change colors, delivery dates and other details. I think it's the national culture."* Since everything is based on trust and not so much on written agreement, if Russians do not like something *"it is not very useful to remind them that nevertheless the agreement says so…"*

"Traditionally, written agreements have not really played a big role in Russian business. I think this is changing now. But anyway, Russians still seem to think that ok, there is an agreement but we'll do this our way anyway. If the Finns fine us, then we'll just pay."

Personal relations have been used also to secure business and **avoid problems caused by organized crime.** "There was this security company that offered services and when we did not buy from them, "accidents" started to take place. At the time it was so difficult that our managing director had an armed guard with him".

Another obvious difference between Finnish and Russian business practices is the considerably **more hierarchical organization of Russian companies**. This has implications in inter-enterprise negotiation. For Finns, it becomes critical to go high enough in negotiation. For Russians, it is not always clear that agreements can be made even with mid-level managers.

"Knowing whom to deal with is essential in Russia. You'll loose the deal if you do not negotiate and agree with the right person."
"Everything takes place through the general director. Nothing happens without his agreement."
"Midlevel managers are operative managers. They do not decide. This, I think has roots in the Czarist era. A strong general manger is respected in Russia. We in Finland are between the Russian and Swedish tradition."

Actually, the hierarchical structure of Russian organizations is well illustrated by an example of negotiations between Finnish and Russian companies. Some Russian top managers have failed to start business with Finns due to **over reliance in strategic networking and neglect of grass root marketing**.

"A general manager of a Russian metal combine wished to introduce his products. We called him to Finland and explained that we'll find you the right negotiators in our company. But he was persistent and demanded to talk to our general manager. Ok, we organized the meeting. But this was frustrating. We were first of all interested in getting to know their products, first. But all he wanted was a general high-level agreement about future cooperation. Operative staff was able to meet each other only after that agreement. Nothing ever came out of this deal. We tried to explain him that in the modern world you have to compete with you products, only then it is possible to make a deal."

The Finnish respondents point out that personal relations between Russian and Finnish managers have been extremely important especially during the 1990s, and largely continue to be so even today. However**, it seems that the role of personal networking is reducing**. This is mainly due to the entry of new generations of Russian managers, increasing competition and lack of time.

"I have the image that legacies are stronger outside business (like bribing to avoid the army and such) than in business. Business in Russia is normalizing now. Russian companies are planning to enter the stock market and the business is harmonizing."
"*In our field of industry things have changed. Especially in Moscow. I'd say it's business as usual now. Ok, we change gifts but that's normal. But we do not anymore go out together in the evenings, which was essential earlier. Russia is becoming more western, people are busy and organizations cannot afford to spend money on overwhelming hospitality. It's not the "socialist friendship" anymore."*

Most Russian respondents share the view of the diminishing role of personal relations in inter-enterprise relations. Many respondents even suggested that it would be better not to burden friendship with business. Today, the majority of the Russian respondents remind that "*business is business"* and *"friendship is friendship, but money is separate*". Good personal relations between enterprise managers are valued as *"additional help in maintaining contacts, but not as a necessity, a panacea"*. It seems that attitudes to business partners are becoming more like those in Finland. *"I think that the blend between Russian and Finnish way of thinking is the best, maybe even ideal. In my experience, we have very normal and nice relationships among people at work. People are not real friends, but we have nice communications and get answers to our questions"*.

In practice, the majority of Russian managers would not tolerate constant delays and breakings of agreements – even from friends. If the "misbehaving" supplier or a client is a friend, problems will be discussed with him/her, but **violations will not be tolerated**. According to the Russian respondents, this attitude is a novelty: *"Now things are changing. I think this is the way it should be. I believe that many things can be solved based on personal contacts. But it doesn't mean that if somebody keeps seriously breaking agreements, I would still continue cooperation."*

In contrast, Russians underline that **friendship is still used in business to boost "safely" new and insecure projects**. "When we know each other and we are friends – we can safely develop new ideas, new projects, new business. Friendship is important in this case". Here, friendship decreases risk and increases the array of useful contacts to support the joint effort. "I have some connections, my friend has some others".

"And there might be something that would not be told to business partners – but it would be shared between friends. And because if we know each other and we are friends and trust each other – we can start new business – or develop a new area of business. "

Finns' views vary as to how rapidly changes take place. Some Finns are **skeptical about rapid changes.** "I cannot say if things are really changing. Of course the younger generations meet western businessmen and get new ideas…but for example this need to create personal networks is so rooted in the Russian culture that it takes generations to change".

Others remind that maybe **Russia already is normal and the Finnish "purity" is exceptional** globally. "Actually trust between people is necessary everywhere. I have worked in every continent. And everywhere business is built on some sort of personal relations. This is elemental when you create long-term business relations."

To conclude, both Finnish and Russian managers underline the importance of personal networking in business. However, in addition to acknowledging the importance of trust in Russian business, Finns point to the problems caused by the tightly closed business circles. These include weak role of written agreements and inefficient competition. As a Russian peculiarity, Finnish managers point to the high hierarchy in Russian companies. This is in vast contrast to Finland, where mid-level managers often have considerable decision-making authority. Differences in hierarchy have sometimes caused problems in negotiations. Finally, both Finns and Russians have noticed that business in Russia has become more western also as regards enterprise networking. Increasing competition and need for greater efficiency have undermined time consuming forms of allying between companies.

Relations within enterprises

The difference in the level of hierarchy is evident also when examining the organizational relations within enterprises. As already mentioned, in Russia, the decision making power is often concentrated on the highest level of the company and mid-level managers' task is merely to carry out orders – not to make decisions. In these companies the general director is a "*czar*", and managers are trying to keep their powers by not delegating the responsibilities to keep their jobs.

The divergent hierarchical structures have induced a range of problems from the Finnish respondents' viewpoint. These include difficulties in division of responsibilities and in job allocation in companies.

Within joint ventures, problems emerge in the administration. Russian high-level managers are used to working individually with a lot of authority. They are not necessarily used to reporting and negotiating with company boards. This has caused problems related with **trust and exercise of power.**

“The hierarchy issues and authority issues are different in Russian and Finnish firms. We have this joint venture and we’ve spelled out the limits of the Russian managing director’s authority. But he did not care for the rules. He decided things as a Russian big boss does and did not negotiate matters with the board. Finally we had to fire him.”
“For Russians it was clearly frustrating to be a general director in the joint venture, because the Russian GM does not obey any restrictions in power.”
“And then we noticed that our Russian managing director had established a competing company of his own. And he explained that this is normal in Russia…”

Also most of the Russian interviewees acknowledge that there is a **reluctance of delegating authority** in Russian companies. However, many of them noted that this problem has seized to exist in their company but they still hear about it from friends and colleagues. “

“There are enterprises where managers are trying to surround themselves with people who know more than themselves. For business owners it is normal to think like that. But there are people who don’t understand it. I know an example: the person goes on vacation and everything goes well. When he comes back people are wondering why do we pay him so much money, when the work goes well without this person. So, they fire him”

Some western oriented joint venture companies have solved the problem by establishing an automatic system for delegation of authorities: *”…When the person leaves (vacation, sick leave) responsibilities are automatically delegated to the next, who knows that if the manager is away he is responsible and so on. Maybe it is better, more logical this way, it cuts the paperwork and there is no choice whether you want to delegate or not.*”

However, management styles seem to be **regionally and industry differentiated** with Moscow and St Petersburg leading the process of modernization. There are clear differences in management styles in the capitals and peripheral areas. In addition, banking and technology-intensive industries clearly show more novel management style.

“There are clear differences in management styles in Moscow and peripheral areas. A local manager is very powerful and carries out management by yelling. The partners in Moscow are more normal, closer to our way.”
“In the headquarters in Moscow things are carried out in a western way. The local subsidiaries are the problem. We have had a lot of problems with the local office, whereas with those in Moscow things are clear.”

Related to the issue of hierarchy, the Russian managers also pointed out the **distance** that prevails between different units in Russian companies. *"It is huge! For example in our company we have several enterprises. It is impossible to let them know about our problems. In our case the distance is like to the moon. When there is a problem they [Finns] expect Russians to talk to their managers, but they don't understand that in most times it is just impossible. "*

The strict hierarchy shows not only in the organization of work, but in work performance, as well. Russian **workers are claimed to be incapable of taking and even unwilling to take responsibility**.

"Russian employees do not do anything unless given precise orders. They are really afraid of making mistakes. I do not think this will change very rapidly."
"Russian directors are unwilling to delegate, and Russian staff is unwilling to take responsibility."
"Independence and activity are not very characteristic to Russian organizations"
"One of our Western managers became quite frustrated trying to get things done in Russia, when the staff was always so afraid of taking responsibility."

The Russian managers seem to share this opinion with the Finns. "People are afraid to take initiative, because the initiative is punished. Everyone has his own work and thinks "why do I need to deal with it, I should rather forward it to someone else, and let someone else figure it out". In Russian companies people try not to go over their responsibilities. Not because they don't want to help, but because they have been punished before. To solve this, responsibilities have to be determined more clearly within company".

Reasons for differences and similar examples are found in history and across nations.

"This is very different in Finland. In Finland, everybody wants power but no one wants to be responsible. The power and responsibility are not on the same level. In Russia, power and responsibility are on the same level, but very high up in the hierarchy."
"These present day [Russian] general managers have lived the 1950s and so. They have had to climb the hierarchy themselves. Of course they have internalized the system."
"Maybe Finnish companies were like that in the 1930s."
"I was interested to notice that our Russian and American partners are similar in this respect. They both check everything from higher levels before they do anything."

Motivation of workers is becoming more alike in Russia and Finland. The most important means of motivation are salary, encouraging leadership, regular work and proper working conditions. However, the role of social contributions (apartment, daycare), which were typical during the socialist times, is still important although declining in Russia. This is acknowledged also by the Finns. Issues related to the motivation of workers are, however, generally decided by the Russian partners.

"We motivate Russian workers with kind words and bonuses. Bonuses must be clearly connected with quality and performance."
"Workers are motivated by salary and social contributions."

There is a peculiarity about the salary issue noted by Russian managers. In Russia the salaries of a director and employees can differ considerably. Some partner companies resolve this issue by implementing the same rules as in Finland, which become very popular:

"…in our company for example, our driver has lowest salary, the highest salary has general director and the difference in salaries is 2-3 fold. But it is not wage-leveling. I think it is a good thing that Finns brought to us. It is good that people don't have envy, they have less gossip. In our company everybody receives enough money not to think about it. We have a golden middle".

Another interesting aspect was noted by Russian managers about **firing ineffective workers**. Often, the Finnish and Russian partners may see the need to restructure the Russian firm by reducing the number of employees. However, the views may differ on the execution of the plan due to relations between the employees. *"The foreigner might suggest* "*let's lay off these ones, they don't do much". The Russian managers say: "no, let's not lay off them, lets' find others". They find different ways and words to defend those people, because by going against those people one can get too many enemies in the company."*

"I have a friend, we studied together. And he doesn't work well. But I can't fire him. I know his family, I know his wife, we studied together as well. So, what do I do: I give him the test time and then show that he hasn't done anything, so I show that I can't pay high salary."

To avoid this problem, the Russian managers are nowadays reluctant to hire friends. "If friends start suggesting that they should work together, they are politely told that there are no vacancies, or sometimes they just put it straight that they don't want to spoil the friendship".

To conclude, it seems that the Finnish and Russian managers largely share opinions about the characteristics of the Russian intra-enterprise relations. Both acknowledge the strict hierarchy of Russian companies, reluctance of managers to delegate authority and lack of workers to take responsibility. In addition, the Finnish managers pointed out the problems in joint ventures due to Russian general managers' reluctance to expose their decisions under evaluation e.g. in the company board. The influence of foreign actors already shows in Moscow and St Petersburg, where management style is clearly more western. In the more peripheral regions and traditional industries, management style is still very authoritarian.

Conclusions

On the whole, it seems that the Finnish and Russian managers agree on the specific nature of the Russian market economy. Differences between Russian and Finnish business practices and Russia-specific peculiarities are distinguished in all social relations of enterprises: in relation to the public sector, in relation to other enterprises and in intra-company relations (partners and labor). The main findings of the study are summarized in Table 3.

As regards the public sector, both Finns and Russians suffer from the unstable legislation and opportunistic enforcement of laws and rules. In this respect, both notice lobbying and negotiation as the most efficient problem solving mechanisms. However, Finns are far more reluctant to resort to lobbying, which in their opinion may come too close to corruption.

As regards inter-enterprise relations, personal networking is once again stressed by both partners. For Finns, problems in networking are caused e.g. by differences in the hierarchical structures of enterprises. It is often difficult to identify contacts with sufficient authority to negotiate. Furthermore, the role of written agreements varies between the two countries. For the Russians, agreements are not as binding as for the Finns.

Finns and Russians have relatively similar views as regards labor relations. The authoritarian management style still seems to prevail in particular in the peripheral areas and in the traditional industries in Russia. The distance both between managers and employees as well as between different units of the company are great. Russian top managers' reluctance to delegate authority and the workers' unwillingness to take responsibility were also acknowledged by both Finns and Russians. These factors are a hindrance to the transfer of knowledge inside the company.

In principle, means to bridge the "cultural gaps" are relatively obvious, as both partners understand the peculiarities of the Russian business environment the same way. Increasing lobbying, negotiation and PR-activities would seem to be a functional solution in all aspects of business. However, for Finns, this often sounds time consuming and inefficient. Furthermore, as the dividing line between lobbying and corruption is often obscure, Finns often prefer to stay neutral and therefore sometimes remain isolated. A viable solution is often hiring local managers and using them to embed business in the long run.

Finally, both Finnish and Russian managers agree on current development trends in Russia. They stress that Russian business practices are rapidly "westernizing" in all respects. As regards the public sector practices, Russia's preparations to join the WTO have given impetus to considerable formal renovations. These still need more efficient implemented at the grass root level, however. In the business sphere, the emergence of new sectors, increasing competition and the entry of new generation of businessmen and businesswomen have lately started to pave the way to more efficient form of networking and thus undermine the traditional strongly personalized network formation. Business and pleasure are increasingly separated from one another. As regards the labor relations, team working and automatic systems of delegation are increasingly gaining ground also in Russian firms.

The modernization will plausibly somewhat decrease Finnish investors need for adaptation in Russia. Admittedly, the speed of modernization varies considerably between regions and sectors. Metropolitan regions with biggest inflows of foreign investment, as well as new business sectors are changing most rapidly.

The findings of the study can by no means considered normative, because they are based on a limited number of interviewees with selected Russian and Finnish managers. However, they do indicate the general trends prevailing in Russia. This pilot study serves as a basis for further research on business norms and company networks in the Baltic Sea region. The recent EU membership of Poland and the three Baltic states evidently fosters the economic cooperation and integration in the Baltic Sea region. Companies now all the more often perceive the whole Baltic Sea region as their home market, which has also resulted in the re-evaluation of their strategies in the region. These countries differ from each other markedly. Therefore, clear comparison of the characteristics of both the formal business environment and the informal institutions that govern the operations of company networks in the Baltic Sea region is required.

Table 3: Summary of the differences and similarities in business norms pointed out by the Finnish and Russian respondents and possible ways to bridge the gap.

Issues	Finnish & Russian managers' perceptions	Bridging the cultural gap in Russia
Public sector		
Unclear legislative framework	Shared views: laws change unexpectedly and their implementation is unpredictable, court is not trusted, situation improving though. Russians: the Finns rely too much on legislation instead of connections Finns: regional differences; controversy between federal and regional laws	Personal relations, negotiation and lobbying with the authorities help in getting information and favorable interpretation of unclear formal rules. The role of the Russian manager is essential. In case of dispute, tendency to avoid going to court in Russia, international courts preferred.
Complex bureaucracy	Shared views: unclear bureaucracy complicates business in Russia Finns: difficult to identify the right authority in each case	Personal relations can help overcome the bureaucratic hurdles. The role of the Russian manager is essential.
Corruption	Shared view: it still exists in Russia due to low public sector wages, although has decreased during the past few years Russians: One just has to cope with it. Finns: Cannot be accepted.	Hospitality and small gifts are common, but may be considered as bribes.
Inter-company relations		
Personal networking	Shared views: Having good personal connections is essential but they are not necessarily the prerequisite for starting a business relationship. Russians: role of personal networking is reducing, it is easier to separate friendship from commercial ties	Business relations are becoming more alike in Russia and Finland. Recommendations matter still and it is easier to get access to firms through personal contacts.
Hierarchical organization structure	Shared views: Russian organizations are more hierarchical than Finnish ones. In Russia, top-level managers conduct negotiations, mid-level managers are mainly operative managers. In Finland, mid-level managers usually have the authority to also close agreements.	Due to this difference, finding the right contact person is essential.
Role of contracts & agreements	Shared views: personal contacts are at least as important as contracts Finns: Russians do not respect contracts the same way as the Finns	Good personal relations and trust with the partner are a more certain way to ensure the fulfillment of the plan than a detailed written contract.
Labor relations		
Hierarchy, delegation of authority	Shared views: decision making power is concentrated on the top managers, managers are reluctant to delegate authority Finns: authoritarian management style causes problems with trust and exercise of power	Foreign firms have an important role in introducing new management styles in Russian firms.
Workers reluctance to take responsibility	Shared view: workers still lack initiative and avoid taking responsibility, which is a legacy from the socialist times	Management style has to be more controlling than e.g. in Finland. Employees can be motivated to take responsibility by salary, social contributions etc.

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RUSSIAN INVESTMENTS IN LITHUANIA – POLITICS, BUSINESS, CORPORATE CULTURE

Peter Zashev

Executive Summary

Briefly reviewing the major sets of factors forming the contemporary Russian business culture one may conclude that serious problems of business ethics plague and continue to plague the way business is conducted in Russia. Concurrently the internationalisation of Russian companies puts forward the question what exactly business cultural influence they spread when they internationalise? The paper elaborates on three main areas of concern, namely, (1)the unbroken link/dependence of Russian companies on state, (2)the non-negative attitude towards bribing and corruption, and finally (3) the somehow neglected in Russia issues of raising efficiency and productivity.

In the paper the mentioned above biggest Russian investments in Lithuania are checked against these main concerns and certain conclusions are made. While there is no evidence to link Russian ownership with deteriorating efficiency and productivity in Russian controlled companies, the unbroken dependence of the Russian corporations from the Russian state and the readiness to use bribing, whenever an opportunity exists need certainly bigger attention. Based on its findings the report also makes some policy recommendations.

As in the 1990s relations between Lithuania and Russia had their ups and downs Lithuania tried hard to minimize its economic dependence on Russia. Ironically the closer Lithuania got to its foreign policy objectives of becoming NATO and EU member, the easier for Russian companies became to enter and operate in the Lithuanian market.

Being only the 7th biggest investor in the Lithuanian economy in 2004 quantitatively Russia's investment record is perhaps not impressive. However, as Yukos controls the biggest GDP contributor and taxpayer in Lithuania, MDM Group owns the 4th biggest Lithuanian bank as well as the 5th biggest (in terms of sales volume) industrial producer, Lukoil has approximately 25% of the Lithuanian retail fuel market while Gazprom has stakes in the biggest gas distribution company, qualitatively Russia has increasingly significant role. These investments and investors are in the focus of the paper.

Introduction

Russian investments abroad are gaining momentum and the question of what exactly business ethics Russian corporations spread during their increased internationalisation is becoming more actual than ever. The Baltic States are natural area of Russian investment interest as they were part of the Russian empire and later the Soviet Union. During these times intensive economic links were created and enhanced. Therefore the Baltic States represent an interesting environment for monitoring and observing what corporate culture Russian companies bring along when they invest and operate abroad.

Immediately after the Baltic States gained their independence in 1991 they took the road of economic and political transition. A strong unifying factor driving the Baltic States politics and economics was the urge and the perception to drift away from their colossus neighbour Russia and to get closer to the West.

Such policies were not always balanced and certainly did not to help find the most optimal and practical relations with Russia but in the long run paid off in the form of full integration of the Baltic States to the West. Only 13 years later the three countries are members of both the North Atlantic Treaty Organisation /NATO/ and the European Union /EU/.

Russia also did not choose the best pattern of foreign policies. For quite some time it was trying to assert political and economic pressure that to a large extent misfired. First, such pressure served the Baltic States as a confirmation that their only course of action is to pursue even more vigorously for continuing integration with the West. Second, it was not only the Baltic States who suffered economically from the spoilt political relations as quite some time Russian investors were almost banned from freely operating and participating in the Baltic economies.

Lithuania is perhaps the country whose relations with Russia could be characterised as quite normal compared to those of Latvia or Estonia. Lithuania did not have a large Russian-speaking minority as in Latvia or Estonia. Still, the Lithuanians were quite cautious in building their new relations with Russia and constantly tried to prevent the active participation of Russian companies on the Lithuanian market.

Ironically enough the closer the Baltic States were getting to NATO and the EU, the easier it became for Russian companies to enter and operate in their markets. The more EU legislation and business practices were adopted by Lithuanian decision - makers in both political and economic matters the more Russian investors were enabled to participate in key areas of the Lithuanian economy.

In the focus of this paper are the Russian investments in Lithuania and the corporate culture Russian companies spread when they operate in this (new) EU market – business ethics, corporate governance, productivity, and efficiency. The study is divided in three parts. Part 1 provides a short background of the political and economic relations between Lithuania and Russia since Lithuania gained its independence. Part 2 focuses on the issue of foreign direct investments /FDI/ in Lithuania and analyses the Russian share of this process in both qualitative and quantitative aspects. The final part briefly states the main factors formulating the contemporary business culture and derives some important concerns that should be observed from a point of view of the country hosting Russian investments. At the end the four most prominent Russian investments in Lithuania are reviewed against the underlined concerns and conclusions are made.

Political and economic cooperation between Lithuania and Russia 1991 - 2004

Political and economic relations between Russia and Lithuania

As the Mikhail Gorbachev's "perestroika" decreased the oppression stemming from the Soviet totalitarian regime in 1988 in Lithuania nationalism drove the movement for independence and the beginning of the state building process. A national movement (Sajudis) was formed, which gained wide public support for its program of restoring an independent Lithuanian state and won the first democratic parliamentary elections in Lithuania.

Predictably Moscow inserted considerable political pressure on Lithuania that was accompanied by corresponding economic sanctions. When the Lithuanian Supreme Council refused to abide by the Soviet constitution, the President's decrees and resolutions of the Congress of People's Deputies, Moscow began an economic blockade against Lithuania (on April 18, 1990) by suspending deliveries of energy resources and raw materials to Lithuania. The shortage of raw materials led to the closing of some factories and there was an acute shortage of petroleum and other types of fuel and oil. In short, the Lithuanian economy began to falter (*Vitkus, 1996*). That was perhaps the strongest signal to the Lithuanian authorities that Lithuania must aim at gaining maximum economic independence from Russia *with an emphasis on independent energy supplies and policies*.

The victory of the Russian democrats after the unsuccessful coup of August 19-21, 1991 meant that the real political power moved in the hands of the Russian Government, which had already committed itself to respect Lithuania's independence. Starting at the end of 1991 Lithuanian-Russian relations began developing on a wholly new legal basis. Lithuania became an independent state *de facto* and *de jure* (*Bildt, 1994*).

At the end of 1991 in Lithuania and the other Baltic States there were still military troops under Russia's command; the economy of the new states was fully and completely integrated into the economic space of the former Soviet Union; in the Baltic States there were many people of Russian nationality (28,1% in Estonia (*CIA, 1998*), 29,6% in Latvia (*CIA, 2002*) and 8,7% in Lithuania (*CIA, 2001*)), who upon the dissolution of the Soviet Union suddenly found themselves living abroad.

Thus, the withdrawal of the Russian armed forces and the regulation of economic relations on a new basis became the main problems in Lithuanian-Russian relations. In Lithuania, alongside the growing political confrontation and re-grouping of political forces, an economic crisis was developing. Certainly, just like the 1990 economic blockade was not Prunskiene's fault, the blame for the deterioration of the Lithuanian economy in the summer of 1992 fell not only on Vagnorius government (*Vitkus, 1996*).

The end of the summer of 1993 and the withdrawal of the Russian troops marked the beginning of a new stage in Lithuanian-Russian relations. Both states were no longer burdened by the complicated problems of the troop withdrawal, the solution of which had required tireless efforts, so the tension about and fear of the breach of the withdrawal timetable receded.

The Lithuanian NATO membership was another issue that for some time looked to seriously overshadow the relations between Lithuania and Russia and which again left economic pragmatism aside. While NATO became less of problem after the USA granted Russia increased non-member role in NATO, later the problem crystallized in the question how citizens, military personnel and equipment would travel between Russia and Kaliningrad. As the Baltic exclave of Kaliningrad is entirely surrounded by Lithuanian and Polish territory no visas were necessary for residents of the exclave who wished to travel to Russia proper. But the EU membership required on some form of visa regulation, saying that such measures are needed to control what could be a large flow of illegal immigrants into the EU territory.

Russian and European Union leaders finally agreed on travel rules for Russia's exclave of Kaliningrad, thus defusing a dispute that had been straining relations. The new travel rules are designed to make it easy for Russians in Kaliningrad to reach the rest of their country through the territory of future EU members Lithuania and Poland. But Lithuania has doubts. The agreement came into force in July 2004. It was a compromise deal under which Kaliningraders will be able to transit with so-called "facilitated travel documents" that will be easier and cheaper to obtain than regular visas (*EU Business, 2002*).

It must be mentioned that the most serious issue in the political dialogue (or dispute) between Russia and the Baltic countries was the treatment of Russian minorities in the Baltic States. However, Lithuania was in much better position to avoid such tensions, as the ethnical Russian minority in Lithuania is approximately 9% of the total population.

The intensity of the Lithuanian national movement, however, did not pose a serious threat to Lithuania’s national minorities or to inter-ethnic relations, because the republic has already adopted significant guarantees of minority rights (*Resler, 1997*). Regarding its relations with Russia that put Lithuania in a favourite position related to the situation in Estonia and Latvia where huge amounts of Russians settled after the World War II.

Economic relations

The economies of Lithuania and the other states that emerged in place of the Soviet Union were fully and completely integrated into the common economic space of the former Soviet Union. However, the Russian market, whose size in theory made it able to absorb an enormous quantity of imports, in fact became inaccessible to Lithuanian producers. One reason was, of course, the newly created borders and other political problems. However it was also true that Lithuania's economy at the time was not reformed and it was unprepared to function on a new basis.

A major problem was the decay of the Soviet financial system: payments between economic subjects were disrupted; mutual indebtedness between suppliers and clients was colossal. Regardless of the general economic crisis, Russia was in a position to exert great influence on Lithuania's politics through economic means. The Lithuanian Government could not ignore the reality; it had to realise that it remained fully economically dependent on the supplies of key raw materials and energy resources from the former Soviet Union, and particularly from Russia. In July 1992, the Bank of Russia suspended payments to Lithuania because of the debts of the latter and reviewed conditions of bilateral economic co-operation (*Vitkus, 1996*).

This amounted to the abolishment of the status of most-favoured nation and meant that from now on Lithuania was to pay for Russia's goods in hard currency at world prices. In Lithuania, economic relations were becoming increasingly complicated and degenerating at a fast pace. This led to the disruption of the whole economic reform process and allowed the level of inflation to rise unrestrictedly (by the summer of 1992 it exceeded 2000%); the standard of living was dropping at a disastrous rate. As a result of such a critical situation and the above mentioned re-grouping of political forces within the Supreme Council, on July 14, 1992 a no-confidence vote was held concerning Vagnorius government (*Ibid.*).

On the background of the tensions around the timeframe of the troop withdrawal the autumn and winter of 1992 were an especially difficult period for Lithuania's economy, which was deteriorating even further. Russia was exerting indirect economic pressure by breaching agreements on supplies of energy resources and by closing its market. This inflicted big losses on Lithuania's economy and deeply affected the living conditions of the Lithuanian population. It was the Russian way to demonstrate that Lithuania should acknowledge its economic dependence on Russia.

Russia's refusal to grant Lithuania most-favoured-nation status further exacerbated the mistrust of Lithuanian politicians for the Russian attitude towards Lithuania. Ironically for Russia, the refusal actually helped Lithuanian companies to readjust themselves and find new markets in the West. According to the then Lithuanian ambassador in Moscow, Kozyrovicius, "the length of abnormal trade relations with Russia (double tariffs), which discriminated against Lithuanian goods, was even beneficial for some of our firms. It forced them to find a favourable market in the West. Almost 80% of all our foreign trade was with Russia, but during 1991-1993 when the trade agreement was inactive the level of trade fell to 29%. This would have been even lower if not for the necessity of importing raw energy materials (fuel, natural gas). The reorientation of Lithuanian business is well illustrated by the example of commerce. In 1993 78% of light commercial production was exported to the CIS. One year later this figure was reversed: 80% of light commercial goods were exported from Lithuania to the West (*Kozyrovicius, 1995*).

The concrete agreements on bilateral trade were signed in November 1993 and came into force in 1995. They gave Lithuania the status of the most favourite trading nation with Russia – a status that is still valid (*Miskinis, 2000*).

In 1997 the trade turnover between Lithuania and Russia amounted to almost 25 % of the total Lithuanian foreign trade turnover. In the second half of 1998, however, with the start of the crisis in Russia the bilateral trade turnover decreased to 19 % (*Ibid.*).

The rapid development of the Russian economy after mid 1999 favourably affected also the volume of Lithuanian exports and imports. Recovered export to the Russian markets was the main factor which conditioned a considerable increase in the total volume of Lithuanian exports during the first half of 2000 – by 26 %, compared to the same period in 1999, the imports increased by 10 % (*Ibid.*). In 2003 Lithuania's exports to current EU countries declined sharply from 48% to 42%. The most important trading partners were Switzerland (12%), Russia (19%) and Germany (10%). In imports, the EU's share grew slightly, up to 45%. Russia's (22%) and Germany's (16%) share is still dominant in Lithuania's imports (*BRE, 2004*).

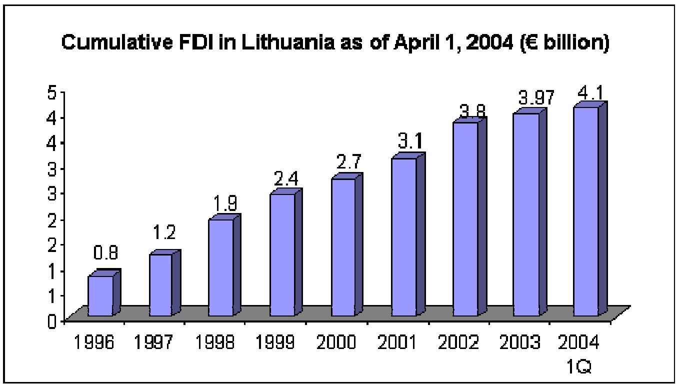
Particular attention is paid to the issues of the economic, commercial and cultural cooperation with the neighbouring Russian region – the Kaliningrad Oblast. Poland, Germany and Lithuania have been the most important trading partners of the Kaliningrad region for many years and retained their positions as such in 2003 (*EMK, 2004*). As of the beginning of 2000 there were 304 joint enterprises with Lithuanian capital registered in the Kaliningrad Oblast. According to the number of joint enterprises in the Kaliningrad district, Lithuania ranks second after Poland (*Miskinis, 2000*).

Foreign direct investments and investors in Lithuania

During the 1990s Lithuania was not the most popular FDI destination in Eastern and Central Europe. Still, by the end of 2003 as could be seen in Table 1 Lithuania has received some €4 billion of foreign direct investments /FDI/. The 1991-2003 cumulative FDI on per capita basis was $1169 that is almost 3,5 times less than in the Czech Republic but it is still considerably higher than in countries such as Bulgaria, Romania or Russia (*IMF, 2004*). Among the main reasons why foreign companies decide to invest in Lithuania are inexpensive and skilled work force, potentially growing market, geographic location and economic and political stability.

Manufacturing, and wholesale and retail trade sectors have received the biggest FDI inflows in Lithuania throughout the 1990s, although their share is gradually decreasing giving place to telecommunications. By January 2004, manufacturing had received more than a quarter of all FDI (*LDA, 2004*).

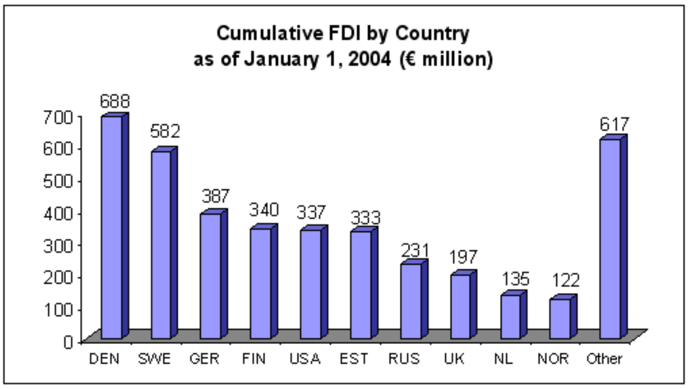
Table 1.



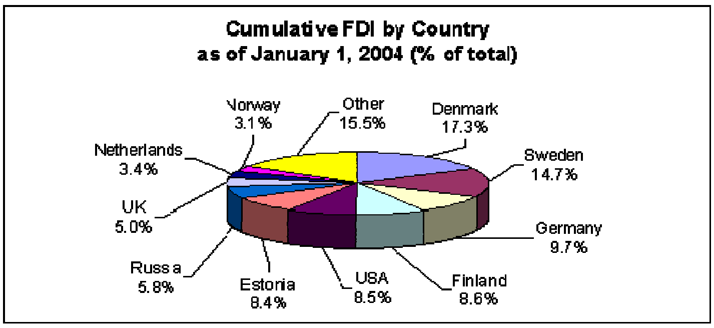
Source: Lithuanian Development Agency

As of January 2004, Denmark has accounted for the biggest share of cumulative FDI (17%), followed by Sweden (15%), Germany (10%), Finland (9%), the United States (9%), and Estonia (9%) (*Table 2*). Currently, the European Union accounts for about two-thirds of all FDI, and its role is expected to increase since Lithuania joined the EU in May 2004.

Table 2.



Source: Lithuanian Development Agency



Source: Lithuanian Development Agency

There are only two Russian companies among the top 36 foreign investors in Lithuania. Yukos ranked 4th with €150 million purchase of Mazeikiu Nafta and Lukoil is ranked 23rd with the €29 million investment in gas stations (*LDA, 2004*). However there is reason to believe that the situation is slightly different. It is quite difficult to monitor accurately the Russian investments as Russian companies often use off shore companies for their investment purposes or just companies registered outside Russia. For instance in December 2000, there were 1073 enterprises registered in Lithuania with the participation of capital from Russia, among them – 839 joint enterprises and 234 enterprises fully owned by Russian capital (*Miskinis, 2002*). As of June 2003 the Cypriot investments in Lithuania amounted for $75 million (*Vahtra&Liuhto, 2004*). The significant amount of Cypriot investments is generally considered to be of the countries recipients domestic or of Russian origin.

According to the amount of capital investments, Russia ranks 7th (Table 2) among the 112 countries, which have invested their capital into the economy of Lithuania. There are two ways to review this figure. One is to note that Russia is one place after even Estonia whose economy with 1,36 million inhabitants is hardly compatible as size and strength. However it should be accounted that the political hostilities and the weakened economic situation in Russia did not contribute toward much of an outward Russian economic expansion before 1999. It was then when Russian companies enabled by a reviving Russian economy and high oil prices got the will and the means to expand internationally. The second is to put the accent on the qualitative dimension of Russian investments. In Lithuania it is not the amount of Russian investments, which causes concern among Lithuanian politicians and decision makers. It is their clear orientation toward strategic sectors of the economy - energy supply and distribution.

Russian investments in Lithuania

The fear of Russian investments

Among the main reasons for trying to rebuff Russian investments were perhaps the fear of loosing control over vital aspects of the economy and secondly the usually unclear source of investments. Along these lines for a long time in Lithuania it was commonly accepted that keeping the Russian investments away is in the interests of national security.

Thus Lithuanian politicians observed potential investments not only in terms of their economic value and essence but also for their political impact. In the light of Lithuanian candidacy for NATO and EU membership it was considered that priority should be given to investments from Western Europe and the USA. In this respect it is interesting to observe that Russian analysts do see only the political motivation in such prioritisation but fail to acknowledge that besides capital Western investment lead also to transfer of management culture, know-how and technology that are as a rule superior to anything Russian companies may offer.

The first tangible Russian effort was the 1994 offer of Lukoil to participate in the construction of Butinge terminal in exchange for shares in it (*Skripov, 2004*). However for political reasons the proposal was categorically rejected. The rejection was also interesting indicator as it was made by the left wing government (Shleziavichus) and left wing president (Brazauskas) with a parliamentary majority also from the left. When opening the construction the Prime Minister Shlezavichus called the project "political investment" that will free Lithuania from the dependency on Russian oil. Thus a statement that the left wing political forces in Lithuania are pro-Russian does not really hold true (*Ibid.*)

Another vivid example was the privatisation of Mazeikiu Nafta in 1997-1999. It was the conservatives who ruled the country at the time and the minister of the economy Vincas Babilus summarised the policy of the Lithuanian Government with the slogan "Don't let Ivan to the pipe!" The Lithuanian government assessed the economic and political pros and cons and the pipe together with the oil refinery and the terminal was given to the American company Williams International.

The three companies (the Butinge terminal, the Naftotiekis oil pipeline company, and the Mazeikiu Nafta refinery) were combined into one, and 33% of the combined company's shares were allocated to Williams International /WI/. The total investment by WI in their 33% share in the new combined Mazeikiu Nafta company was about $150 million. WI has also committed another $650 million investment to modernization. As part of the deal, the Lithuanian government agreed to cover a previous $350 million deficit the pipeline company had incurred. The deal gave the WI management control of the company and the right to buy a majority of the shares within five years, and also included the right to transfer 10% to financial institutions like the EBRD and 10% to oil suppliers (*US DoE, 2004*).

However, there were objections to the deal from some Lithuanian citizens and from the Russian oil company Lukoil. The former caused delays in completing the deal while the latter caused continuing oil supply shortages. Repeated attempts by WI to reach a lasting supply agreement were unsuccessful, and some crude supplies were arranged from North Sea and Kazakh suppliers.

As the political benefits (better relations with the USA) were marginal and the economic benefits were somewhat dubious the overall calculation proved to be wrong. The economic losses were tremendous as it became apparent that Russian oil suppliers deliberately or not can not secure a steady supply of oil for the refinery. Different evaluations show that for the approximately 3 years WI owned the company it generated losses of approximately $500 million (*Skripov, 2004*).

Over time the Lithuanian government realised that the Western origin of investors alone is not enough to guarantee that the investment is fruitful and productive in the long run. The not really successful sale of Mazeikiu Nafta to WI was complemented also by the near complete destruction of the leading Lithuanian textile manufacturer in Alituse by the Singapore company Tolaram Group.

Still to Lithuanian politicians it is uneasy to accept that the only sphere of the Lithuanian economy Russians have particular interest is in the strategically important energy resources supply and distribution. For them it remains hard to believe that the investment decisions of Russian companies are taken exclusively on economic but not on political principles. Along these lines it becomes perhaps more understandable why Lithuania was particularly worried about the activities of Russian state owned (or state controlled) companies such as Gazprom, Rosneft, TNK, RAO UES.

After the year 2000, Russian companies again intensified their investment interest toward Lithuania and this time their efforts reached certain degree of success. According to the data of the Department of Statistics in July 2002 there were 119 investors of Russian Federation with $172,3 million or 5% of all direct foreign investments in Lithuania. Among the largest enterprises, which have Russian investments, besides Mazeikiu Nafta, could be mentioned enterprises such as:

- Kuro aparatura (fuel injection equipment for diesel engines, bought for $3 million by the Russian OOO Kris (*Baltkurs, 2002*)
- Polasta is 49,18% owned by Surgutgazprom and produces plastic products and chemistry (*Gazprom, 2003*)
- Atrama (boilers and heaters)
- Silmega (plastics)
- Gargzdu mida (polymeric bitumen roofing)
- Alytaus pieninė (dairy products)
- Nilma (forestry products)
- Baltic Garantas (insurance and pension fund)
- Korelita (fabrics and fibres)
- Stella Vitae (natural gas supply)
- Atomkomplekt (nuclear power engineering)

(*Lithuania Presents, 2002*)

By 2004 the figure went to cumulative investments of €231 million that represented 6% of all direct foreign investments in Lithuania (*LDA, 2004*).

Russian investments in Lithuania - the four biggest cases

In the focus of this article are four cases with the major Russian investments in Lithuania. These are:

- the purchase of Mazeikiu Nafta refinery by Yukos
- the Gazprom investments in the Kaunas power plant and Lietuvos Dujos
- the purchase of Lifosa by the Russian Eurokhim Holding / MDM Group
- the purchase of Snoras Bank by the Russian Konversbank / MDM Group

Yukos in Lithuania

In June 2001, Williams International reached a 10-year oil supply agreement with Yukos, Russia's largest oil company. Under the deal, Yukos guaranteed almost 100,000 b/d to the Mazeikiu Nafta refinery and 80,000 b/d for exports through the Butinge terminal. As part of the deal, Yukos got the right to buy 27% of Mazeikiu Nafta, and WI's stake was reduced to 27%. This gave WI and Yukos equal ownership, but Williams International retained management control of the company. As part of the deal, the Lithuanian government's share was reduced to 41%. The deal was ratified by the Lithuanian parliament in August 2001. That was the basically the competitive advantage of Yukos over Lukoil – Yukos preferred to use "one step at a time" approach instead of the much more confrontational strategy of Lukoil. In September 2002, Yukos bought out WI share of Mazeikiu Nafta for $85 million and thus took control of the company. Right after the buyout, Yukos increased the crude oil supply for Mazeikiu Nafta to about 145,000 b/d (*US DoE, 2004*).

The financial results for the first six months of 2004 according to the company's auditor PricewaterhouseCoopers reviewed net profit of $82.4 million compared to $23 million US dollars net profit during the same period in 2003. Company's revenues reached $1.1 billion during the first six months of 2004 or $391.9 million more than in the same period of 2003. According to P. Nelson English, General Director of Mazeikiu Nafta that was the most profitable six months in the company's history due to high refining margin and record throughputs (*MN, 2004*). Mazeikiu Nafta refined over 3.9 million metric tons of crude and other feedstock during the first six months of 2004, more than 1 million metric tons more than in the same period last year (Ibid.). The refinery reached a record monthly throughput in June by processing 754 thousand metric tons of crude oil and continues to run at record daily rates. The Butinge Terminal loaded 4.62 million metric tons of crude during the first six months of 2004, compared to 5.87 million metric tons in the same period of 2003. Sales of gasoline, diesel and other products within six months of 2004 amounted to 672 thousand metric tons in Lithuania, 249 thousand metric tons in Latvia, 167 thousand metric tons in Estonia and 167 thousand metric tons in Poland. Sales in strategic markets for same period a year ago were 633 thousand metric tons in Lithuania, 194 thousand metric tons in Latvia, 129 thousand metric tons in Estonia and 116 thousand metric tons in Poland. Almost 2.23 million metric tons of products were transported via the Klaipeda seaport to Western Europe, the US, Canada and other parts of the world during the six months of 2004, up from 1.39 million metric tons within the six months of 2003 (*Ibid.*).

However such good results did not spare Mazeikiu Nafta from the problems related to the Russia's government assault against Yukos. At the beginning of the Yukos crisis the Lithuanian stock market reacted quite. However as of August 2004 the situation got upside down and in one single week Mazeikiu Nafta share rate dropped by 22.48% as market participants became seriously worried about the stability of the company. Also recently gossips started that Russian Oil Company Lukoil (favoured by Kremlin) aims to purchase Mazeikiu Nafta (*Byla, 2004*).

Gazprom in Lithuania

The best way to describe the asymmetrical relationship between the Russian natural gas monopolist and Lithuania is to acknowledge that Gazprom is much more important to Lithuania than Lithuania is to Gazprom. The Lithuanian share of Gazprom total exports for 2002 was less than 1,4% (*Gazprom, 2003*). The Kaunas power plant produces about 80% of the heating consumed in Kaunas, Lithuania's second largest city (*Pravda, 2003*). In September 2002 the winner of the tender was announced as a consortium consisting of Gazprom, Dujotekana and Clement Power Venture. The Kauno Termofikatsios Elektrine (KTE) international consortium and Lithuanian company Kauno Energia have signed an agreement on the sale of the Kaunas power plant. According to Gazprom's press office, *KTE* paid around $35 million for the plant as well as pledged financing for a $42-million investment programme up to 2006 (*Ibid.*).

The JSC Lietuvos Dujos is a Lithuanian gas company dealing with gas procurement, transmission and distribution in Lithuania. The company operates 1630 km of high-pressure gas pipelines and employs 2200 people. Lietuvos Dujos is one of the largest state companies in the country and owns a compressor station, a gas measurement station and 58 gas distribution stations. Gazprom acquired a 34% stake with $37 million and guaranteed natural gas supplies for a decade. The stakes were sold from the government's 58% holding. The German company Ruhrgas also owns 36% of Lietuvos Dujos. Gazprom is expected - in conjunction with the German company -- to upgrade the local gas sector, extend the grid, and pave the way to connect the grid with the EU network. In March 2004 Gazprom finalised the deal to acquire Lietuvos Dujos' 34% stake and signed the Shareholders' Agreement adopted between the State Property Fund of the Lithuanian Republic, Gazprom (as the Gas Supplier), and Ruhrgas Energie Beteiligung AG (as the Strategic Investor) (*Ibid.*).

Stella Vitae is another major player in the natural gas market where Gazprom is reported to hold 30% stake in the company (*Pravda, 2001*). Another company where Gazprom (through its affiliate company Surgutgazprom) holds 49,18% is Polasta that is owned by and produces plastic products and chemistry (*Gazprom, 2003*)

Lukoil Baltija in Lithuania

Lukoil was established as a closed stock company, a joint venture between Lithuania, Russia and Luxembourg, in November 1992. Initially, it served to co-ordinate the supply of crude oil for the Mazeikiu Nafta oil refinery and the export of oil products to Russia.

Since the conclusion of the WI deal, Mazeikiu Nafta has encountered problems obtaining crude oil supplies from Russia. It was the Lukoil way to demonstrate its disappointment with the privatisation strategy the Lithuanian government applied for the oil refinery. As a result, Mazeikiu Nafta suffered close to $40 million in losses in 1999 and posted $10 million dollars in losses for the first half of 2000. In May 2000, after months of negotiations, WI and Lukoil announced that they had signed a protocol of intent to create joint supply and marketing enterprises in the Baltic region.

Under the deal, a jointly owned supply company will deliver 6 million tons of crude a year (120,000 bbl/d) from Lukoil and other Russian companies to the Mazeikiu refinery. The Lithuanian refiner will process the crude and sell resulting oil products through a series of marketing enterprises jointly owned by Mazeikiu Nafta and Lukoil. However Lukoil continued to insert pressure to become shareholder in the company insisting that oil should be supplied at world prices that at the time were about $10 higher than the prices at which Mazeikiu Nafta was purchasing the Russian oil. WI offered Lukoil 33% of the shares, two places in the board of directors of Mazeikiu Nafta and the position of associated deputy director of the refinery (*Bernstein, 2001*). Lukoil was reluctant to accept such an offer, as the operational management in this case would have remained in the hands of WI. The discussion between WI and Lukoil was becoming increasingly tense as Lukoil was accusing WI management in incompetence while WI was insisting that the situation is deteriorating due to an intentional uncooperativeness of Lukoil.

Later, following economic changes, Lukoil Baltija began buying crude oil and refining it. Profits have been invested in building petrol stations and enlarging the infrastructure of the enterprise. In 2003 Ivan Paleichik, Lukoil Baltija chairman, said the company is expected to expand its existing chain from 100 to 120 petrol stations by the end of the year. In 2003 the company controlled nearly 25% of Lithuania's fuel retail market (*Baltic Business Monitor, 2003*).

MDM Group in Lithuania / Lifosa and Snoras

Both Eurokhim holding and Konversbank belong to MDM Group of Russia that is owned by an Austrian parent company, MDM Holding GmbH (*MDM, 2004*). In 2003, Antilles Comercio Internacional S.A. (Portugal), a company controlled by Mr. Melnichenko, sold a 50% stake in MDM Holding GmbH to Metano-Servicos E Marketing S.A. (Portugal), a company controlled by Sergey Popov, Mr. Melnichenko’s long-standing partner in MDM Industrial Group (*Ibid.*).

In August 2002, Eurokhim acquired 70% of Lifosa shares for €4,5 million (*NSE, 2002*). Lifosa is one of the biggest in Europe producers of phosphate fertilisers and the 5th biggest (in terms of sales volume) Lithuanian manufacturer. Eurokhim is a vertically integrated holding including companies in mining, chemical processing and trading where management planning, budgeting and investment processes were centralised in the holding. Thus it has a full control over the assets, industrial and investment activities, and cash flows of all the participating enterprises (*Gromova, 2003*). In the production of phosphate products the holding is the second biggest in Europe and sixth worldwide with annual turnover of $900 million (*MHK, 2004*).

In 2003 the board of Lithuania's Central Bank has granted permission to the Russian Konversbank and its subsidiary, Luxembourg-based Incorion Investment Holding Company, to raise its ownership stake in the commercial bank Snoras, assuming management control as well. After the stock purchase Konversbank holds a combined 58% stake in the Lithuanian commercial bank (*RFE, 2003*). Snoras bank is the forth bank in Lithuania by size and possesses one of the most advanced and extensive banking service networks in the country. Snoras bank has over half a million customers or almost every sixth Lithuanian resident uses its services and is a member of Konvers Group, an international Banking group[1] with (*Snoras bank, 2004*). The new owners sold the belonging to Snoras bank non-life insurance company Snoro Garantas to the Russian insurance company Reso-Garantia (*BBM, 2003*). For the first half of 2004 Snoras bank had 15% growth of profits that amounted to LTL 10.6 million - the highest growth among all Lithuanian banks (*BBM, 2004*).

It seems that even if Russia is only the 7th biggest investor in Lithuania, its investments are in key areas with strategic importance. Russian companies control the 4th biggest Lithuanian bank, approximately 25% of the retail fuel market, the Kaunas power plant, and stakes in the biggest gas distribution company. Russian companies own Mazeikiu Nafta (as of 2001 some 30% of Lithuania's GDP were associated with the refinery (*Roe et al., 2001*) as well as the 5th biggest (in terms of sales volume) industrial producer.

Therefore the importance of the topic what corporate culture and business ethics Russian companies spread when they internationalise for Lithuania could be more than an academic elaboration.

Russian business culture – fundamentals, fears and evidence from Russian companies operating in Lithuania

An important influence of the contemporary Russian business culture seems to be often unnoticed – the one Russian companies could spread in their foreign operations. The growing international expansion of Russian companies (*Liuhto 2001; Liuhto&Jumpponen, 2001, 2003; Vahtra&Liuhto, 2004)* results in some "export" of the underlying recent business values and attitudes of Russian corporations. That has certain impact on the involved foreign players and environments be it businessmen, officials, companies, bureaucracies, international organizations etc.

In parallel with their international business expansions Russian companies certainly utilize fully or partially their own corporate culture. This chapter attempts to outline the factors shaping the contemporary Russian business culture and elaborate on the possible negative influence they may have in the foreign activities of Russian companies.

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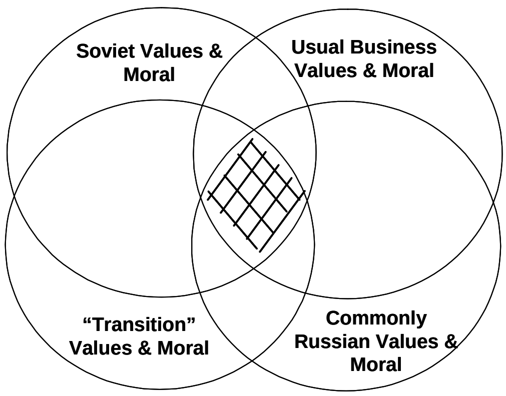
[1] Starting in 2003 Konversbank started forming Konvers Group that included Konversbank, Academchem Bank and Snoras bank. Among others the group is supposed to be the financial branch of the Russian Academy of Science and Ministry of Nuclear Power.

Why fear contemporary Russian corporate culture?

The contemporary Russian corporate culture could be presented as the cross-section of four different sets of factors and their consequent impact on collective and individual culture and mentality as shown in Figure 1.

Figure 2 Four sets of factors forming the contemporary Russian business culture.



The first set is formed by the traditional Russian values and norms that distinct Russians as compared to other national cultures. The second set could be defined as those norms and values that were added / enforced to the Russian mentality during the time of the Soviet Union. The third set represents those new developments and modifications in mentality and culture that the last 12 years of transition process required from every social group and/or individual in Russia. Finally, the fourth set of factors is assembled by the influence of Western business culture whose impact constantly increases due to the growing business interaction.

A more detailed critical survey of the four sets is provided below with accent on the influence they have had and the features they have brought to contemporary Russian corporate culture.

Commonly Russian values and moral

As one of the most striking factors influencing the commonly Russian business values and moral could be underlined the near total lack of competition in the Russian social and economical life – an argument that was pointed out by many authors (see e.g. Prohorov, 2002). Thus among the three main features of the Moscow state were:

- *militaristic nature* as the state had to fight external enemies and expand further geographically
- *society based on force rather than law* with clearly determined division of social groups. These groups differ by their duties rather than by their rights
- *supreme power of the state / tsar* with not clarified and unlimited authority space

All these features were slowly suffocating the very concept of free competition in the allocation of any type of resources – human, financial, natural etc. As a result a highly centralized system was built where the state in the face of the Russian emperor had unlimited and not clarified powers. The latter were transmitted to the rest through an ever growing, slow and inefficient apparatus of state bureaucracy. It is not by a surprise that in such conditions the competitiveness was directed mainly on attracting the attention of the supreme power through gifts, bribes and network of important acquaintances.

Such system will also partially explain that all prominent international Russian business projects – be there in railways, investments or simple exports were in most cases directly or indirectly sanctioned and/or financed by the state.

Soviet values and moral

The system did not change much in the soviet times – the state succeeded into implementing total control on all activities that could be characterized as deeper and broader if compared to the centralized administration during tsar's times.

Again the state had the not clarified and unlimited authority to allocate resources of all types. Furthermore the state imposed an ideological embargo that additionally stalled the system. The Soviet rule also imposed concepts such as the "uravnilovka" that eliminated the link between work and pay, "planning" versus market that geared further the bureaucracy and made cheating an inbuilt part of the economic system, "repression" that became a state concept and thus eliminated initiative, decision making and freedom of choice.

Again, surviving and economic (and physical) prospering in the system was dependent on one's links to the state power in its various forms: communist party, state administration, and military, KGB etc. Again the competition was levelled down to none as most factories obtained a monopolist status. They were then given predetermined figures on input and output and workers did not have initiative due to the "uravnilovka".

The Soviet system also did not succeed to eliminate the corruption and bribing that plagued the Russian state machine in the times of the tsar. Quite the opposite, in the presence of an almost total deficit for goods and services corruption became the normal way of life. The basic lesson Soviet managers learned was that being obedient to the system through keeping a low profile was the best strategy to follow. Maximizing the requested from the planning committee input and minimizing the expected output was a common strategy.

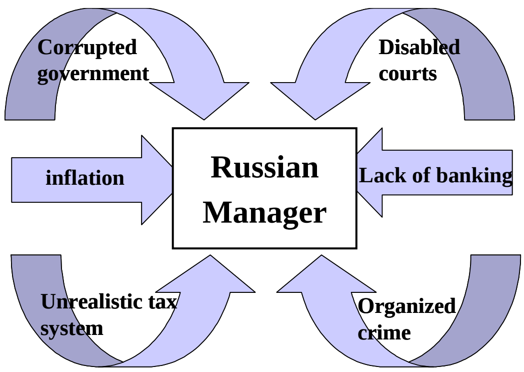
The foreign operations of Soviet companies were an absolute state monopoly controlled by the party, the state and KGB. Officially only the Foreign Trade Organizations were authorized to link Soviet factories with their overseas markets, suppliers, partners etc. Any investment decision, be it a power plant in Cuba, factory in Sudan or military equipment to Egypt was part of a conscious centrally planned and controlled foreign policy rather than a money wise business rational based decision.

Transition values and moral

Perhaps the most interesting and intriguing period that has a considerable influence on the Russian business culture is the economic and political transition that Russia is experiencing for the last 14 years.

A dramatic change has appeared in the form of a massive (initial) retreat of the state. Dodgy or not, fair or not, the privatisation in Russia created in few years a new social group of owners – investors, capitalists, industrialists etc. Still, it must be noticed that it was not their entrepreneurial spirit that was the main factor for their success. It was rather a well build network of contacts with the government at all different levels in combination with a total disrespect for the "transitional" semi-Soviet, semi-market legal system.

Figure 3: Sources of pressure on company management



The state retreat in the 1990s and its inability to perform vital functions generated significant vacuum in the economic and social situation in Russia. Russian managers at the time were imposed to number of stressful forces as shown in Figure 2.

One of them was the high inflation that was making business itself a difficult task and almost impossible to make any mid- or long-term business decisions and planning. Such a high degree of unpredictability was one of the main reasons for Russian managers to be focused mainly on short-term incomes, profits etc.

Another reason for that was the absence of normal corporate banking (situation that largely remains the same) and of bank credits to businesses. Those in fact created demand for alternative sources of financing that were provided typically at very risky conditions and from very risky places.

Another serious obstacle was the growing organized crime that was constantly trying (and to a large degree succeeded) to be deeply involved in business. Drugs, prostitution and racketeering were only the initial operations that soon went into much more sophisticated schemes such as tax dodging, money laundering, banking and privatisation.

In the presence of next to none existing legal system and dysfunctional courts business disputes and debt collection became a domain of activities for the organized crime.

Not succeeding into building a stable macroeconomic environment, launching a failed bank reform, not effectively combating organized crime were perhaps not the biggest shortcomings of the Russian state in the early 1990s. The worst three pressures that the state offered to businesses and managers were extremely weak and corrupted institutional / bureaucratic machine, practically disabled courts and an unrealistic tax system that made most members of the business community outlaws by definition.

Surprisingly the state stopped performing vital duties of control and regulation but still remained the prior arbiter with the inherited historically feature of having unqualified and unaccountable features.

What corporate culture Russian companies spread in Lithuania

From the presented above assumptions one may jump to the conclusion that Russian companies are some sort of puppets in the hands of the Russian state machine, that they bribe themselves out of any situation, rely mainly on informal networking, have over manned and inefficient labour and managerial practices and generally in their survival mechanism there is little respect for law. To some extent this description may fit many Russian companies operating in Russia.

Hence, if serious problems of business ethics plague and continue to plague the way business is conducted within Russia, the internationalisation of Russian companies puts forward the question what exactly business cultural influence they spread when they internationalise? Standardization or localization - do Russian companies and executives use a standardized approach of utilizing Russian business culture or they try to adapt to the local environment? Is the statement that Russians see no problem with favouritism, price fixing, ignoring senseless laws and regulations and manipulating data valid (*Puffer, 1996*) and do they bring such type of thinking in their foreign operations? Is it correct to conclude that Russian companies prefer Russian managers in their offices abroad? Are the features in Russian business ethics perceived as negative, influencing other business cultures when the Russian corporations go abroad and if yes then to what extent? When it comes to their overseas operations the situation is a bit more complicated than that.

The Russian companies are also acknowledged to be among the most active bribers when doing business abroad (*Transparency International, 2002*)

The business cultural influence of foreign investors is a subject that is still relatively unexplored by the cross-cultural management discipline. The main problem is how that influence could be qualified and quantified. There are many factors that should be considered. One is the size of the investor's home country and economy and the size of the country/economy - recipient of the investment. For instance, Lukoil acquisition of the Getty Petroleum marketing (gas stations chain) in the USA is unlikely to have significant cultural impact due to the geographic and economic size of the country recipient of the investment. On the other hand the Russian investments in Lithuania are more likely to have tangible impact in terms of business cultural impact as both Lithuanian geography and economy are considerably smaller.

Another factor to be considered is how far apart are the investor's home country and the investor's host country in terms of national cultures. The latter could be described in terms of language, religion, ethnicity, shared history etc. Or it could be compared in terms of a Hofstede analysis (*1985*). Last but not least the size of the investments should be also considered and measured not only in absolute terms but also in terms of their impact and importance for the economy of the host country.

The discussed above assumptions provide enough reason to assume that as most worrying features of Russian corporate culture could be considered:

- an unbroken link/dependence of Russian companies on state and stemming from it consequences over political versus economic motivation when making corporate decisions
- non-negative attitude towards bribing and corruption
- the somehow neglected in Russia issues of raising efficiency and productivity

The analysis below will attempt to check to what extent these concerns match the reality in the case of Russia's four biggest investments in Lithuania as described in paragraph 1.3.

The unbroken dependence on the state

Are the biggest Russian investors in Lithuania emitters of official Russian state policies? To what extent their relations with the Russian state made them dependent on it?

The current ownership of OAO Gazprom shows that the company belongs 38,37% to the Russian state, 36,28% to Russian legal subjects, 13,85% to private persons, 11,5% to foreign investors (*Gazprom, 2004*). Even though that information is not sufficient to understand who actually controls and runs Gazprom (it does not answer who are the legal subjects themselves – private or state owned), it is widely accepted that Gazprom is a state owned company that has natural monopoly over exploration, production and distribution of natural gas.

As such the company's CEO would naturally be selected and appointed by Kremlin and personally the president. It is not by surprise then that the current Gazprom CEO Alexei Miller is a personal appointment of President Vladimir Putin. Miller is the President's former colleague and, according to experts, his mission at Gazprom is more political, to transmit Kremlin policies, than economic management of Gazprom. It is obvious then that most overseas investment decisions of Gazprom must first have a Kremlin clearance. Such as the decisions to buy the Kaunas power plant and to take stake in Lietuvos Dujos.

That is exactly what worries Lithuanian politicians. The former chairman of the Lithuanian parliament, Vytautas Landsbergis argues "We should avoid such Russian expansion in the energy sector, which is pre-planned, calculated, and which is also part of a political expansion seeking to increase Russian influence in Lithuania. In the past Vladimir Putin has said Russia's policy aims could be achieved by using so-called "energy diplomacy" (*Mite, 2004*)

In contrast, a member of the Lithuanian parliamentary committee of economics, Birute Vesaite, says it would be silly to build stumbling blocks for Russian capital just because it is coming from Russia. "We have no other way out," Vesaite says. "Who are the main oil and gas suppliers for Lithuania?" Lithuania may have no alternative. That's the view of Nicolas Redman, a Russia analyst at the London-based Economist Intelligence Unit. He says the country cannot afford to buy gas from the West when the Russian product is cheaper and closer (*Ibid.*).

Still, Vytautas Radzvilas, an analyst at the Lithuanian Institute of International Affairs in Vilnius says "there is no doubt" that Russia is seeking to maximize its influence through economic means. However, he says that the presence of the German company will make it difficult for the Russians to abuse their position.

Yukos is also an interesting example as it shows the opposite case when a completely private company is subjected to such pressure by the Russian government that it turned Yukos from the wealthiest in Russia to the verge of bankruptcy in less than one year. Yukos was internationally recognized as one of the most efficient, market driven and transparent Russian companies. However, Mr. Khodorkovski did something wrong in the eyes of Kremlin and the state demonstrated that it intents to almost ruin the Russian most successful oil company for the sake of politics.

Lithuanians are monitoring the development quite closely. The situation of the Lithuanian oil refinery Mazeikiu Nafta would worsen only in case the stable supply of raw material from Russia was disturbed. It was believed that the fallen ratings of the Russian shareholder Yukos and ceaseless attacks of the Russian authorities against this oil giant could not influence the output of Mazeikiu Nafta and its financial operations. However the latest strategy applied by Russian authorities is exactly to cut short the oil supply to Yukos (*Reuters, 2004*).

Lukoil is perhaps the opposite story of Yukos. It is an oil company that is approved by Kremlin and its CEO Vagit Alekperov is in good standing with President Vladimir Putin. In July 2004 Russian president Vladimir Putin, ConocoPhilips CEO James Mulva and Lukoil president Vagit Alekperov discussed oil and gas projects during a meeting in the Krasnodar territory (*Interfax, 24.07.2004*).

Still only few years ago the Russian tax police have simultaneously opened criminal charges against Lukoil and its director, Vagit Alekperov for concealing revenues in “especially large amounts.” (*GPF, 2000*) In 1995 a big scandal involved Lukoil and its practice of mixing different gasoline types (*Rstaki, 1999*). The Yukos case shows that the Russian government could easily bring back these issues if needed. The question is how long could Lukoil stay as a favourite to the Russian government? Being dependent on the Russian government arbitrary visions, is it possible to claim that Lukoil will e in the long term a competitive, stable and predictable international player?

Corruption and bribing

Official corruption in Russia is endemic, a system-wide state of affairs with deep historical roots. A shocking number of both foreign and Russian private businesses regularly pay bribes to government officials. Most justify the practice on the basis that in a highly regulated market where officials of every level are poorly paid, bribery is a harmless means to facilitate government approvals and avoid penalties. In a system fuelled by bribery, the free market forces of competition, efficiency and quality are displaced. Economic decisions are taken by government officials on the basis of ulterior motives. For example, when a bribe helps secure a government contract, public funding is not being allocated for the best service at the lowest cost.

As artificially high project costs use up limited Russian budgetary resources, bribery diminishes the funds available for government spending on basic infrastructure. Bribery is also a brake on competition in Russia, which is desperately needed as a catalyst for economic growth. For example, bribes are sometimes paid in order to keep a competitor out of the market, by preventing it from receiving a license or winning a bid (*Murray, 1998*)

The Russian companies are also acknowledged to be among the most active bribers when doing business abroad (*Transparency International, 2002*) In May 2003, a leading Iraqi politician -- Iyad Allawi of the Iraqi National Accord (who has been appointed as interim Iraqi Prime Minister) -- accused former Russian Prime Minister Yevgeny Primakov of accepting money in return for defending Saddam (*Stanley, 2003*).

The ability to bribe and corrupt is to a large extent dependable on the legal and social framework of the country hosting Russian investments. In the 2003 corruption perception index Lithuania is ranked 41st while Russia shares 86th place together with (*TI, 2003*). That is why we may discover more corruption scandals involving Russian companies in, say, Lithuania than in Finland. A general assumption might be that wherever an opportunity to bribe arises, a Russian company would most probably not hesitate to use it. That is inbuilt feature of the Russian business culture that was always part of it – no matter if historically it was during tsars times, communism or transition, no matter if it was during the oppressive Ivan the Terrible or Stalin's regimes or in the more relaxed times of Catherine the Great or Brezhnev. The economic transition of the 1990s during which MDM Group, Yukos and Lukoil were created and Gazprom transformed also does not give reason to believe that Russian companies should not actively use bribing whenever the opportunity exists. Hypothetically bribing would be comparatively more available option when the company is fully owned by a Russian parent company as it is with Snoras bank, Lukoil Baltija or Lifosa.

The opportunities to do it in the case of Lietuvos Dujos are limited as the participation of the German partner (Germany is ranked 16th in the TI corruption perception index) Ruhr gas certainly provides with checks and balances.

Productivity and efficiency

Even Karl Marx understood that productivity is the crux of capitalism. It's hourly output per worker, and for years before and after the collapse of the Soviet Union, Russia's workers were at the bottom of the league tables. According to the completed by McKinsey Global Institute a yearlong study of the Russian economy in 1999 productivity in Russia was less than 20% of the U.S. level and stagnating (*Lewis, 1999*). However, the same survey concluded that approximately 75% of the Russian industrial capacity, if well managed and improved with modest investments, could rapidly reach 60% to 70% of U.S. productivity (*Lewis, 1999*).

The standard of living is determined by the productivity of a country's economy, which is measured by the value of goods and services produced per unit of national resources (human, capital and physical). Productivity then defines competitiveness (*Porter, 1998*). As recognised by the Moscow bureau of the International Labour Organisation a considerable part of the labour force is concentrated in unprofitable enterprises. Labour time is not efficiently used. Productivity is low and not monitored.

Another case study from 70 firms in 8 of Russia’s regions in the summer of 2000 collected interviews of general directors and other senior management and revealed that some job destruction has occurred, but many firms are still over-employed *(Broadman, Recanatini, 2001)*. "Labour productivity and efficiency levels have been Russia's biggest problems since the Soviet era," says Ruben Vardanyan, CEO of Troika Group, a Moscow financial services firm (*Belton, 2002*). Some experts go as far as to claim that in reality most Russian companies lost their competitiveness in the 1990s and by 2002 just under 15% of the remaining fixed capital in Russian industry is able to produce competitive goods (*Beloussov, 2002*).

Is there basis for concern in the case of Yukos, Lukoil, Gazprom and MDM Group? Of course, the conventional assumption here will be that the state owned companies would be less efficiently managed than the other privately owned companies. Indeed, the biggest productivity gains have been made at privatised companies. Not as burdened as some other Russian oil companies by excessive national pride – the belief that Western executives can't really teach the Russians anything – at the end of 1990s Mr. Khodorkovski settled into a stable working relationship with Schlumberger, the giant oil-services provider, and the two set out to improve the productivity of Yukos' vast number of wells in western Siberia (*Powell, 2002*). As a result Yukos has cut costs per barrel from $7 in 1998 to less than a third of that as productivity has doubled since 1998, thanks to a $1.3 billion investment in new fields and technology. In a comparison it costs state-run oil company Tatneft $4.5 to produce a barrel of oil, double what it costs Yukos (*Belton, 2002*). In respect of productivity and efficiency state-controlled enterprises such as Gazprom and RAO Unified Energy System /RAO UES/ have been slow to make changes.

Such statement could be confirmed by the latest study by a key minority shareholder in Gazprom, Hermitage Capital Management (*Belton, 2004*) According to the report Gazprom appears to have haemorrhaged more than $2 billion last year via a massive increase in miscellaneous expenses and staff costs, as well as from lost sales to key European export markets granted to a middleman with a murky background, according to a new study.

Gazprom CEO Alexei Miller has pledged to put an end to the egregious mismanagement at the company under his predecessor, Rem Vyakhirev, when up to $3 billion per year was squirreled away into crony companies, investors alleged. But despite successes in returning some lost assets and in keeping down costs, Miller oversaw a "significant deterioration" last year, Hermitage says. "The situation looked like it was getting better in the early post-Vyakhirev years," said William Browder, CEO of Hermitage Capital Management, which manages some $1.5 billion in assets on the Russian stock market. "Now, however, it seems to be quickly deteriorating."

Other analysts said that overall, Gazprom's corporate governance performance has much improved and in general Gazprom appears to be operating more honestly than it ever was. Still a comparison of the 2002-2003 productivity levels between the 10 most productive industries in Russia (output volume measured in rubbles per employee) and Finnish companies (turnover per employee) from the same industrial field reveals that at the average Russian companies are 20,2 times less productive (*Zashev, 2004*) In Russia it is the Oil & Gas industry considered to be the productivity champion. The Russian productivity (turnover per employee) in Oil & Gas is 22 times lower than the joint average for Fortum, Finland and TotalFina, France (*Ibid.*).

In the case of MDM Group with Lifosa and Snoras again the factor that the Russian parent company is private could be seen as overwhelming. The results of both Lifosa and Snoras after they became part of the MDM Group demonstrate that the companies are efficiently managed. Still, their major restructuring was done before the purchases. Lifosa has reorganized and became leaner, signed a distributorship contract with the world leader Cargill before the deal with Eurokhim. Eurokhim was needed mainly in the quality of main raw material supplier and that is seen by the 5 members of the board of directors – Eurokhim president Nikolai Levackii and executive director Alexei Kabin representing the owners, the Lifosa minority shareholder Danas Tvarijonavichus and Lifosa general director Jonas Dastikas as the operational management and the Cargill representative Arian Van den Blink as the company’s main distributor. Amo9ng other things the board decided that the audit of the company would be done by Price Waterhouse (*Finmarket, 2002*).

The business and managerial success of Lifosa and Mazeikiu Nafta helped to ease the suspicion of the Lithuanian political establishment towards the nature and the true intentions behind the Russian investments in Lithuania. The suspicion though is still there. It took Gazprom more than one and a half years to negotiate the Lietuvos Dujos stake purchase. There are voices among the conservatives for the government to buy out the Mazeikiu Nafta from Yukos. They also suggest establishing a list of strategic assets that will be of limits for capital from Russia. Others insist to use a more liberal approach described as the "capital balance" such as in the case of Lietuvos Dujos (*Skripov, 2004*).

Conclusions

The Russian investments in Lithuania are playing increasingly important role in the economic life of the country. For quite some time the Lithuanian politicians tried to prevent Russian companies from actively investing and operating in the country. The political and economic pressure that Russia inserted on Lithuania in the first half of the 1990s is a lesson that Lithuania will not easily forget and one that taught the Lithuanian decisions makers that it is important to be not only politically but also economically independent from the colossus neighbour.

However, the closer Lithuania became to NATO and EU memberships the easier it became for Russian investors to establish themselves in the country. Several factors contributed for it: the growing security confidence stemming from the membership in both organisations, the mutual interest of buyer and supplier of raw materials to find a mutual business partnership and lastly the understanding that for an investment to work it is not enough to have it coming from the West.

As of the beginning of 2004, the volume of Russian investments in Lithuania puts Russia in only 7th place. Still, it is the qualitative dimension of Russian investments that impresses. Russian companies control the 4th biggest Lithuanian bank, approximately 25% of the retail fuel market, the Kaunas power plant, and stakes in the biggest gas distribution company. Russian company owns Mazeikiu Nafta. According to some experts as of 2001 some 30% of Lithuania's GDP were associated with the refinery (*Roe et al., 2001*). The importance of Mazeikiu Nafta in the Lithuanian economy is further underlined by the fact that in the year 2000 the company contributed almost a quarter of the country's gross tax revenues (*IBN, 2001*). The 5th biggest (in terms of sales volume) industrial producer is also owned by a Russian investor. That is if not taking into account the 839 joint Lithuania-Russian enterprises and 234 enterprises of Russian capital (*Miskinis, 2002*).

Therefore the importance of what corporate culture and business ethics Russian companies spread when they internationalise for Lithuania could be more than an academic elaboration.

A brief review of the main factors that assemble the contemporary Russian business culture provides with enough information to consider as the main concerns of Russian corporate culture abroad the unbroken dependence of Russian companies from the state, the attitude towards corruption and bribes and finally the productivity and efficiency issues. These concerns do not cover the entire spectrum of problem areas but could be considered as top priorities from country recipient of Russian investments point of view. The preliminary evidence based on the operations of three investors and four investments reviewed provides with an opportunity to draw several preliminary conclusions.

The unbroken link and dependence on the state is perhaps the most worrying particularity of Russian investors as their decision-making could be easily influenced / distorted by political considerations of the Russian state machine as opposed to economics-based decisions. While Gazprom is state owned, Yukos recent destiny shows that private companies in Russia are not secured even if efficient and transparent (as for the Russian conditions). Along the same lines Lukoil and MDM Group are in good standing with Kremlin but it is not possible to predict for how long.

In terms of attitude towards corruption and bribery it is not possible to collect credible evidence and provide clear-cut examples of such. Still, the Russian business environment for the last several hundred years and the fuzzy ways companies such as Yukos, Lukoil and MDM group were built in the 1990s suggests strongly that whenever opportunity exists to use bribery as a business tool, a Russian company will not hesitate to use it.

Finally the efficiency and productivity issues are less an area of concern, as it could be expected when observing the general situation in Russia in this respect. There is a clear distinction between the state owned Gazprom and the privately owned Yukos, Lukoil and MDM Group. In addition it also depends on specifics such as if the purchased company was restructured before the purchase etc.

The more important findings of this report are summarized Table 3.

Table 3

Assumption	Concern	Finding
Russian investments start playing serious role in the Lithuanian economy	Still fresh from their Soviet experience, Lithuanian politicians fear that Russia is gaining economic power in Lithuania and the related to it greater opportunities of political influence.	Even though Russia officially qualifies as only 7th biggest investor in Lithuania, its investments are in key areas and indeed provide with great economic power.
Russian corporations form their business culture in Russia. To some extent they will utilize their business culture during their international expansion.	There are three main concerns highlighted from point of view of the country recipient of Russian investments.	These are: - unbroken link of Russian companies with the state - attitude towards corruption and bribing - efficiency and productivity
- unbroken link of Russian companies with the state	No matter private or state owned Russian corporations depend on the state and thus could be used as leverages in the Russian foreign policy.	There is enough evidence to argue that this should be the biggest concern. Gazprom is directly controlled by the state. Yukos is privately owned but that did not help to be almost ruined by the state. Lukoil and MDM Group are privately owned and favoured by the state. But for how long? The dominance of Russian state over Russian companies (big and small, state owned or private) suggests that Russian companies could be used by the state as leverages of foreign policies.
- attitude towards corruption and bribing	Russian corporations were created in an environment where corruption and bribing were and to large extent still are within the rules of the game. Are Russian companies using	There is no evidence to claim that the Russian investors observed in the paper used bribing in their operations in Lithuania. Still, as Russian companies use bribing on a daily basis in Russia, it is very likely that they will use any existing opportunity provided the country hosting Russian investments lacks the instruments to fight corruption.

	bribing in their foreign operations?	
- efficiency and productivity	If companies in Russia are plagued by inefficiency, poor management and low productivity, is there a danger that these could be brought to the Russian owned companies abroad.	There is no enough evidence to claim that Russian investments are bringing efficiency and productivity down. In fact, the observed cases in Lithuania demonstrate growth in earning and profitability after the Russian investors is present. Still this issue needs a more thorough elaboration as efficiency and productivity are result of more complex factors than simply ownership.

Still the main findings of this paper are based on mainly secondary sources of information and thus should be subject of critical scrutiny. A further study based on primary sources such as interviews and questionnaires will definitely help better understand the corporate culture Russian companies export together with their foreign investments.

However, even at this stage it is possible to provide some policy recommendations to decision makers. Combining Russian capital with the investment of established Western investors seem to be a better formula. It could guarantee transparent and efficient management, lessen the danger of using corruptive practices and block the danger of having politically based business decisions.

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REGIONAL DIMENSION OF ECONOMIC COOPERATION BETWEEN JAPAN AND RUSSIA[1]

Andrey Belov

Summary

The past decade has brought remarkable changes to the economic cooperation of North-West Japan (Hokkaido and Japan Sea coastal prefectures) and the Russian Far East, such as fast growth of intra-regional trade, great structural changes, a huge increase in the number of cooperating companies and thousands of Russians coming to Japanese ports, which until recently were closed to them. Similar trends were observed in Asian, European and American regions involved in trade with Russia. In Japan, the initial "Siberian euphoria" has gradually been replaced by a much more realistic approach. The reason is that liberalization of trade, globalization and regional development created a number of problems: the prevalence of geopolitical over economic considerations in energy projects, the growth of the shadow sector in certain arrears of mutual trade, the very uneven distribution of benefits and losses from cross-border cooperation and the deep differences of public opinion in Japan and Russia. This paper argues that in terms of public finance theory, these problems can be considered as examples of a failure of market mechanisms, shadow economy, negative externalities and asymmetric information, which can only be solved by effective public policy and state intervention.

Keywords: Japan, Russia, foreign trade, Russian Far East, regional development

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Introduction

In the period 2003-2004, regional policy appeared at the top of the Russian government's priority list. The reason is that in recent years, an uneven distribution of economic benefits and losses turned some Russian cities and oil-pumping provinces into Western-style high-income societies. At the same time, the impoverished North-Caucasus Region became a breeding ground of separatism and terrorism. The second "Region at Risk" is the Russian Far East. Rich in resources and connected by railway to Europe, it was dedicated to being an important international land bridge, energy provider and a Russian gateway to booming Asia and the Pacific basin. The sobering reality is that since the beginning of the 1990s, the region has lost at least one seventh of its population, one quarter of its gross regional product and half of its manufacturing industries. On the positive side of Russian Far East regional development, we may mention arms reduction, encouraging trends in foreign policy and an expansion of economic cooperation with Northeast Asia. Starting from the year 2000, the main ingredients of the social and economic dynamics of the Russian Far East are limited economic recovery, resumption of infrastructure development by the Federal Government and the inflow of FDI in energy related projects.

Since 1992, foreign trade achieved a new significance for the Russian Far East. The regional economy reoriented itself from the Russian domestic market to the countries of Northeast Asia; Japan, China, the Republic of Korea and the USA became its leading trade and investment partners. Inter-government trade agreements of the Soviet period were replaced by a network of connections between market-driven private companies. The structure and nature of exports and imports had changed dramatically; cross-border trade between neighboring regions increased by about 50 %.

Japan plays a special role in economic cooperation with the Russian Far East, providing the greatest market for natural resources as well as machinery, technology and development capital. As a result, both positive and negatives effects of the expanded regional economic exchanges can be found in the Japan-Russia case in a highly concentrated form. This article is focused on these problems, which have been brought about by the liberalization of trade between the Russian Far East and the North-Western prefectures of Japan. The study starts with some methodological notes and background information on Japanese and Russian economic relationships, and then turns to the recent developments in energy, used cars and fishery trade. Finally, it argues that the current situation may require a corresponding public policy and proper government intervention.

Methodological notes

Several scholars contributed to the analysis of government intervention, in connection with foreign trade and regional development of the Russian Far East. Mikheeva & Minakir (1998) argued that only such “outside” factors as export revenues, foreign investments or federal budget support can become a driving force for a sustainable economic growth in the region. Gaddy & Hill (2003) illustrated a necessity of both domestic and foreign economic policy to overcome huge structural distortions in the Siberia and the Far East caused by the Soviet system. Belov (2003) found that in the 1990’s, the Far East had developed considerably weaker institutional mechanisms compared to other territories of Russia. Therefore, benefits from the expansion of international exchanges, the inflow of foreign workers and cross-border trade have concentrated for the most part in the shadow sector of the economy. The institutional weakness resulted in the distorted directions of domestic and international policy. Each of these authors points up the necessity of proper government policy based on an original set of arguments, such as an input-output model, structural approach and institutional analysis.

This study aims at the analysis of Japan-Russia trade and its influence on regional development from one more different angle, i.e. in terms of public finance theory. The goal is to show that in some areas of mutual economic exchange we have strong evidence of a market failure, shadow economy, negative externalities and asymmetric information. It may more convincingly justify state intervention, identify directions of an effective public policy and confirm a need for closer international cooperation.

The research is based on interviews and data mining conducted in Japan and Russia since 1994. The last 7 interviews with businessmen, local officials and media representatives were carried out in Toyama and Hokkaido (Japan) in the period July-August 2004. Besides this, the author examined the central and local government sources of both countries as well as academic publications focusing on Russian regional issues. For the most part, Japanese statistics and definitions for exports and imports are used in the paper, if not indicated otherwise (Japanese data provides a more sustainable and more accurate outlook of bilateral trade).

Background of the Japan-Russia trade

Three stages of trade development

At least three major stages could be distinguished in the development of Japanese-Russian relations during the past 50 years. The first stage started at the end of the 1960’s, when Japan became an active player in the exploration and usage of natural resources as well as in the construction of the Russian Far East and Siberian infrastructure. Japanese and Soviet governments had signed a few so-called “compensation deals” or joint development projects, connected with forestry (the first agreement signed in 1968), the paper-pulp industry (1971), the development of coal and natural gas fields in Southern Yakutiya (1974), the exploration and development of oil and gas fields on the Sakhalin shelf (1975). As a result, in the period of 1960-1970, Japan was a leading foreign trade partner of the USSR but lost its position to West Germany in early 1970th.

The second stage of Japanese-Soviet relations began in 1986-1988, when M. Gorbachev put forward some new ideas about USSR cooperation with Asian-Pacific region countries. Since 1987 the Law on Joint Ventures (JV) went into effect and the third JV registered in the USSR was created with the capital of the Japanese firm (JV “Igirma-Tairiku”, lumber production). 1988 was the starting year for fast development of cross-border or frontier trade, which soon became an important stimulus of Japanese-Soviet economic relations. By the end of the 1980s, the trade was driven by two mechanism systems: “plan-orientated” (inter-state agreements) and “market-orientated” (JVs and frontier trade). In 1989, mutual trade turnover exceeded US$ 6 billion for the first time in the history of Japanese-Russian relations.

Since 1992, Japanese-Russian trade has reached a third stage. Export and import became extremely unstable but trade relations achieved a new significance for both countries. That is why the present state of Japanese-Russian trade needs special attention.

The “Post-Soviet model” of trade

The brake-down of the Soviet Union, the decay of former international trade connections, the fast liberalization of trade and hard currency operations, as well as long-term economic crises in both countries had a rather negative influence on the state of Japanese Russian trade. Nevertheless, an absolutely new “post-soviet model” spread its roots in the area of bilateral trade. Let us describe its main features.

Firstly, inter-government trade agreements were replaced by a network of connections between market-driven private companies. Japanese and Russian domestic market situations, the dynamics of world prices and currency rates, along with Chinese, Korean and American competition, became an important factor for trade development. Japanese investments in the Russian economy are not especially big and up to now do not show a substantial stabilizing influence on trade relations. All this could explain why Japanese-Russian trade is so unstable and why during the last 12 years the turnover was back to the level of the 1970s twice (in 1992 and 1998) and also twice nearly reached its 1989 maximum (in 1995 and 2003).

Table 1: Trade of Japan and USSR/Russia, in billions of US$

Year	Export	Import	Total Sum	Balance
1989	3,081	3,004	6,085	77
1990	2,562	3,350	5,912	-788
1991	2,113	3,316	5,429	-1,203
1992	1,076	2,402	3,478	-1,326
1993	1,500	2,769	4,269	-1,269
1994	1,167	3,490	4,657	-2,323
1995	1,170	4,763	5,933	-3,593
1996	1,026	3,953	4,979	-2,927
1997	1,014	4,018	5,032	-3,004
1998	969	2,892	3,861	-1,923
1999	480	3,756	4,236	-3,276
2000	571	4,592	5,163	-4,021
2001	720	3,870	4,590	-3,150
2002	942	3,277	4,219	-2,335
2003	1,764	4,218	5,982	-2,454

Source: Institute for Russian & East European Studies (Japan), 2004.

Secondly, the structure and nature of exports and imports had changed dramatically. Up to the early 1990s, Japan was supplying investment goods to the Soviet economy and had a positive balance of bilateral trade. At the beginning of the 1990s, investment demand in Russia rapidly decreased and Japanese exports became more consumer-orientated. Liberalization of the Japanese domestic market increased demand for Russian non-ferrous metals, fish and sea products, lumber and coal which were difficult to sell in Russia. As a result, Japanese exports shrunk while imports expanded. The negative trade balance, most unusual for Japan, reached its peak level of US$ 4,021 billion in the year 2000.

In 2003, imports from Russia to Japan were based on non-ferrous metals (33.7%), fish and sea products (24.8%), unprocessed wood and lumber (13.7%), oil (8.7%) and coal (7.2%). More than a half of the exports to Russia consisted of transport vehicles including second-hand ones (53.1% and 12.7% accordingly) followed by a big gap to industrial equipment (16.7%) and electronic goods (12.6%) (Institute for Russian & East European Studies, Japan, 2004).

Thirdly, due to trade structure and mechanism changes, a lot of activities are not reflected in the official customs statistics. For example, Japanese fish and marine products import data substantially exceeded Russian export figures because for a long period of time fish caught outside the Russian 12 mile zone was not subject to customs control. Consumer electric goods are sold to Russia via customs warehouses in Singapore, the United Arab Emirates and other countries for the minimization of import tax payments. These products are not reflected in bilateral statistics. Used cars, which are brought to Russia by tourists and sailors as their private luggage, are also not included in official reports. Finally, Japanese companies produce a substantial group of commodities available in Russia (cars, domestic electronics, etc) outside of the country. It indicates that the presence of Japanese companies and goods on the Russian market could be more profound than is shown by official statistical figures.

Fourthly, serious changes in bilateral trade did not yet sufficiently increase the share of Japan or Russia in the total trade turnover of each others countries.

Table 2: The Share of Russia (Japan) in Japan's (Russia's) Trade Turnover

Share of Russia in Japan's Trade	Total Sum	Export	Import
1992	0.61%	0.32%	1.03%
2003	0.70%	0.38%	1.11%
Share of Japan in Russia's Trade			
1992	3.51%	3.17%	3.93%
2003	2.25%	1.82%	3.24%

Source: Institute for Russian & East European Studies (Japan), 2004.

In the period January-December 2003, Russia occupied 23rd position in the Japanese trade partners' list, while Japan was in 13th place for Russia. Such numbers, as well as the Table 2 data, do not sound very optimistic if considered separately to the general background of bilateral relationships. We have to take into account that in recent years, the major factor of international economic dynamics in Northeast Asia was a redirection of investment and trade flows towards China. Since 1992, Japan-China trade has increased by 4.5 times and Russia-China trade increased by 2.5 times. Apparently, Japanese-Russian relations will become more important only after the stabilization of both countries' trade with the rising Asian giant. Besides, the previous decade was the worst in post-World War II economic history both for Japan and Russia. The final breakthrough in the economic development of their neighbouring regions occurred only in 2003. At the moment, the regional economies of both countries are rapidly improving and a certain number of large-scale energy and infrastructure related projects are developing in the Russian Far East, creating new possibilities for export and import. And finally, for many Japanese prefectures and areas in the Russian Far East, mutual relations are far more important than bilateral relations between the countries.

The fifth and last peculiarity of the "post-soviet model" is connected to an increase in neighbouring regions trade during the last 11 years, i.e. trade between the Russian Far East and northern prefectures of Japan. At the beginning of the 1990s, about 20% of trade flow was located at ports in Hokkaido and the Japan Sea coast (Hakodate, Niigata, Toyama, Tsuruga, Kita-Kyushu, etc.) By the end of the 1990s, the share of those ports increased to about 40% while the weight of the Pacific coast (Tokyo, Yokohama, Nagoya, Osaka, Kobe etc.) came down to 60%. It was as a result of deep changes both in the nature of trade and in regional politics of the two countries. Japan, for example, adopted the concept of revitalization of depressed regions (northern and Sea of Japan coastal prefectures) through international frontier exchanges. The central government and local administrations took a number of measures that yielded the above-mentioned results.

"Macro business" and "micro business" in Japan-Russia trade

The analysis of bilateral trade shows that there are two major layers of groups of Japanese companies dealing with Russia. The first group, which may be called a "macro-business" layer, includes gigantic worldwide famous firms such as Toyota, Japan Tobacco, Sumitomo, Hitachi, NEC etc. For example, net revenues of Toyota in the 2003-2004 financial year reached 17.3 trillion Japanese yen (US$ 149 billion), which exceeds the GDP of Greece, Finland and Portugal. Naturally, the attention of such a company could bring Russia serious economic benefits. Incidentally, in 2003 Toyota (including "Lexus") was the most popular brand on Russia's new foreign car market. 26,476 new Toyotas were sold in Russia (Sakaguchi, 2004), but this is only 0.5% of Toyota's overseas sales. It is easy to understand, for Toyota and other members of the "macro-business" group, except of a very few energy-related companies, the Russia-orientated business is not so important yet.

The major number of "macro-companies" is located either in Tokyo or in the megalopolises of Japan's Pacific coastline. Such companies can lobby certain political decisions; they have acquired enormous economic potential and are highly competitive on the domestic and international markets. For those giants, Russia is a small partner, the attraction of which is not in the present but in the future, in its geographical location and influence on some neighbouring countries.

The other group, which we call the "micro-business" layer, consists of thousands of small Japanese firms. It is virtually impossible to calculate their exact number. Those firms not only buy Russian lumber and marine products, offer maintenance and services for the Russian ships and crewmembers at Japanese ports, they also sell second-hand cars and consumer goods to the Russian sailors and tourists as well as looking for other opportunities in the Russian Far East. "Micro-business" in bilateral relations appeared at the beginning of the 1990s, during the period of economic liberalization in Japan and Russia. As a rule, "micro-companies" are located close to Russia in northern regions and the Sea of Japan coastal prefectures, i.e. the less developed areas of Japan. They have all the traditional pluses and minuses of the small enterprise in a market economy. As a positive feature, we can mention low entrance costs and fast reaction to the changing market situation. We can also point out scarce economic resources, the development of a shadow economy and lack of skills under the conditions of a "High Risk-High Return" situation as negative characteristics of small Japanese firms.

At first sight, "macro" and "micro" businesses hardly seem to share similar characteristics. Nevertheless, the activities of both groups of companies may cause problems which would be difficult to solve on the market level and which may need state intervention. For research in this area, public finance theory provides a helpful theoretical framework. "Macro" businesses could easily become a monopolistic player in Russia's emerging market. As a consequence, the related problems might be connected with a failure of market mechanisms. "Micro" businesses tend to have close ties with the shadow economy. Both types of businesses may be the course of positive and negative externalities and asymmetric information. The following study is focused on the reasons for government interference and is concentrated on three items, such as oil (the fastest growing and most promising segment of Japan's imports from Russia), automobiles (the item with the largest share in Japan's exports) and marine products (the area with the largest shadow sector). The closing section deals with the existing differences in each partner's perception between Russians and Japanese.

Energy-related "macro-business": a market failure

The major area of interests of Japanese "macro-business" is related to the imports of gas and oil from Russia. From the beginning of the 1970s, Japan was struggling in order to decrease its dependence on Middle East oil and secure oil shipment routes, as well as reduce an oil share in its energy balance. Russia could play an important role in solving those problems. At the moment, the Sakhalin shelf exploration and oil pipeline construction from Eastern Siberia to the port of Nakhodka (the Russian Far East Pacific coastline) are attracting a lot of attention. In 2003, Japanese companies signed an agreement to purchase 3.4 million tons of liquid natural gas from Sakhalin (the Sakhalin II project, shipments will start in 2007). The Nakhodka pipeline construction should be finished by 2008; its capacity will reach 60 million tons per year. When the two above mentioned projects kick off, the present Japan-Russia turnover will multiply by three to the year 2010 and investments from Japan will increase by 10 times (Mochizuki, 2004).

The import of energy resources from Russia has good prospects, although its influence on the development of Japanese-Russian relations could be multidimensional. First of all, we should take into account the importance of the political and strategic factors for the present energy source cooperation. Japan and China's fierce competition for the access to the Eastern Siberia oilfields gives the best example. The collision of interests is so deep that "If Japan does win Russia's oil, relations between Tokyo and Beijing may sink to their lowest, potentially most dangerous levels since World War II" (Roberts, 2004). Both of the countries offered their own transportation routes and financing options. The Chinese one went through a feasibility study in 2002; in May 2003, it received an approval by the Presidents of China and Russia and reached a general agreement stage between the Russian Company Yukos and the China National Petroleum Company (CNPC). Nevertheless, it appears that Russia was afraid of China as a monopoly buyer, was not sure of the offered price formula, and was pressurized by the big Far Eastern regions which were bypassed by the projected "Chinese" route (Amur, Khabarovsk and Primorski regions). Probably, we can say that in this case of natural resources development the market failed to create a benefits-losses compensation mechanism.

In 2003, Prime Minister Koizumi put forward an offer, which Russia practically could not reject. He suggested to the Russian President an alternative pipeline variant on the basis of US$ 5.2 billion of construction investments as well as offering a further US$ 7.5 billion package of low interest loans and state guarantees for private company investments. According to Russian and Japanese mass media, in December 30 of the 2004, the Russian government made the decision to construct the pipeline from eastern Siberia to the Pacific coast. The pipeline, scheduled for completion by 2010, is expected to cost US$ 10.75 billion to build. As far as the feasibility research is not finished, the final calculations have yet to be made. The estimated costs of oil transportation to Japan from Siberia could be three times higher, compared to that of from the Persian Gulf. In such a case, the Japanese Government needs to come up with huge tax incentives to pursue companies to buy expensive Russian fuel on a liberalized national petroleum market.

The pipeline direction choice was an extremely difficult problem for Russia, which is looking for its own position in the Asian-Pacific region. The benefits of economic cooperation with China are too close to the fear of possible Chinese domination on the vast Siberian terrain. Japan and the USA are sharing the same reservations and are ready to use their potential to keep the present balance of power. The problems of the balance of political and economic factors for the project are not solved yet. Approximately the same situation exists in the Caspian basin and some other Russian oil provinces (Satpaev, 2003). It is obvious though that the market is not able to write a safe map for such a dangerous road, therefore we may need an effective state intervention.

Crabs and used cars “micro-business”: negative externalities and shadow economy

Let us analyse certain characteristics of the imports of fish and marine products from Russia and the exports of used cars to Russia as an example of “micro-business”. Such trade plays an important role in bilateral economic relations and gives us a good example of problems generated on a regional level. In 2003, 24.8% of Japanese imports from Russia consisted of fish, crustaceans and other marine products, about 40% of which were imported via ports in Hokkaido, the most northern prefecture of Japan. Used cars and spare parts exports amounted to 12.7% and approximately 40 % were shipped to Russia via Toyama prefecture (Sea of Japan coast). Namely, Hokkaido and Toyama will become objects of our further research. The role and status of those regions in the national economy are shown in the following table.

Table 3: Hokkaido and Toyama Prefectures in the Economy of Japan

	Japan	Hokkaido	Toyama
Surface area (thousand sq. km, 2002)	377,887 (100%)	83,454 (22.0%)	2,808 (0.7%)
Population (thousand, 2002)	125,570 (100%)	5,692 (4.5%)	1,123 (0.8%)
Gross Regional Product, GRP (bln JP￥, 2000), including:	509,702 (100%)	20,713 (4.0%)	4,526 (0.8%)
Primary industries (%)	1.2%	3.2%	1.2%
Secondary industries (%)	29.0%	22.3%	36.9%
Tertiary industries (%)	74.1%	76.7%	64.2%
Net taxes (%)	-4.4%	-2.3%	-2.4%
GRP per capita (thousand JP￥, 2000)	3,101	2,856	2,931
Trade turnover (bln JP￥, 2002)	94,337 (100%)	916.1 (0.9%)	233.5 (0.2%)
Export (bln JP￥, 2002)	52,109 (100%)	231.8 (0.4%)	84.4 (0.1%)
Import (bln JP￥, 2002)	42,228 (100%)	684.3 (1.6)	149.0 (0.3%)

Source: Statistics Bureau of Japan, 2004

Imports of fish and marine products to Hokkaido

Hokkaido is the biggest northern prefecture of Japan, with the lowest population density. In comparison with the all Japan average, the ratio of agriculture, forestry, fishery and tourism in Hokkaido's GRP is relatively high, although the processing industry is somewhat lagging behind the national level (Table 3). At the beginning of 1990's Hokkaido's economy felt into a prolonged depression. Liberalization of foreign trade, which started in the middle of 1990's, was considered as a powerful anti-depression weapon. The short distance to Russia was one of the reasons for the rapid development of frontier trade in the 1990s (Table 4). The share of Hokkaido in the total Japan-Russia trade turnover increased from 5.8% in the year 1991 to 15.2% in 2002 (Hokkaido Government, 2003).

Table 4: Trade of Hokkaido and USSR/Russia

Year	Export to Russia (bln JP￥)	Import from Russia (bln JP￥)	Total Sum of Trade with Russia (bln JP￥)	Share of Russia in Hokkaido's Trade (%)	Russian Ships to Hokkaido (Number)
1989	3.2	35.5	38.7	6.5%	488
1990	4.1	45.5	49.6	7.4%	778
1991	5.7	37.5	43.2	6.6%	1,298
1992	7.1	48.5	55.6	8.6%	2,760
1993	5.0	47.3	52.3	8.8%	3,302
1994	3.4	57.4	60.8	9.5%	4,605
1995	4.0	59.8	63.8	9.4%	6,068
1996	5.8	77.0	82.8	9.8%	7,723
1997	5.2	82.4	87.6	9.9%	9,576
1998	6.3	70.3	76.6	10.3%	9,459
1999	6.2	82.4	88.6	11.8%	9,192
2000	6.0	85.3	91.3	10.5%	9,503
2001	6.1	89.3	95.4	10.1%	8,719
2002	5.9	74.4	80.3	8.7%	5,438
2003	10.1	81.0	91.1	9.9%	5,450

Source: Hokkaido Government, 2003.

The largest oil and gas projects for Russia involving foreign capital are developing at a very near distance from Hokkaido on the northern shelf of Sakhalin. In 2003, the development speed rapidly increased, which gave small Hokkaido companies some new export opportunities. So it is possible to say that Hokkaido offers a positive example of "macro" and "micro-business" cooperation.

Nevertheless, the biggest percentage of Hokkaido's imports from Russia is based on fish and crustaceans. Such imports amounted to 70-80% of the total, and about 50% of it was crab. A real "crab rush", which spread around Hokkaido, seriously influenced economic relations with Russia. Japanese consumers enjoyed price dumping caused by increased crab shipments. More trading companies were organized; new options for the export of Hokkaido fishing equipment and packaging materials were created; more people took part in the maintenance and service of Russian ships. In the peak period of 1996-2000, 7-9,000 Russian crab-carrying ships visited 11 Hokkaido ports (Table 4) and 140-170,000 crewmembers went ashore each year (Hokkaido Government, 2003). As a negative result of the crab rush on the Japanese side, we may mention the increase of illegal imports, the instability in the Hokkaido fish market, as well as social problems at small ports caused by the overflow of Russian sailors.

Japanese crab importers were gaining considerable profits, while the inhabitants of small port towns suffered a serious social burden, which was transferred to them on a personal level. If we consider this case in the framework of public finance theory, it looks like an example of negative externality with a need for state intervention. The first administrative reaction was not effective enough, so local communities started independent actions. For example, “Japanese Only” signs appeared on the doors of 3 saunas in Otaru and on about 90 shops and restaurants in Mombetsu town. The two saunas cancelled their restrictions under the influence of local administration and public organizations later, but the situation in Mombetsu is improving very slowly (Doshin Information Institute, 2001). Small port towns have a lot of unsolved problems, particularly crime growth, although Hokkaido government and the regional mass media are paying serious attention to it.

And what was going on behind the border – in the Russian Far East? At the beginning of the 1990s during an acute investment crisis, several billion dollars of Russian and foreign investments were poured into the fishing industry. As a result, enormous modern fleets of state-of-the-art trawlers; crab-catchers and processors newly built in Norway, Spain and Germany or re-equipped in China, Korea and the USA, have appeared in the Okhotsk Sea waters. Russian Far East companies invaded a large segment of the European market of Alaska Pollack fillet and the crab markets of Japan and North America. However, fishing fleet harvesting capacity very soon exceeded natural stocks. Over fishing resulted in the depletion of resources and the decline of the overall catch. Investors started to flee. In less than 10 years, the Far Eastern fishing industry went through a full cycle from complete renovation, revival and boom to a new crisis.

The reason is connected to the breakdown of the Soviet fishing rights system, a long-term inability of the Russian government to effectively manage marine resources, as well as a lack of international cooperation in the fishing industry (Allison, 2003). Domestic conditions for legal and easily controlled business were extremely unfavourable. As a result, onshore fish processing rapidly dropped (canned fish production in the period 1990-1999 decreased 12.5 times). The Far Eastern companies have moved for maintenance and service to foreign ports in Korea, China, Japan, USA and Canada with the biggest base established in the South Korean port of Busan. In addition, poaching and smuggling rapidly developed at sea, i.e. where law could not reach these infringements. Since the beginning of the 1990s, the large part of Far Eastern marine product trade was carried out illegally and was not reflected in Russian industrial and customs statistics (Belov, 1997). According to Russian data in the period 1994-2002, the total export of crab and shrimps from Russia to Japan was about 44 thousand tons for a total sum of US$ 387 million. At the same time according to Japanese customs statistics, imports from Russia to Japan amounted to 643.7 thousand tons for a total sum of US$ 52.5 billion (Arai, 2003). The reason for such a gap could be explained by the imperfect rules of Russian statistics, by the lack of enforcement and by the weak control on fishing companies’ activities. The Russian Ministry of Economic Development once claimed that 75% of fish exports to Japan were illegal and estimated a yearly profit of such trade at 150 billion Japanese yen (US$ 1.25 billion at 120 JY for 1 US$). In addition to Japan, Russian Far East marine resources were exported to more than 40 countries all over the world.

The first real steps to improve the situation began only in the period 2001-2002. The Russian government subjected all export fish shipments to customs control, regardless of the area of harvesting. The Japanese side tried to enforce the rule of law more aggressively and started to demand customs declarations from captains of entering Russian ships. Illegal fishing and exports declined for the first time in 10 years. Accordingly, Hokkaido imports from Russia went down and less Russian ships made port calls. But the image of economic relations with Russia in fishery as well as natural stocks of marine resources already was considerably if not irreversibly damaged.

Poaching, smuggling and the transfer of a fishing boat service bases from Russia to foreign ports are not unique characteristics of the Russian Far East. A very similar situation, but in a smaller scale, exists between Russia and Norway and the Republic of Korea. In the period 2000-2003, Russian specialists several times mentioned discrepancies in customs' statistics, illegal fishing and benefits for some local Norwegian and Korean ports from inflow of Russian ships in fishery industry newspaper "Rybatskie Vedomosti" and magazine "Rybnoe Khozyaistvo". Probably, the above mentioned problems are universal for each fish catching and trading regions under the conditions of weak institutions and slow government response.

Exports of used cars from Toyama

Toyama Prefecture is much smaller than Hokkaido in area and population. Nevertheless, the prefecture has relatively developed processing industries and a slightly higher GRP per capita. For several years, Fushiki (Toyama's largest and most modern port) has held first place in Japan on the number of visiting Russian ships. In 2003, the share of Toyama in Japan-Russia trade turnover came to 0.6% (0.5% exports and 0.6% imports). During the 12-year period of post-Soviet trade, the main imported commodities were unprocessed wood and aluminium. As for exports, industrial equipment and plastic materials were replaced with second-hand cars and domestic electrical goods (Toyama Prefecture, 2003).

In 2003, transportation equipment became a major Japan to Russia export item (53.1%) with 106,831 cars, buses and trucks (including 68,123 used vehicles) supplied (Institute for Russian & East European Studies, 2004). As for used cars, the Japanese export total in that year amounted to 712,068 units, which means that Russia's share reached 9.5%. Russian tourists and crewmembers carried an additional 150,000 vehicles as private luggage (Otake, 2004). Therefore, the total number of used cars taken to Russia exceeded 218,000 vehicles. 87,000 of them (about 40%) were exported from the port of Fushiki in Toyama prefecture (Nomura, 2004b). The main reason is a convenient ferry connection between Toyama and several ports on the Russian Pacific side.

Table5: Used Cars Carried to Russia from Toyama as Private Luggage

Year	1991	1995	1996	1997	1998	1999	2000	2001	2002	2003
Thousand cars	5.7	20.1	33.6	46.4	41.3	21.5	34.2	62.8	65.7	57.9

Source: Nomura, 2004b.

The export of second-hand cars in Japan is a rather specific business. Perhaps its main peculiarity consists of low entrance costs. The main market player, The Japan Used Car Dealers Association (JU), was organized in 1992. The largest share of transactions is conducted through 140 auctions, which are in operation 6 days a week, except Sundays. 70 % of the trade is available through designated computer terminals. Company registration in Japan, acquisition of JU membership and access to trading are not particularly difficult or expensive for foreign businessmen. Unsurprisingly, citizens of South-East Asia, China, Australia, New Zealand, Russia and other countries registered 300 firms out of the 1,000 regular dealers at the biggest Tokyo used car auction (Otake, 2004).

Amongst the 800 companies exporting second-hand cars from Japan, 350 firms are established by Pakistan citizens, 100 by Bangladeshis and 100 by citizens of Sri Lanka. These numbers reflect not only the geography of Japanese used car shipments but also show the high competitiveness of South-East Asia businessmen. In Toyama, at least 150 Pakistani dealers, exporting 80% of second hand cars to Russia, have their offices near the port. At the same time, The Shipment of Vehicles to Russia Control Association of Toyama Prefecture, organized by Japanese dealers in 1993, has only 37 members, more than half of whom are already out of business. And this is rather understandable. The only unusual thing is that Japanese citizens living around big international ports probably lack a clear strategy towards the increasing number of other races, religions and cultures represented there. The general attitude of Japanese experts to the inflow of foreign buyers and sellers could be seen in the advice to Toyama Prefecture: “One would like to believe that in future it would be possible to create a model of “Internationalisation from Inside” based on the port area. Such a model needs to be orientated on mutual coexistence with foreigners. Using the existing Toyama-Pakistan Connections Society, we have to avoid daily life disturbances between people who live in the area and Pakistanis, as well as overcome the difficulties in relations with Russians.” (Nomura, 2004b).

And some more important points: in the year 2003, about 60,000 stolen vehicles were brought out of the country by international criminal organizations (Otake, 2004). The total number of registered vehicle thefts stood at 64,233. Therefore, according to Japanese experts, nearly all cars stolen in Japan are taken out of the country. In the period June 2002-September 2003, Lionel Dumont, a French citizen of Algerian descent, came to Japan using a false passport and was engaged in the used car business in Niigata (Sea of Japan port near to Toyama). According to mass media information, Dumont is one of the suspected leaders of the al-Qaeda terrorist organization and was trying to set up an al-Qaeda network in Japan. Naturally, these are isolated cases, however it shows that even law-obiding dealers may be afraid to loose the good reputation of their business.

Those examples show us how important are connections with Russia for Hokkaido fishermen and Toyama car dealers. But they also demonstrate the existence of a large shadow sector in fishery and used cars’ trade and reflect a complicated psychological situation formed around trade relations with Russia in some regions of Japan. Perhaps it happens because certain parts of the social burden of the fish and car "micro-business" are transferred to the local community and public efforts to eliminate the negative externalities are not efficient.

Differencies in partner´s mutual perceptions: asymmetric information

The last example, demonstrating a need for government intervention, is connected to deep differences in partners' mutual perceptions. It means that the image of Japan and Japanese in Russia is strikingly different from that of Russia and Russians viewed by the Japanese side. The existing image gap has several causes.

During the last hundred years, as both Japanese and Russian experts use to say, Japan and Russia were rivals more often than partners. Nevertheless, democratization of the USSR started in the middle of the 1980s. After the breakdown of the USSR, international politics changed direction; military expenses dropped dramatically, Russian troops left the disputed "Northern Territories" and so on. The Japan Defence Agency in a 2003 White Book for the first time pointed out the low possibility that Russia's military potential in the Far East in the foreseeable future will return to its Cold War capacity and structure level. So even the conservative by definition Japanese defence forces had admitted that the "Threat from the North", which was frightening Japan during hundreds of years, all but disappeared. The position of the Japanese government towards relations with Russia changed gradually, from the priority of territorial issue, to the necessity to create a reasonable climate for the solution of political problems. The Japanese finally have a reason to think about Russia as a "normal country" with a value system similar to Japan (Kimura, p.19).

Despite all these changes, the last decade was one of the most difficult in modern Russian history. Economic and ethnic problems, criminal activities and mafia, as well as scandals involving some Russia-friendly Japanese politicians, seriously affected the image of Russia. Unsurprisingly, in 2002 American researchers mentioned a dominating negative public opinion about Russia and Russians in Sapporo and Niigata (the biggest cities in Hokkaido and the Sea of Japan coastline). Most likely such opinion will not change in the nearest future (Akaha & Vassilieva, 2002).

We can find also some different examples. In 2003, 25 of 490 surveyed processing firms wanted to start industrial activities in Russia in the coming three years. From this point of view, Russia moved to 10th place in their priority list (16th in 2002) and passed Singapore, Hong Kong, the Czech Republic and some other countries (Nomura, 2004a). The developing interest of Japanese businessmen already shows itself in the dynamics of Japanese investments. In the year 2003, Japan invested into the Russian economy US$ 966 million in comparison with US$ 441 million in the previous year of 2002 (Institute for Russian & East European Studies, 2004). This is a rather impressive increase also because of the fact that yearly direct investments to the sum of US$ 817 million put Japan in 3rd place after Cyprus and Holland. At the same time, the share of Japan in the total accumulated investments is not so big (US$ 1.9 billion or 3.3%). The Japanese invested mainly in the Russian Far East and

Sakhalin oil and gas projects. And what is even more important, the improvement of business climate is not followed by comparable changes in politics or public opinion.

The situation for Russia is quite different. A direct presence of a Russian company in the Japanese market can be considered as something rather exotic. Political decisions are also retarded in a way, while one can see a "real Japanese boom" developing amongst ordinary Russians. The amount of Japanese restaurants and shops, books and films translated into Russian reached such a level that they have become an everyday life phenomenon for a wide group of the Russian population. It is said that the Japanese boom has happened in Russia for the second time, with the first occurring during the Japan-Russia war at the beginning of the 20th century. According to one Russian journalist, at that period Saint Petersburg beauties strutted in Japanese clothes in their boudoirs, while geishas of Kyoto were selling their luxurious kimonos trying to help the Japanese Army (Kulanov, 2003).

We can also add that in Soviet times, Japanese language was taught in 20 universities and now in 70 plus another 30 various language courses. In 1998, only one special magazine about Japan was issued in Russian, but in 2004 the number was 4. Five years ago, a quick Internet search for "Japan" in the Russian Yandex portal returned about 400 pages, but now it is more the 7 million. Only Germany surpasses Japan by the number of Yandex linked Russian language internet pages. Several opinion polls, especially in the Far Eastern part of Russia, show the admiration for Japan's economic successes and cultural heritage by ordinary Russians (Larin, 2004).

The stunning growth of the popularity of Japanese culture has several reasons. First of all, it is an international phenomenon noticeable in all continents. The 1990's was a period of deep structural reforms in Japan. A new generation of political leaders, businessmen and artists took the opportunities for creative work. Their joint efforts substantially raised the so-called Japan's Gross National Cool (McGray). On the economic side, we had a new orientation of Japanese exports from selling goods to content and services. For example, cultural exports are now worth three and a half times the value of all the televisions Japan exported in 2002. The U.S. market for made-in-Japan animation was estimated at \$4.36 billion in 2002, 3.2 times the value of Japanese exports of steel products to the U.S. (Nakata, 2004). By the looks of it, while Japan was in prolonged economic depression, the country managed to find a new "post-industrial" export potential niche on world markets. At the moment, Russia is not on the front line in the absorption of Japanese cultural influence. Sushi-bars rather go to Moscow through New York and Kitano's films come from Cannes more often than from Tokyo. Secondly, in recent years some traditional Japanese local markets became global (tuna, Alaska Pollack roe, live crab, etc). As a result, certain elements of Japanese business culture, and cooking and eating habits spread worldwide. Following electronic devices and Quality Control Circles, the ancient Japanese dish of sushi «went global» (Bestor, 2002). Thirdly, we can mention how Russians perceive the place of their country in the modern world. In fact, Russia is not an active participant in European or Asian integration, and the country feels somewhat overwhelmed by the political power of the USA and the economic potential of China, but growingly respectful of the economic and social achievements of Japan. The Japanese boom is obviously rather complex and not such a well "researched" phenomenon. All we can say is that, a solid base for positive perception of not only Japanese goods but Japanese ideas is being created in Russia.

The above-mentioned examples demonstrate the deep differences of public opinions in Japan and Russia. According to several opinion polls, the image gap between the two countries is really big, and probably widening. From the economic point of view, the country and its citizen's image abroad can be considered as a kind of externality or as a case of asymmetric information. Due to the existing differences in each partner's perception, Japanese business in Russia gains certain benefits and Russian business in Japan has to burden some extra costs. Sooner or later, the incongruous image problem should be solved. In such a case, the economic approach could be useful for the development of a corresponding public policy.

Conclusion

The conducted empirical study has confirmed that the most important areas of Japan-Russia economic relationships can be characterized by a prevalence of political over economic factors, the development of illegal economic activities, transferring of the social burden on local communities and the existence of considerable differences in each country's mutual perceptions. In terms of economics and public finance theory, these problems may be described as cases of market failure, shadow economy, negative externalities and asymmetric information. Such an approach convincingly demonstrates a significance of government intervention and provides the following policy implications.

Firstly, the need for a deeper state involvement and closer government cooperation of the two countries is confirmed by means of economic analysis. At the same time, Japan's policy toward Russia is famous for a complex mix of political and economical considerations. If the government of Japan decides to put economics at the top of its priority list, the suggested approach can provide a credible and face-saving explanation for such a policy shift. Secondly, the liberalization of trade under conditions of an institutional vacuum in Russia and insufficient international cooperation created a number of problems, which cannot be solved by the market alone. At present, the partner with more profound government institutions should take the initiative in dealing with these issues. Arguably, the most urgent task for Japan is a more assertive introduction of the rule of law in the areas of joint interests and concerns. Thirdly, the existing plans of inter-government cooperation should be revised to incorporate effective countermeasures against market failure and other mentioned problems.

At first glance, the review of Japan-Russia regional trade ("Narrower Asia") seems to be almost irrelevant compared to the issues of cooperation with European ("Wider Europe"), American or other Asian regions. Nevertheless, the post-Soviet model of international economic exchange probably has brought similar problems to frontier business and local communities all over the world. These problems must be solved by effective government intervention. The studies in this area should provide the necessary information for general public and policy makers. It means that a future research agenda must be aimed at cross-regional comparisons and extensive mining for appropriate empirical data.

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Chapter 4

OPPORTUNITIES AND CHALLENGES IN SELECTED INDUSTRIES OF EASTERN EUROPE

THE ROLE OF THE GOVERNMENT IN ATTRACTING FDI:
THE CASE OF BULGARIA

Tsvetan Manchev

Abstract

Bulgaria is a small open economy with scarce natural resources, which implies that the country depends on imports of raw materials and energy goods, as well as on exports of processed goods and services. In order to be more competitive Bulgarian enterprises need new technologies and know-how; however, the insufficient domestic savings could not ensure the financial base of the needed investments. In such an environment the FDI inflows are logically considered by business and political circles as the key factor for restructuring, innovation and increasing competitiveness.

The main task of this paper is to reveal the role of policy makers in attracting FDI. Based on the analysis this paper claims that the predictability of business environment, which itself is backed by the consistent legislation, structural and institutional reforms, together with macroeconomic stability is a far more effective stimulus for FDI to come than the preferences for foreign investors *per se*. The above conclusion could be useful for every small open economy in transition.

Introduction

After the beginning of the democratic reforms in 1989 all Bulgarian governments considered foreign investment as a crucial factor for achieving economic growth and prosperity. There has always been a large political consensus in favour of the need of a government policy stimulating foreign investments. The political will to attract FDI, expressed in one of the first laws adopted by the Parliament after the first democratic elections in the country - the Law on Foreign Investments of July 1991 - had just a "symbolical value" and practically no impact on the process of attracting foreign investments. It was soon replaced by another law adopted in early 1992 – the Law on the Business Activities of Foreign Persons and Protection of Foreign Investment. Over the years of transition the legislatively embedded incentives for FDI in various forms were the goal of all governments in power.

At the same time, the "inadequate set of incentives" was one of the key reasons for every new government to conclude that the level of FDI was insufficient and to reconsider and "repair" the respective legislation. The changes in the legislation after the 1990s were so often (table 1) that they did not allow a thorough analysis of their effects, which would have benefited policymakers and facilitated the decision-making process. The Bulgarian experience with FDI in the last fifteen years can generally be divided in four sub-periods.

Table 1: Bulgarian Laws on foreign investments for the period 1991 – 2004

	Promulgated on	Repealed on	Number of amendments
Law on foreign investments	14 July1991	28 Jan. 1992	1
Law on Promotion and Protection of Foreign Investment (title after the third amendment)	28 January 1992 under the title Law on the Business Activities of Foreign Persons and Protection of Foreign Investment	24 Oct. 1997	4
Investment Promotion Law (title after the sixth amendment)	24 October 1997 under the title Foreign Investment Law	In force	7

First, just before the financial liberalisation in late 1980s and early 1990s Bulgaria was crossed out from the map of world capital flows mainly due to the moratorium on the external debt payments following a dubious economic policy at the end of the previous decade and the absence of a basic legislative framework for foreign investment. At that time, market institutions in the country emerged in vigorous political dynamics surrounded by completely depleted foreign reserves, a full state control of interest rates, monetary overhang and precipitous dollarization, which soon after the collapse of the traditional CMEA ties brought the country to the edge of hyperinflation.

Second, in early 1990s capital inflows were limited to some speculative influx and the fragile macroeconomic stabilisation was funded primarily by loans from international financial institutions. The mentioned Law on the Business Activities of Foreign Persons and Protection of Foreign Investment (1992) granted equal rights to both foreign and Bulgarian citizens and legal persons to acquire shares or interests in commercial companies. It could not itself offset the negative effects on foreign investors' trust in the country fuelled primarily by an unclear and non-transparent strategy of the initial economic and financial liberalisation. The inadequate legislative, accounting, information and institutional framework of the market reforms and the slow progress of the negotiations with the Bank Advisory Committee of Paris and the London Club Creditors, further decreased investors' confidence. These allowed the governments, rapidly changing office, to pursue populist policies despite the external shocks, which created an environment of soft budget constrains, a large-scale budget deficit (financed primarily through the banking system dominated by state banks), a time inconsistent monetary policy under a floating exchange rate regime, and a slow and opaque privatisation.

Third, the acute financial and political crisis in late 1996 and early 1997 was caused by the liquidity problems in the financial system, the destabilisation of the monetary policy and the lack of people's confidence in the central bank following the bank runs. These not only stopped temporarily all capital flows to the country, including the financial support previously agreed with international financial institutions, but the sharp turmoil in domestic financial markets brought Bulgaria almost to the edge of hyperinflation once again in this decade. These processes led to new elections in the spring of 1997, when a right-oriented political party came in power with a program, strongly supported by international financial institutions, to achieve macroeconomic stability and carry out the long-delayed structural reforms. The introduction of the currency board arrangement in mid-1997 and the fast privatisation aiming to restore foreign investors' confidence in the country were the core of the 1997 stabilisation strategy.

Fourth, the post-crisis period was characterised by increasing FDI inflows mainly from world-recognised private investors. The successful turn in capital inflows can primarily be attributed to the abrupt changes in the capital flow management and the sharp rearrangement of the legislative, accounting, information and institutional framework with the purpose to meet the EC criteria for membership before the end of 2006. The factors which turned the investors' decisions in favour of Bulgaria were the political and economic stability, the credible economic and financial policy supported by a medium-term stand-by arrangement with IMF, the established liberal trade and investment climate despite the continuously unfriendly external environment. All these strengthened the domestic market's growth potential and proved the advantages of the labour resources in terms of productivity, skills and costs. In recent years Bulgaria succeeded in both attracting and effectively absorbing foreign investments, while maintaining one of the highest GDP growth rates in Europe at the beginning of the 21st century.

This paper provides below evidences of the role of the successive socio-economic reforms for achieving a sustainable growth and establishing democracy and a fully functioning market economy. First, it briefly describes the milestones of the financial liberalisation process. Second, the main components of the macroeconomic policy-mix are presented. It is followed by data on the interrelation between FDI and the economic growth in Bulgaria. Finally, some conclusions are drawn.

Financial Liberalization

The first furtive steps towards trade and capital liberalisation were made in 1991 when the central allocation of convertible currencies was abolished and the state monopoly over foreign trade was dismantled. However, the incomplete liberalisation of prices combined with the stalled institutional reforms were responsible for the instability of the foreign trade policies and inevitably led to the proliferation in the state micro-management of foreign trade. In consequence, Bulgarian markets were significantly protected during most of the 1990s, thus contributing to reducing the country's export potential. These combined with the relatively high Most Favoured Nation (MFN) tariff rates and the frequently introduced import surcharges posed an extra barrier to trade already negatively affected by the adverse external shocks. Despite the hesitant reforms in the field of trade liberalisation in 1996 Bulgaria became a member of the World Trade Organisation.

The serious efforts for removing the foreign trade policy-related distortions and reducing the instability of Bulgaria's policy began after the 1996-1997 financial crisis. Bulgaria restarted liberalising the trade at a slow pace in 1997, but later on the process picked up speed. Ever since Bulgaria has made significant progress in the sphere of telecommunications and financial services liberalisation and to a lesser extent in improving the access of foreign goods to the local market. The country agreed on a reduction in bound rates for industrial and agricultural products. The unweighted average industrial tariff fell from 28% in 1998 to 22.7% in 2003. For the agriculture the reduction was from 59 to 47.6% in the same period. The import surcharge was removed a year ahead of the initial schedule, on January 1, 1999, and also contributed to the significant decrease in the imports cost.

The second driving force of the Bulgarian trade liberalisation process was the regional free trade agreements. Beginning with the Europe Agreement (signed at the end of 1993), Bulgaria signed free trade agreements (FTAs) about industrial products and many agricultural product categories with countries with which the EU already signed or intends to sign preferential trade agreements[1]. As of 1 January 1998, the exported Bulgarian industrial products had a

[1] Bulgaria joined CEFTA as of 1 January 1999, but it had concluded FTAs with some CEFTA members far before. Bulgaria has also FTAs with Turkey, FYR of Macedonia, the Baltic States, Israel and Morocco, which also have a preferential status in the EU markets.

tariff-free access to the EU markets. The removal of Bulgarian barriers proceeded at a slower pace and was accomplished at the end of 2001. As for the agricultural products, the preferential access for some products that Bulgaria had under a unilateral GSP[2] scheme of the EU was retained. The EU gave preferential treatment within tariff quotas for some Bulgarian agricultural products, such as wine, and without limitation for certain processed agricultural products. Since July 1998, the EC increased the tariff quotas by 5% annually - as of July 2000 they were 25-28% larger than in 1995-1997. In 2000 new conditions for the access of some agricultural products were agreed. As of July 1, 2000, the tariff rates for some agricultural products were zeroed and new duty-free quotas were established. The next round of the negotiations between Bulgaria and the European Union on additional liberalization of trade with agricultural goods were held in 2002. As a result the negotiated agricultural concessions were included in the Protocol for adapting the trade aspects of the European agreement for association between the EU and the Republic of Bulgaria, signed on April 14, 2003 in Brussels.

The pursuit of regional liberalisation produced at least two positive effects for Bulgaria. First, it dramatically increased the contestability of the domestic market for industrial products due to the fall in duties on imports from preferential partners. Second, it led to a significant increase in reverse discrimination as the differences between MFN rates and other rates widened. Recently, improvements in Bulgaria's internal trade were also made in order to simplify and rationalize the licensing and regulatory regime. Over the period 2000-2003, 21% of the existing licensing, permit and registration regimes in the country was removed and another 33% was alleviated. The introduction of the "one-shop-stop" service in 2001 in all ministries, 28 districts and 14 municipalities was further expanded by the new legislation adopted in 2004[3]. The project is in final stage of preparation and will be accomplish until the end of 2005.

The Foreign Exchange Law (1999) and regulations are now fully compliant with the EU Directives. They determine the status of "resident" and "non-resident" accounts with banks[4]. In 2003 the Parliament adopted amendments to the Foreign Exchange Law and the registration at the BNB was replaced by a follow-up declaration while removing the licensing regime for cash amounts of over 10 000 euro. At the same time, the reporting for the purposes of balance of payments, foreign debt and the international investment position statistics was greatly improved in line with the requirements of the European Central Bank and Eurostat. Under the Foreign Exchange Law, the BNB imposes measures and penalties on banks and financial houses for any transactions or operations representing money laundering or

[2] Trade in wine was covered by the separate agreement.

[3] According to the Investment Promotion Law, Bulgarian and foreign investors in the country will further benefit from the "one desk" service, provided by the new Bulgarian Investment Agency.

[4] Both may have foreign currency deposit accounts with domestic banks, which may be credited without any restrictions, and from which transfers may be made abroad freely up to the amount of 10000 euro app or upon the presentation of information and documents, determined by a BNB regulation for greater volumes.

violations of the Law on the Measures Against Money Laundering and the acts for its implementation.

According to the Foreign Exchange Law foreign investors can repatriate profits freely. Tax preferences for foreign investors were steadily abolished and currently foreign and domestic investments are treated on an equal basis. The constitutional problem prohibiting the acquisition of direct title by foreigners of real estate and land is partially resolved. Joint ventures or 100%-foreign owned companies registered under the Bulgarian law are allowed to buy land for business purposes. Securities transactions in the money and capital markets, and the transactions in units of collective investment undertakings, are free. Free are also credits related to commercial transactions, financial loans guarantees granted by residents to non-residents and vice versa, transfers under insurance contracts, personal capital movements, operations in current and deposit accounts with financial institutions.

The Law on Measures against Money Laundering (1998) is largely in line with international standards. The law sets forth the obligations of the BNB and the Bureau of Financial Intelligence within the Ministry of Finance for the development of an operational procedure for detecting and preventing money laundering. It also determines these economic agents' obligations and activities for identification of "clients', collection, storage and disclosure of information necessary for implementing measures against money laundering. Respective amendments to the Penal Code were also made.

Under the Law on the BNB (1997), the central bank is responsible for implementing the monetary and exchange rate policy under a currency board arrangement and for developing banking regulations as well as exercising banking supervision. Licensed banks do not request any guarantee from the Government of Bulgaria and their borrowings comply with the prudential regulations set by the BNB. These banks may borrow from abroad without the BNB's permission. They may also extend foreign currency and lev loans to resident and non-residents. The Law on Banks and the BNB prudential regulations are in line with the Basle Committee recommendations. The first steps for implementing the Basle Capital Accord II, which is scheduled for 2006, have already been taken. Under these regulations banks have greater freedom together with clear obligations to develop internal risk management systems in line with the best international practices. According to the regulations, banks' open foreign currency positions in euro are excluded in calculating their net open foreign currency position.

The Law on Public Offering of Securities was passed at the end of 1999 and later amended in compliance with the EU Directives and world well-established practices. This Law's main objective is to govern the public offering and trade securities, the activities of regulated securities markets, the Central Depository, investment intermediaries, investment companies, fund management companies, and the conditions for carrying out such activities and the State control on them. It treats domestic and foreign persons on an equal basis. The law explicitly provides for the admission of foreign securities to the Bulgarian capital market. Both policy-makers and investors have broadly accepted the view that the Law on Public Offering of Securities provides adequate protection of investors and creates prerequisites for the development of a transparent and efficient capital market in the country.

Macroeconomic policy-mix

In mid-1997 as part of a stabilisation program supported by the international financial institutions Bulgaria rapidly changed its foreign exchange regime – from independent float to a currency board arrangement[5]. The foreign exchange regime was constituted with the Law on the Bulgarian National Bank (BNB, 1997) and is considered one of the cornerstones of the post-crisis economic stabilisation in the country by ensuring predictable climate for foreign investors. To constitute further the stability of the national currency the Law on the Re-denomination of the Bulgarian Lev was adopted in February 1999, effective from January 2000.

The Bulgarian currency is already very much aligned with the Euro primarily due to the stable political commitment to keep the existing exchange rate until Bulgaria joints the EMU, on the recently approved date for Bulgaria's accession to the EU and the compliance of the current monetary regime with the ERM II mechanism. Formalizing the euro as a currency for cash transactions in Bulgaria does not even seem problematic soon after its appearance. Based on the recent experience of Estonia and Lithuania, Bulgaria will opt for the immediate entry in ERM II from January 1st, 2007.

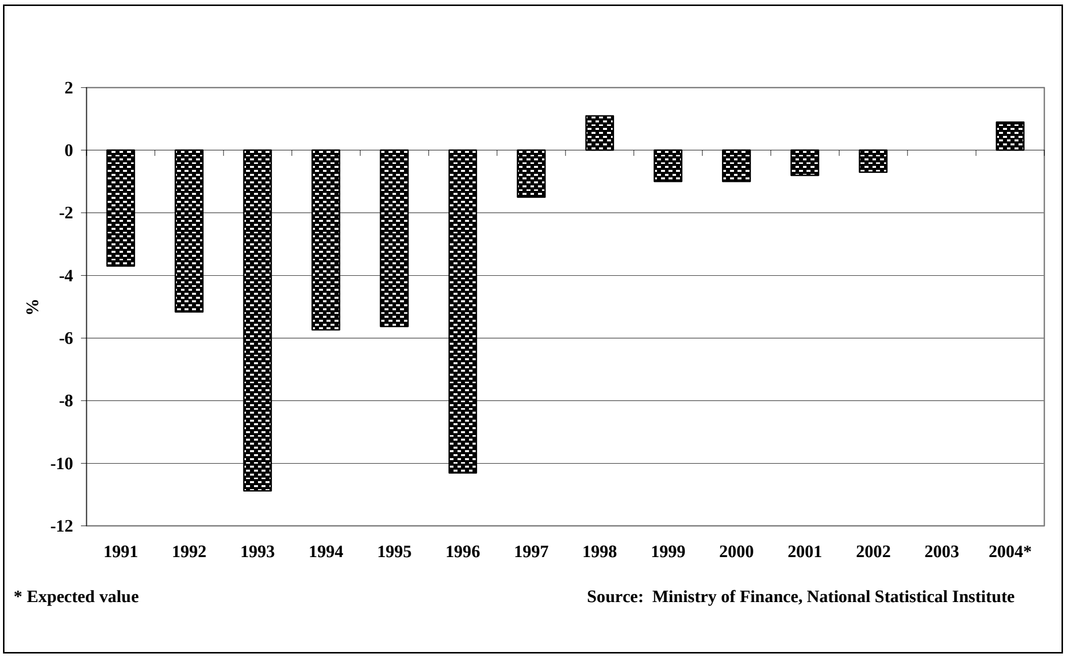
In November 2004 the government and the BNB signed an Agreement on the policy and commitments to be followed in the process of introducing the Euro in the Republic of Bulgaria in the period until 2009 / 2010, formulating the major steps to be done for the rapid introduction of the common European currency in Bulgaria.

Since mid-1997 the prudent fiscal policy has helped to constrain the budget deficit. It was initially designed to keep an annual consolidated government budget deficit of around 1-1.5 percentage points of GDP. The post-privatisation reforms after September 2001 allowed for the deficit to decline or for the government even to maintain a slight surplus, which is a far better performance than that in the early 1990s. The sound government budget accounts in recent years were associated mainly with (1) the improved budget revenues collection; (2) the optimisation of both interest and non-interest expenditures through an active public debt management and the reform of the social security, pension and health care systems; (3) the consolidation of extra-budgetary accounts and implementation of a "single budget account" procedure contributing to a more efficient cash flow management and (4) the sharp and pre-announced decrease in the overall tax burden in 2002-2004. To the maintenance of an almost balanced budget also contributed (1) the medium-term agreements with the IMF and other international financial institutions on the country's external financing from official donors; (2) the accomplishment of the trade and price liberalisation process; (3) the successful restructuring of the banking sector through a confident privatisation; and (4) the fast privatisation of state enterprises and the staunch commitment to pulling down the monopolies

[5] According to the Law on the BNB, 1000 Bulgarian levs are equal to 1 DEM after July 1st, 1997 with an automatic fix to the euro (1 euro is 1955.8 levs) from January 1-st, 2002.

in energy, telecommunication[6] and tobacco industries. The recent arrangement and enforcement of the tough EU state aid rules also contributed to increasing the flexibility of the fiscal policy.

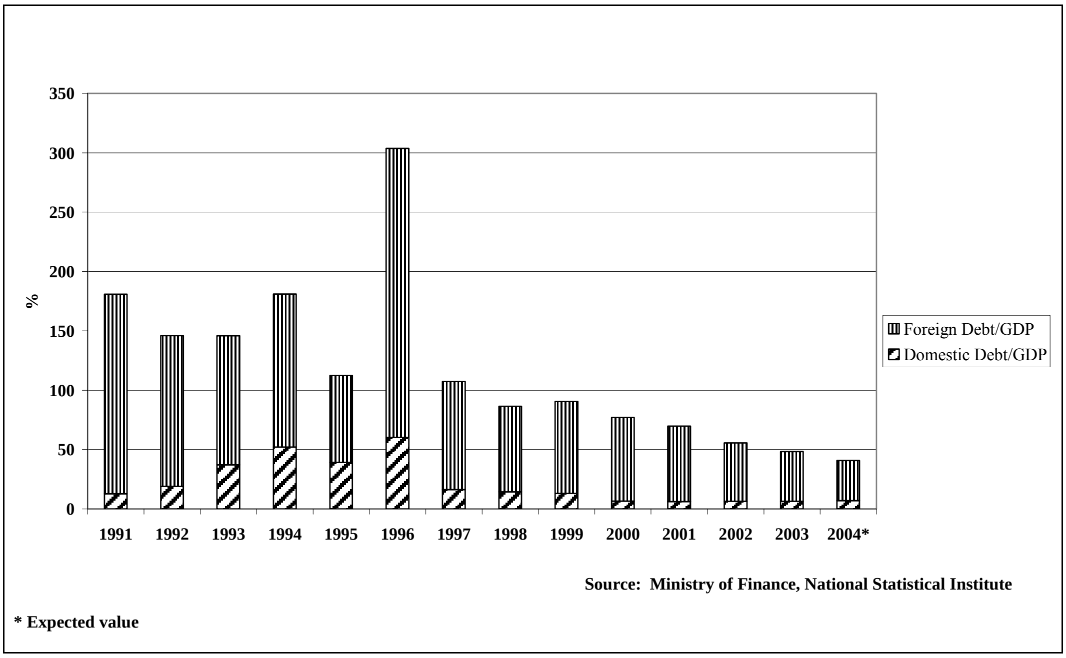
Figure 1: Budget deficit in Bulgaria



Based on the strong fiscal stance and the active debt management the public and publicly guaranteed debt fell down dramatically without any visible damage on the growth and socio-economic cohesion. It accounted for about 41% of GDP at the end of 2004 compared with more than 100% of GDP at the end of 1997. The currency and maturity structures of the debt improved substantially, which re-opened Bulgaria's access to international capital markets and further decreased the risks to the fiscal policy. In June 2004 Bulgaria got its first investment-grade rating from S&P. The grade was soon reconfirmed by Fitch IBCA.

[6] The privatization of the Bulgarian Telecommunication Company was finalised. In the first half of 2004 the privatization of electricity distribution companies is under way and is expected to end in late 2004.

Figure 2: Government debt in Bulgaria



The stability of the currency board arrangement and the steady progress in the reduction of gross external debt further provided for relatively low inflation and the subsequent stability of the real interest rates. In a currency board environment the desirable convergence of domestic interest rates toward the average euro-zone levels occurs steadily and strongly related with the degree of financial deepening and competitiveness of the Bulgarian economy. Since the introduction of the currency board arrangement in July 1997 the foreign exchange reserves of the central bank, incl. gold, have risen more than three times and at the end of 2004 reached 6.8 bill. euro[7].

[7] For the period mentioned Bulgaria has received a serious balance of payments support from the IMF (about 500 mln. euro) and other donors (1200 mln. euro).

Figure 3: Inflation

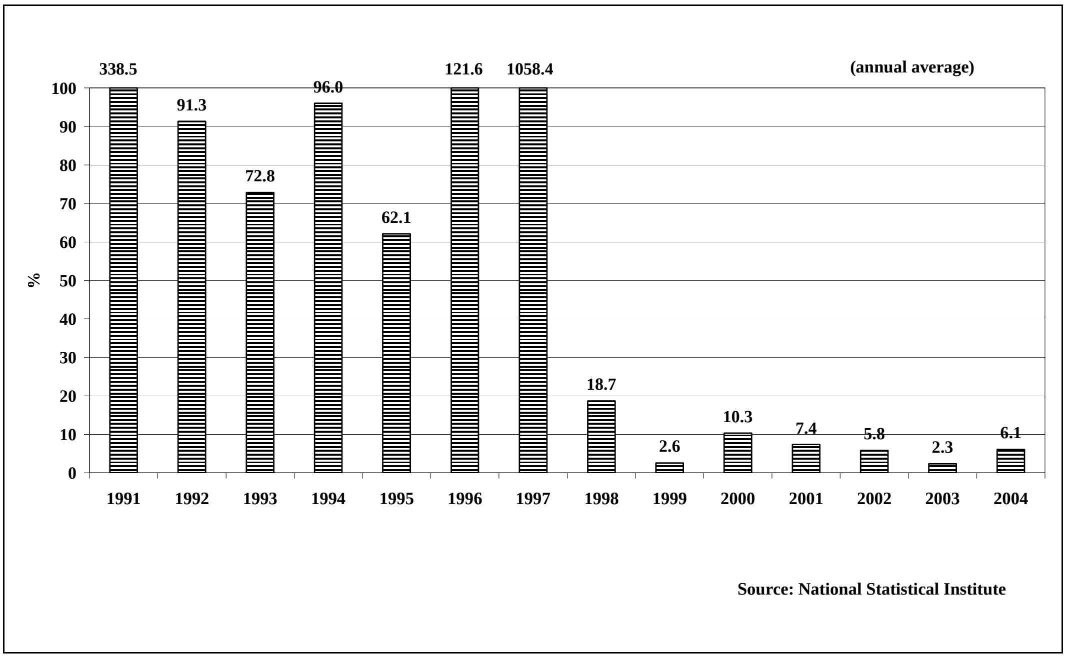
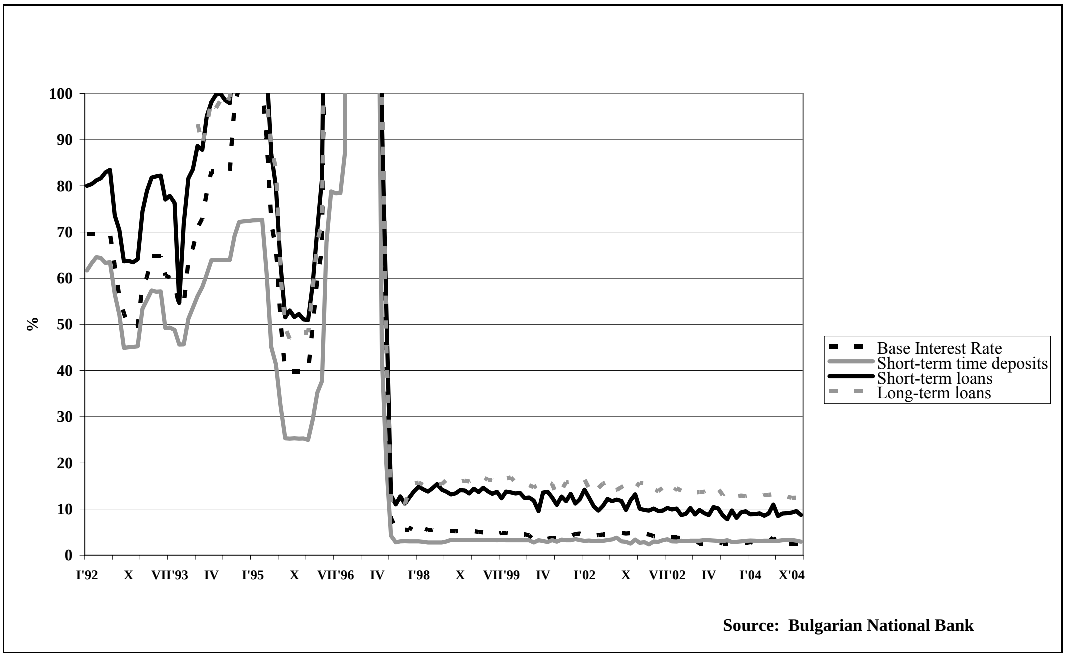


Figure 4: Interest rates



The government income policy[8] in the post-crisis period, initially designed on the basis of strong budget constrains contradicted with the high cost of painful reforms paid by Bulgarians and instant changes in the quality of life needed. This invited some populist deviations (fortunately very rare) in the implementation phase of the income policy, which reduced the effectiveness, but caused no sharp deviation from the ultimate goal of holding down the wage bill in a number of loss-making enterprises and large state monopolies. The contradictions revealed in the discussions with social partners on the appropriateness of the income policy have been consistently managed and kept in line with the overall budgetary goals.

In response to the socio-economic challenges, an active labour market policy[9] was introduced in 2002, which is fully consistent with the goals of the overall government policy for achieving sustained economic growth. The policy provides for the implementation of a series of programmes for subsidised employment. The largest in scope of which - 'From Social Benefits to Employment Promotion' National Programme - was launched in the second half of 2002. The goal of the Programme was to ensure the reintegration of long-term unemployed persons receiving monthly social assistance benefits by creating jobs in community services. The project budget was set and based on the strict monitoring procedures.

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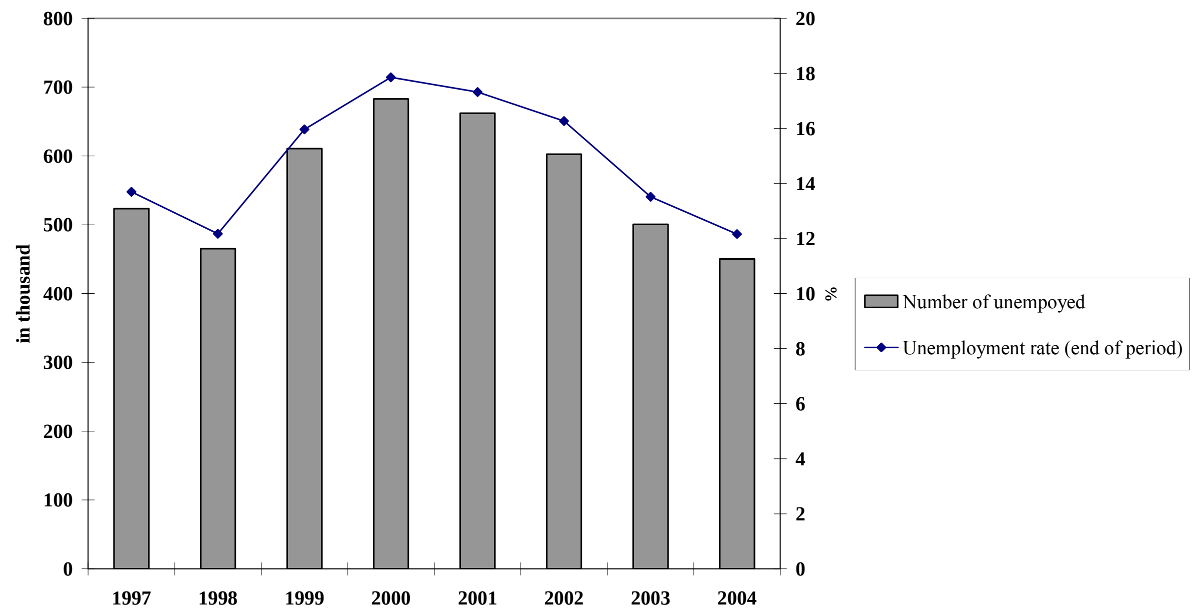
[9] The Act amending the Employment Promotion Act was enforced in March 2003. The Act aimed at achieving greater flexibility and better targeting of employment policy so as to enhance its effectiveness. In 2003, the Corporate Income Tax Act was also amended to provide for investment incentives and job creation in areas with stubborn unemployment. The Act introduced a tax incentive in the form of a 100% tax remittance to producers investing in areas with high unemployment in case they meet certain requirements. Furthermore, tax incentives are envisaged for employers who have hired unemployed with reduced working capacity, long-term unemployed or unemployed aged over 50 for a period of at least 12 months in a given fiscal year.

Figure 5: Unemployment rate



Source: Ministry of Labour and Social Policy

Bulgarian experience in the transition fully proves the close interrelation between the trends of foreign investment inflows and the pace of structural reforms in many aspects. It also raises some questions concerning the “bottle-necks” of the reform process. First, Bulgaria has recently experienced increasing capital inflows, when the signs of structural reforms and credible economic policy are seen, irrespective of the continuous external shocks. Second, capital inflows, together with the IFIs loans, provide indispensable financing for the current account deficit during the transition.

Figure 6: Trade deficit and current account deficit

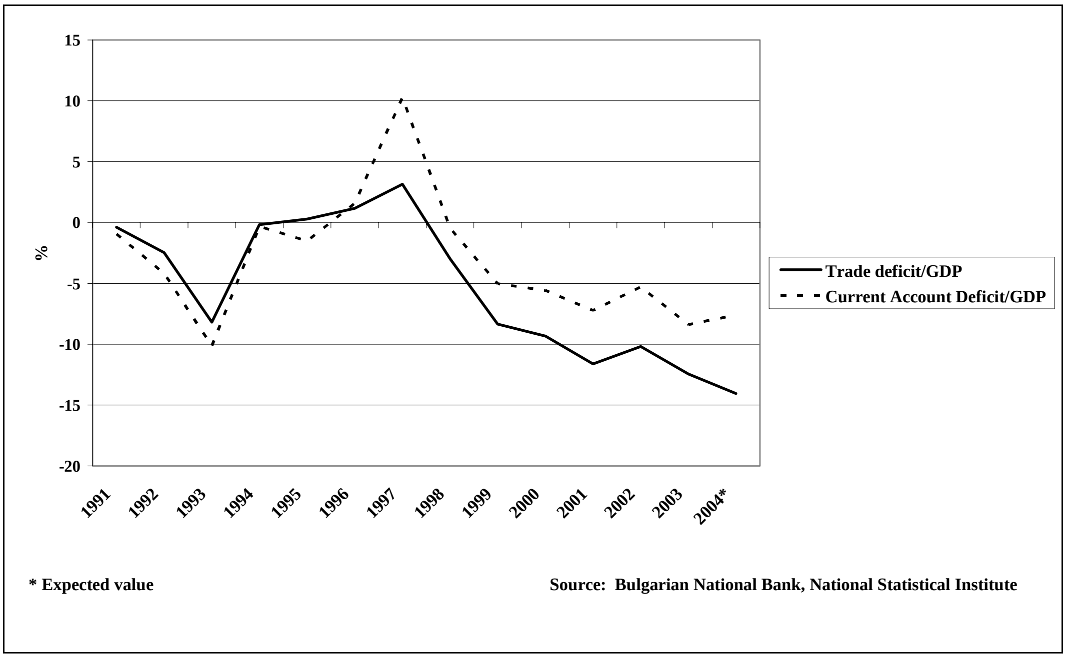
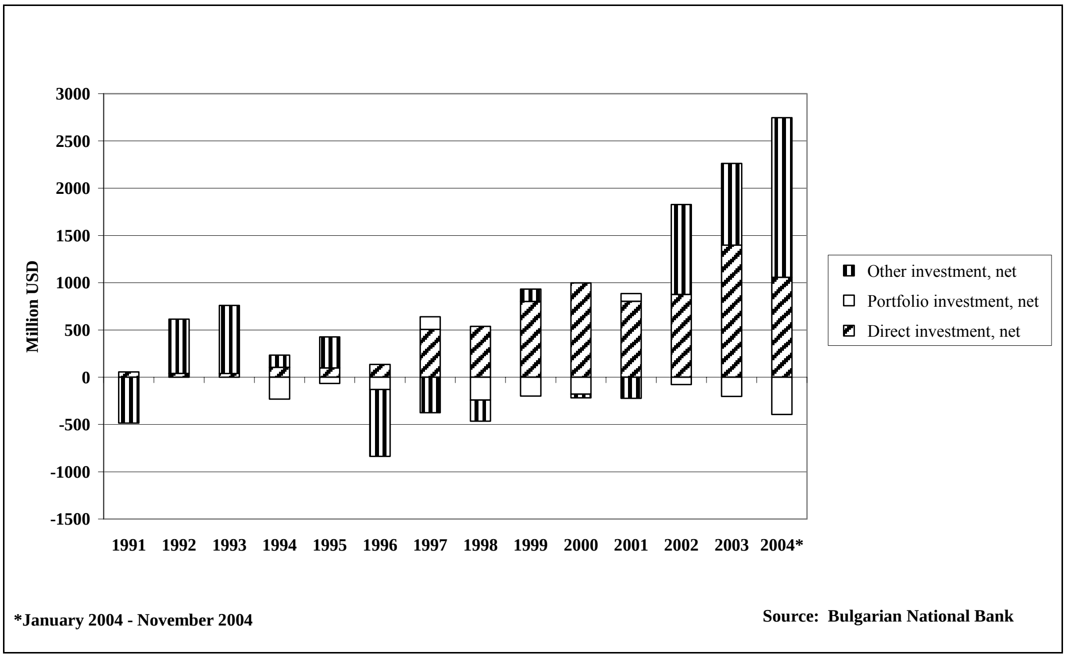


Figure 7: Financial account of the Balance of Payments



Third, the faster changing industries mostly export-oriented ones accumulated a substantial portion of the increasing FDI. The recent trends of exports in certain industries follow the trend in the foreign investments. Good examples are the textile, footwear and clothing industries, and to a lesser extent the pharmaceutical, chemical and perto-chemical industries, mechanical and electrical engineering, as well as metallurgy. The most important exporting companies and export products in 2004 belong to the textile and clothing industries. At the same time these sectors accounted for about 19% of Bulgarian exports.

Fourth, there is no doubt foreign investments have already played an important role in the Bulgarian economy but backward linkages with the local economy remain below the expectations. Performance of domestic companies and of ones with prevailing foreign participation tend to vary considerably in certain areas such as wage levels, gross value-added, net sales, capital base and export orientation. This has given rise to fears among the economists, that a “dual economy” could exist in Bulgaria with a more successful “external sector” operating in isolation from the other parts of the economy. Low interest of foreign investors to the rural regions as well as the aim of fostering better linkages with local suppliers has also developed some concerns.

Fifth, since 1991 Bulgaria has undergone abrupt changes in the export structure by countries, but such changes are still not observed in the structure by products. This processes resulted in continuing low share of the export of medium-to-high-tech products within the total volume. These do not allow a country to realize the comparative advantages of its skilled labour.

Sixth, the quick privatisation in the banking sector since 1996 has attracted reputable foreign investors[10]. They imposed strategy-driven restructuring with clients’ satisfaction as the primary goal, and contributed a lot to the post-crisis operational restructuring of the banks Substantial development has been registered in bank planning and marketing, implementation of sound “best recommended” practice in bank risk management, problem credits workout, as well as greater transparency of bank financial statements. These (1) encourage technological transfer to the local bank industry; (2) contribute to successful emergence on the international arena; (3) raise the quality of corporate policy; (4) push individual banks and then the sector to speed up their restructuring in alignment with the international criteria for sound banking; (5) enforce internal management rules, control and reporting mechanisms; (6) force movement toward a new corporate culture, closely resembling that of world-recognized banks.

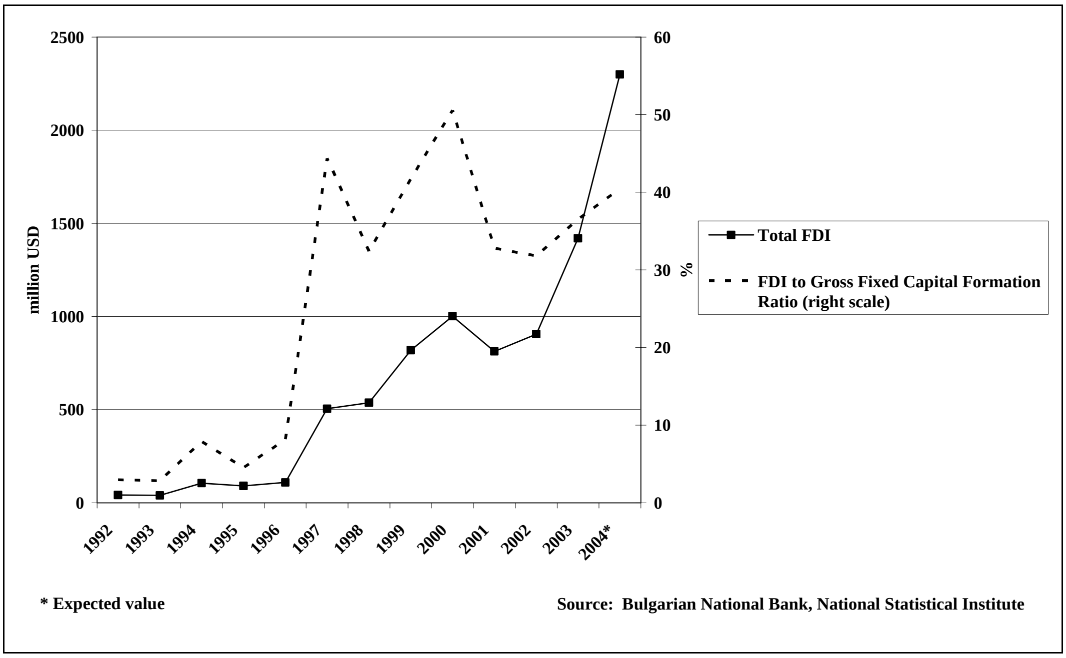
Macroeconomic stabilization is an unquestionable achievement of the recent reforms. It is confirmed strongly by all reviews under different IFI agreements. The recent accession of Bulgaria to the North Atlantic Treaty Organisation and the timely completion of the negotiations for EU accession are also a clear sign that the political and economic reforms in the country were successful and irreversible.

[10] Like Societe Generale, Bank Austria Creditanstalt, Bank Uni-Credito Italiano, National Bank of Greece, OTP PT Bank etc.

FDI and economic growth

In spite of the complicated external environment, Bulgaria's macroeconomic performance has witnessed a remarkable turnaround since the crisis. Bulgaria has increased its share as a user of worldwide direct investment and has registered one the highest GDP growth rates in Europe. During the 1997-2004 period, about USD 8 billion were invested in the country, which was 95% of the total amount of foreign direct investment since the beginning of market reforms. On a per capita basis, recent foreign investments in Bulgaria almost touched the highest levels in Central and Eastern Europe. In the recent years the growth rate of FDIs in Bulgaria has exceeded the average for CEE that is why the Bulgarian share in CEE' foreign investments increases.

Figure 8: Total FDI and FDI to Gross Fixed Capital Formation Ratio



Overall foreign direct investment inflows in Bulgaria rose from the negligible levels in the first half of the 1990s to a peak of around 8% in the beginning of the 21-st century. They financed the current account deficit, strengthened the export capacity, and thus supported the smooth functioning of the currency board arrangement, but also represented significant share in the gross fixed capital formation. Since 1997 foreign direct investment to gross fixed capital formation ratio has fluctuated between 32% and 50%, far above its pre-crisis levels. Unfortunately, there are no reliable data available for the share of companies with prevailing foreign participation in GDP and gross export.

Figure 9: FDI per capita

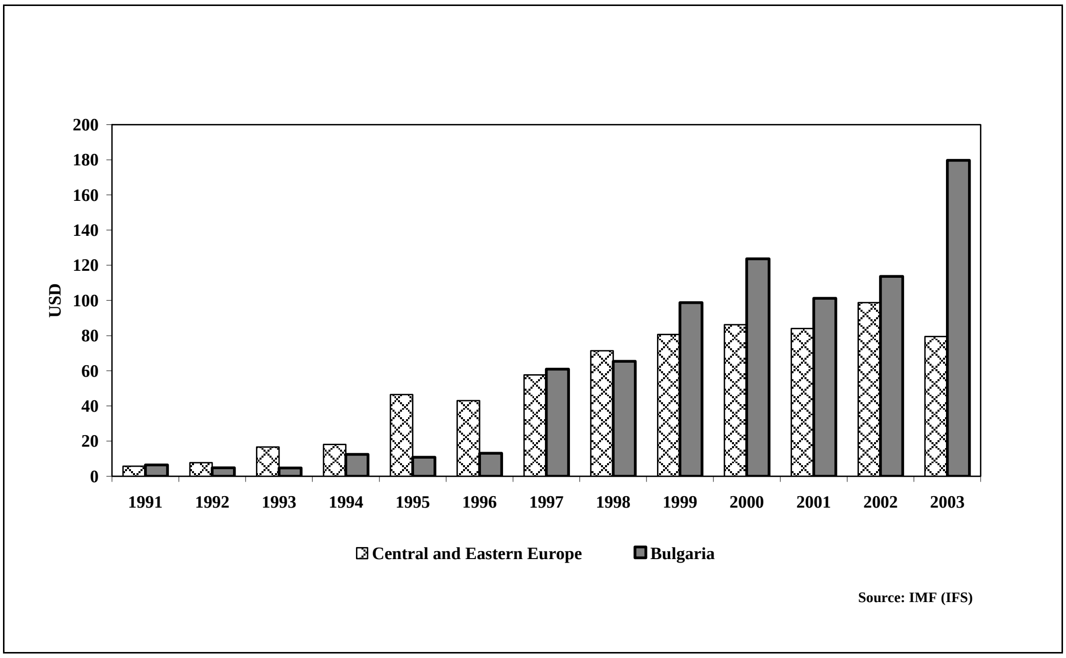
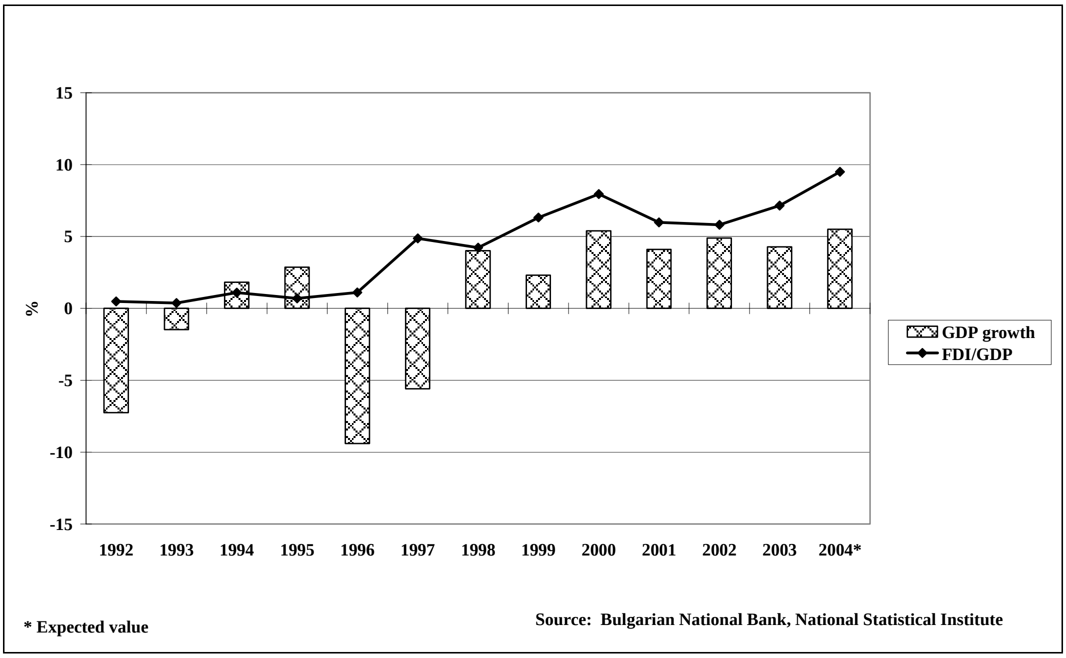


Figure 10: FDI and GDP growth



Accelerating GDP growth dynamics reached the growth rate peak of 5.8% in 2000. Year 2003 was the sixth in a row to see Bulgaria attaining relatively high growth (4.3%)[11]. The

[11] In the third quarter of 2004 the growth rate recovered to 5.7%.

greatest contribution to this came from end user consumer spending by households and investment in equity. The growth of goods and service imports outstripped that of exports, with the balance of payments contributing adversely to GDP growth in comparison to the previous 2 years.

Conclusions

The general outcome of the analysis is that the sound economic management can, to a large extent, offset adverse movements in the external environment and is a prerequisite for successful economic development of small open economies. Some concrete remarks are:

First, the Bulgarian experience in the transition to a market economy last decade proves in the best possible way the hypothesis of high importance of capital inflows for the economies with low rate of domestic savings and a soaring needs of investment for technological and operational restructuring of the economy.

Second, the design of the general reforms strategy, its proper communication to the investors and international financial community in general, the credible legislative and institutional reforms and sound macroeconomic policy have been the corner-stones for an optimistic turn in the volume of foreign investment to Bulgaria since mid-1997, despite the continuing averse shocks affecting the economy.

Third, debt and debt service reduction operations for high indebted countries, like Bulgaria, together with financial support from the international financial institutions coupled with a restrictive macroeconomic policy, especially fiscal policy, could succeed in closing the financial gap in the short term, but are not enough to return the economy on the road to sustainable long-term growth. Deep structural reforms are needed to revive investors' confidence and to smooth the path of capital inflows and economic growth.

Fourth, the key measures of successful recent economic reforms and capital inflows management in Bulgaria have also been at least (1) the introduction of the legislation, which properly defends the property rights and supports accurate enforcement of the investment contracts, (2) adequate trade and capital liberalization; (3) sound monetary policy based on the simple rules of the currency board arrangement; (4) quick privatization; (5) appropriate banking regulations and bank supervision based on the achievements of the best international practices.

The implementation of legislation securing strictly investors' property and rights, as well as the proper contract enforcement has been a prerequisite for restoring the confidence of investors to Bulgaria. The recent positive trends in the Bulgarian exports as well as the growing capital inflows in industrial sector have also proved the advantages of trade and capital liberalization primarily the importance of participating in the world and regional trade integration on reciprocal basis.

Fifth, the leading role of the government as a manager of financial and economic restructuring, which replaced the compromised central bank as a crisis manager, and the sharp privatization of the banking sector with key participation in the process of reputable and experienced foreign banks have been of crucial importance for the successful reform process. Changes in prudential regulations, banking supervision and deposit insurance toward the achievements of the best international practices have brought foreign investors into the Bulgarian reform process.

Sixth, the importance of regional stability, co-operation and development for smoothing capital inflows to domestic economy should also be considered, because of the small size of the Bulgarian market and its geographic location. Bulgaria's transition in the last decade was seriously damaged by the consecutive adverse external shocks starting with the process of collapse of the former CMEA and continuing with several regional war conflicts, embargo on Yugoslavia, and the Turkish financial crisis. These resulted in low confidence of foreign investors and almost closed the whole region for capital inflows.

Seventh, it seems it has not been enough for development of a sound capital market, which would efficiently allocate the limited resources among the sectors on market basis, to strengthen the legislative and regulatory framework and to develop good rules and regulations for the operation of the Stock Exchange. For establishing such properly functioning and stable capital markets in Bulgaria, further efforts are needed to invite securities of reputable companies and also to facilitate domestic savings.

Although not analysed in details in the paper a number of challenges in the capital flows management process can be mentioned:

First, the rapid shifts of priorities in the privatisation process and the intensive use of management-buy-outs as a privatisation method following vigorous political dynamics not only caused a substantial delay in the property transformation and lowered the overall financial effect of privatization, but also inevitably destroyed the confidence of strategic foreign investors in the country.

Second, the absence of clear long-term strategies for the development of different sectors and regions compatible with the overall economic reform strategy as well as the lack of clear understanding by the policy-makers that the country's priorities may cost us unbalanced development on regional and micro level, which would disturb the maintenance of economic policy on macro level or upset the technological improvement and economic competitiveness.

Third, the information problems continue to be important impediments to detailed analyses of capital flows impact on economic development. In many such cases the policy-makers have been deprived of powerful tools for optimising capital flow management and further accelerating economic growth and living standards The information problems as well as the bureaucracy and political turbulence should also be considered as a primary reason for foreign investors to withdraw from a number of investment projects in Bulgaria during the decade.

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INWARD FOREIGN INFLUENCES ON THE OUTWARD INTERNATIONALISATION OF ESTONIAN BANKS

Urmas Varblane, Tõnu Roolaht[1]

Abstract

The foreign ownership of internationalising Estonian companies has a considerable impact on the expansion of their sales abroad. By comparison with the internationalisation of manufacturing companies, the internationalisation process of service companies has several variations in its international pattern. Depending on the nature of the services offered, large-scale export activities might not be a visible option. This paper explains how the inward-outward connections in the internationalisation of Estonian banks have influenced their capabilities and subsequent autonomy from owners. The study investigates ownership ties, but several aspects of our discussion can be generalised to the buyer-seller relationship and to various other partnerships. Acquisitions by Swedish banks in 1998 had a different impact on the internationalisation of the two leading banks of Estonia. Inward-outward connections in case of Hansapank mean that they started to control FöreningsSparbanken's activities in the Baltics. In the case of Eesti Ühispank, on the other hand, inward-outward linkages mean that they lost all their activities in the other Baltic countries and have been, to a great extent, pushed back to domestic activities. These differences in strategies between Swedish banks could be explained by the historical background of the companies, which led to differing internationalisation experience and to different organisational solutions.

Keywords: Internationalisation of service companies, inward-outward connections, Estonian banking sector

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Introduction

The internationalisation process of companies in transition economies can be characterised by two specific features. Firstly, several companies that enter foreign markets belong to foreign owners. Secondly, the development of service companies has been faster than the reorganisation of the manufacturing sector. The foreign owners of Estonian companies have a considerable impact on the continuing expansion of their sales abroad. On the other hand, the internationalisation process of service companies has several variations in its international pattern by comparison with the internationalisation of manufacturing companies. Unlike manufacturers of tangible goods, most service companies cannot use large-scale export activities.

Foreign direct investments (FDI) by Nordic companies have been in many respects instrumental in helping reorganise the Estonian economy. Their role was especially important during the aftermath of the Russian currency crisis in 1997. The emerging unfavourable exchange rate of the rouble against the US dollar harmed the business operations of Estonian companies at the Russian market, which in turn led to the collapse of Estonian stock prices and spread the financial hardship to the Estonian banking sector. In 1997, leading Estonian banks were also directly involved in the Russian market, either via their investments into the acquisition of Russian banks, or via greenfield investments into their own branches or leasing service affiliates. These radical changes in the economic environment had an adverse impact on the credit ratings and expansion intentions of Estonian banks.

The low value of Estonian companies' stocks, however, attracted many foreign investors who used this opportunity for acquisitions of Estonian companies established by domestic entrepreneurs. Until 1998, the domestic owners had a majority in stock capital of the largest Estonian banks (Hansapank, Eesti Ühispank). As indicated, at that point these financial institutions had already established some affiliates in neighbouring foreign markets ─ besides Russia also in Latvia and Lithuania. In 1998, the two largest Estonian banks were targeted by two Swedish banking groups.

This paper aims to show how the inward-outward connections in the internationalisation of Estonian banks are related to the capabilities and subsequent autonomy of the parties involved. However, although this study investigates ownership ties, several aspects of the discussion could readily be generalised to the buyer-seller relationship or to other partnership types.

In the first subsection, the definitions of inward and outward internationalisation as well as inward-outward connections will be explained. Thereafter, the differences between the internationalisation processes in the service sector and in the traditional manufacturing industries will be highlighted. Before turning to empirical evidence, relevant literature on interconnections between internationalisation experience, subsidiary roles, and power distribution will be reviewed. The empirical section offers two case studies of inward-outward internationalisation, whose evidence is used for discussing the implications of Estonian experience for the international business theory, management practice, and economic policy. The paper concludes with suggestions for further research.

Inward-outward internationalization in service sector and strategic autonomy

Both sides of internationalisation

When describing the internationalisation of a company, attention is often paid only to the output side of the value chain (see, for example, Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne 1977; Welch and Luostarinen, 1988; Dunning, 1991; Leonidou and Katsikeas, 1996). The foreign market entry process includes exporting activities, contractual agreements, and outward FDI. In a more general view, internationalisation is a two-way process of increase in a company's involvement in international activities (Luostarinen and Welch, 1997). This definition incorporates not only the outward side of internationalisation, but also inward internationalisation and cooperative internationalisation.

Outward internationalisation has been widely researched from different angles, including gradual (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne 1977; Welch and Luostarinen, 1988), economic theory based (Casson, 1984; Teece, 1981, Dunning, 1991; Williamson, 1994), and relational models (Thorelli 1986; Johanson and Mattson, 1987). In this paper we predominantly rely on gradual models, while important relational perspectives are described as well.

In essence, gradual models describe internationalisation as a stage by stage increase in foreign market commitment, according to the changes in company's experiential knowledge (Johanson and Vahlne 1977). During that process less resource-intensive entry modes such as indirect exporting are in time replaced or supplemented by more elaborate modes (for example, by a wholly-owned subsidiary). In parallel with the changes in entry mode, the company will also enter new, and gradually more and more distant target markets.(Ibid.) Welch and Luostarinen (1988) showed that the gradual pattern should not be the same in every target market and as the company gains more experience some commitment stages could be skipped. The notion of a 'born global' company (Rennie, 1993; Knight and Cavusgil, 1996) introduces also the modern era phenomenon of rapid internationalisation shortly after the inception of a company. Thus, for example, when a company can successfully internalise its partners' or owners' prior experience, (Madsen and Servais, 1997; Roolaht, 2002), the stages of internationalisation will become much less evident.

The aspect of inward internationalisation has found much less research attention, although one must admit that the works on international purchasing and supply chain management (see Babbar and Prasad, 1998 as one example) deal in many respects with the same issue. Nevertheless, there are several writings that specifically address the notion of inward internationalisation (Welch and Luostarinen, 1993; Luostarinen and Hellman, 1994; Korhonen *et al.*, 1996; Korhonen, 1999; Fletcher, 2001; Karlsen *et al.*, 2003). Inward internationalisation involves inward operations such as importing of equipment, raw materials, supplies and even finished goods along with in-licensing and production of materials abroad)(see Korhonen, 1999 for a more elaborate discussion). In this paper we add to the definition of inward internationalisation the inward FDI from foreign investors as well as the inward transfers of knowledge from partner (owner) companies and employees (see also Roolaht, 2002). These additions reflect the growing importance of inter- and intra-corporate networks.

Luostarinen and Welch (1993) (re)introduced the focus to the inward-outward connections, stating that inward international activities, for instance, purchasing of materials, equipment etc., might have a considerable role in helping one to enter the target market with the firm's output (see Table 1). This could happen directly via counter-trade and other forms, or indirectly, for example, through formation of contacts with market channels in cooperation with the firm's foreign supplier (Welch and Luostarinen, 1993).

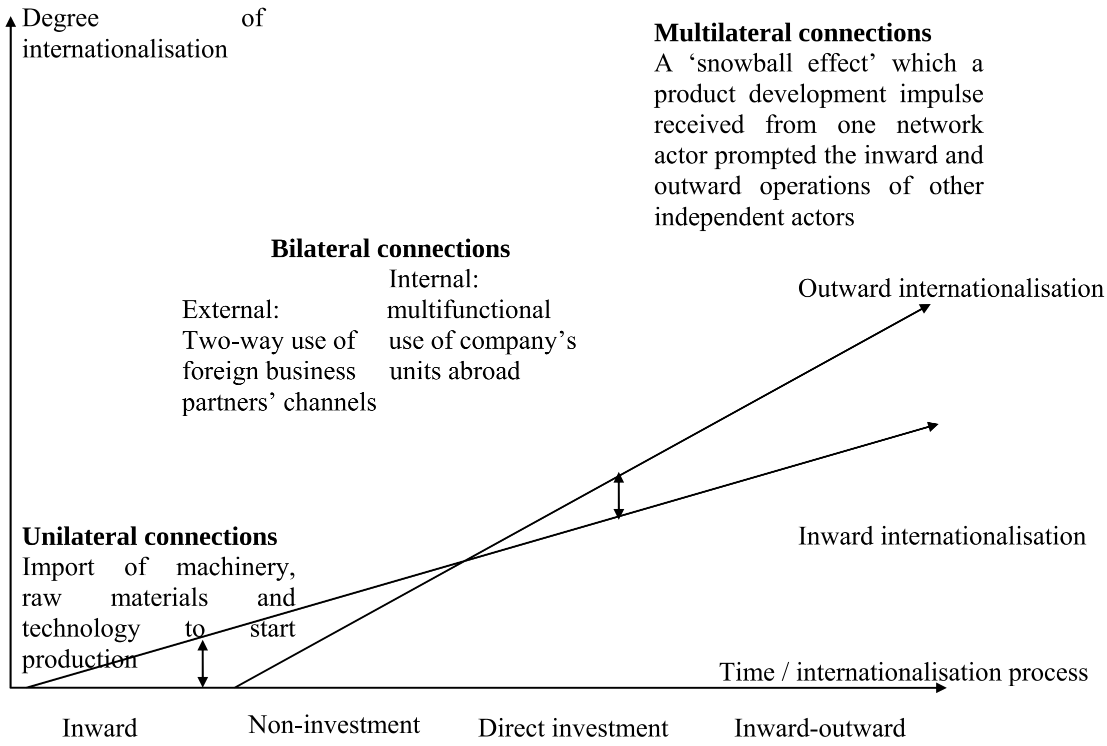
Table 1: Direct and indirect inward-outward connections

	Direct connections	Indirect connections
Examples	• Counter-trade • Cooperation deals • Cross-licensing • Intra-corporate transfers • International subcontracting	• Company uses experience as importer of technology in outward foreign licensing • Foreign supplier leads to foreign contact and outward orders
Nature	Often contractual in nature, or subject to centralized decision-making by MNE	Typically there is a time separation; learning process and type of international contacts are important.

Source: Welch and Luostarinen 1993, p. 46

Inward operations usually precede outward operations, especially when equipment and materials have to be imported already before the start of production (Luostarinen and Hellman, 1994). A more elaborate context of inward-outward connections is offered by Korhonen (1999) (see Figure 1).

Figure 1: Types of inward-outward connections (source: Korhonen, 1999)



In conclusion, inward international operations frequently have an important influence on the outward internationalisation process either because of the need to import raw materials that are essential for production or because of the experience gathered via technological or knowledge transfers. In addition to inward-outward connections, different economic sectors also tend to have various differences in their internationalisation processes. In the following discussion we will outline the specifics of service company internationalisation.

The characteristics of service internationalisation

Unlike products, services can often be characterised as intangible, perishable and inseparable (Knight, 1999). These characteristics of services are considered to engender the use of wholly owned subsidiaries or joint ventures as primary entry modes in service sector internationalisation (Buckley *et al.*; 1992; Erramilli, 1990). Bouquet *et al.* (2004) also show that when successful service provision prescribes close contacts with end customers, or in other words, low separability of production and consumption, then wholly owned subsidiaries and expatriate staff are preferred. However, Vandermerwe and Chadwick (1989) introduce a construct that describes services in terms of the degree of customer/producer interaction and the elative involvement of goods (see Figure 2). They argue that even though traditionally sector 4 services and banking services tend to internationalise via outward FDI, including mergers and acquisitions, the development of modern telecommunication services and the

Internet increases the possibility to export these services from the domestic market (Vandermerwe and Chadwick, 1989). The evidence presented suggests that internationalising service companies often leapfrog to high commitment market entry modes (like FDI) at a very early stage of internationalisation.

Figure 2: Six sector service matrixes (source: Vandermerwe and Chadwick, 1989)

	The degree of customer/producer interaction *Lower*	*Higher*
'Pure' services low on goods	**Sector 1** Domestic mail delivery, Knife sharpening	**Sector 4** Engineering Consulting Management, Advertising Education, Insurance Medicine
Services with some goods or delivered through goods	**Sector 2** Retailing Couriers, Fast-food Hotels, Shipping Air Freight	**Sector 5** Banking Personnel Air Travel Maintenance
Services embodied in goods	**Sector 3** Music/Compact Disks, Software/Diskettes, Movies/Videocassettes, Training/Books, Journals On-line, News Services	**Sector 6** Teleshopping, Electronic mail

The internationalisation of service companies could also be driven by following the expansion of their client companies (Terpstra and Yu, 1988; Hellman 1996). For example, the foreign expansion of banks and insurance companies is often related to their willingness to continue the relationship with their major clients by extending the service offering to the manufacturing companies' target market. The service company's foreign expansion is also influenced by consumer ethnocentrism (Ruyter *et al.*, 1998). From one viewpoint, ethnocentric customers in the target market might reduce the prospects for rapid internationalisation, but on the other hand, companies should make investments into domestication of their services according to the local business customs. Björkman and Kock (1997) in their turn discuss inward internationalisation in services. In order to illustrate their arguments, they look at services to incoming tourists as inward operations where clients are imported to the service.

The internationalisation of the service sector in the Central and Eastern European Countries (CEECs) has been investigated by Stare (2003) whose study concludes that in terms of market dimension, CEE companies follow the traditional pattern of internationalisation described by Johanson and Vahlne (1977). However, in terms of entry mode it is shown that leapfrogging to FDI methods is very common among CEE service companies, while their foreign expansion is predominantly driven by market-seeking motives. The differences in the economic development of the CEECs allow companies to benefit from the international transfers of their service solutions which are more developed in comparison to other markets in the region (Stare, 2003).

To sum up, internationalisation of services depends on the exact nature of the services offered. The 'pure' services with a low or non-existent tangible aspect that need close interaction between the provider and consumer usually call for investment into a subsidiary or joint venture, unless export via the internet and other e-channels becomes a viable option. Service internationalisation is likely to be driven by 'customer following' policies, while ethnocentric target market consumers have to be accounted for as an important influence. In the next section, in order to highlight the alternatives for inward-outward connections, we will address the issues of gathering experience and distribution of power between the foreign owner and its internationalising subsidiary.

When does a foreign subsidiary deserve a strategic mandate?

There are two focal types of experiential knowledge in the internationalisation process: market-specific experiential knowledge and internationalisation knowledge (Eriksson *et. al.*, 1997). Market-specific knowledge consists of foreign business knowledge described as the experiential knowledge of clients, the market, and competitors, and foreign institutional knowledge that refers to the experiential knowledge of the government, institutional framework, rules, norms, and values (Eriksson *et al.*, 1997 p.343). The knowledge of the firm's capability and resources to engage in international operations is, on the other hand, labelled as internationalisation knowledge (Ibid., p. 343). The distribution of power and autonomy between a foreign owner and its subsidiaries depends on where these types of knowledge are stored. Before looking at this issue in greater detail, a short overview of the discourse about subsidiary roles is appropriate.

Due to an increased need for integration of subsidiaries brought on by globalisation, the role of subsidiaries is changing towards specialisation. Some units assume the coordinating functions of (regional) headquarters, while others constitute arms-length operations. Several authors discuss these changes in the strategic role of subsidiaries in the light of growth in lateral relations (White and Poynter, 1984; Bartlett and Ghoshal 1986; Martinez and Jarillo, 1991; Gupta and Govindarajan, 1991;Roth and Morrison, 1992; Birkinshaw and Morrison, 1995; Taggart, 1997; Hood and Taggart 1999).

One of the earliest approaches defined a marketing satellite, 'miniature replica', rationalised manufacturer, product specialist, and strategic independent types of subsidiaries (White and Poynter, 1984). A 'miniature replica' is a unit that duplicates the layout of the headquarters, while the strategically independent position is most beneficial to successful internationalisation of the subsidiary. Bartlett and Ghoshal (1986) divide subsidiaries into four categories: implementer, contributor, strategic leader, and 'black hole'. Martinez and Jarillo (1991) define subsidiaries as autonomous, receptive, or active. According to that classification, an active subsidiary is most integrated into strategic decision making, while a receptive unit is likely to perform only certain supporting tasks. The strategic roles connected with information flows to and from subsidiaries are: local innovator (low inflow/low outflow), local implementer (high inflow/low outflow), global innovator (low inflow/high outflow), and integrated player (high inflow/high outflow) (Gupta and Govindarajan, 1991). The features of the last strategic position are most characteristic of the inward-outward pattern of activities that would facilitate subsidiaries' international involvement.

James Taggart has given several names to subsidiaries: partner, militant, collaborator, vassal (Taggart, 1997; empirically in Hood and Taggart, 1999), or autarchic subsidiary for a country-centred corporate strategy, confederate subsidiary for cases of high FDI with extensive coordination, strategic auxiliary for pure global strategy, and detached subsidiary for country-centred corporate strategy (Taggart, 1998). Roth, Morrison, and Birkinshaw discuss the idea of the subsidiary with a global or world mandate (Roth and Morrison, 1992; Birkinshaw and Morrison, 1995). This subsidiary is comparable to former regional headquarters because it controls and coordinates several business functions in subordinated subsidiaries. The classifications of foreign subsidiaries are summarised in Table 2.

Table 2: Strategic roles of subsidiaries

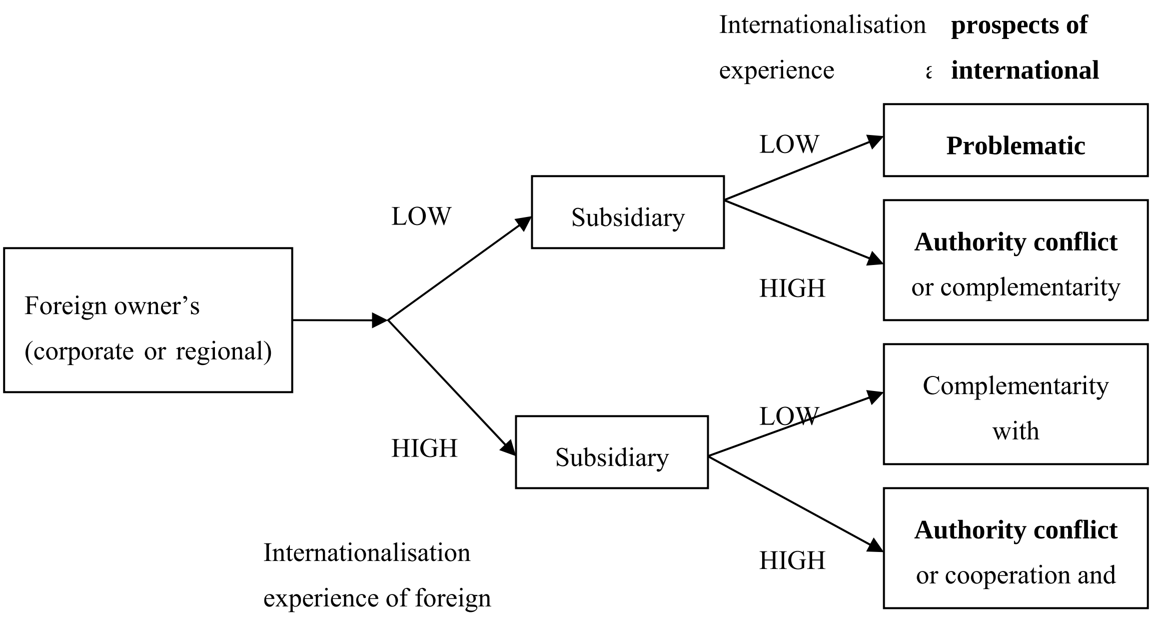
AUTHORS:	STRATEGIC SUBSIDIARY TYPES:
White and Poynter (1984)	'miniature replica', rationalised manufacturer, product specialist, strategic independent
Bartlett and Ghoshal (1986)	implementer, contributor, strategic leader, 'black hole'
Martinez and Jarillo (1991)	autonomous, receptive, active
Gupta and Govindarajan (1991)	local innovator, local implementer, global innovator, integrated player
Roth and Morrison (1992)	integrated, global subsidiary mandate
Birkinshaw and Morrison (1995)	local implementer, specialised contributor, world mandate
Taggart (1997)	partner, militant, collaborator, vassal
Taggart (1998)	autarchic subsidiary, confederate subsidiary, strategic auxiliary, detached subsidiary

Sources: White and Poynter, 1984; Bartlett and Ghoshal 1986; Martinez and Jarillo, 1991; Gupta and Govindarajan, 1991;Roth and Morrison, 1992; Birkinshaw and Morrison, 1995; Taggart, 1997; Taggart, 1998.

The types given in bold are to be considered as the most important ones in relation to inward-outward connections, or from the subsidiary's foreign expansion perspective, because these are the types that give them the highest authority and control over their foreign activities. Gupta and Govindarajan (1991) argue that an increased strategic role of subsidiaries, and accordingly of their managers, is related to their grown responsibility in the integrated value chain. Thus, they needed to have equal authority that would match their responsibility. This increase in subsidiary responsibilities is closely related to the fact that experiential knowledge is often accumulated locally rather than centrally from the foreign owner's headquarters. Andersson (2003) points out that in assigning subsidiary roles; their external network connections with target market partners have to be taken into account as potential facilitators of corporate development. Jakobsen and Rusten (2003) found that subsidiaries with a high degree of autonomy are more involved in cooperation with other firms in the region than their lower autonomy counterparts. These results indicate that a subsidiary's retained autonomy is especially important if multi-domestication is strategically a better policy than aiming for global coordination.

We have shown that in the case of services, close customer/producer interaction is often needed. This specific aspect of services calls for local rather than central accumulation of experiential knowledge. However, if only market-specific knowledge is disseminated predominantly at subsidiary level, the subsidiary could still function only as a marketing extension (local implementer). A more profound strategic authority should rely upon experiential knowledge that also includes internationalisation knowledge which is superior to that possessed by the foreign owner. Figure 3 depicts the relationship between experience allocation and prospects for inward-outward international development.

Figure 3: Internationalisation prospects of inward-outward connections



As could be seen above, internationalisation prospects do not depend on the parties' internationalisation experience alone. Equally important is the recognition and acknowledgement of differences in their competence. If a foreign owner ignores the experience level of its subsidiary and leaves it without appropriate autonomy, then the authority conflict between the owner and its subsidiary will hamper the internationalisation process. Distribution of authority is likewise difficult in such situations where both levels are experienced and highly competent. However, if conflicts are avoided, these situations are far less problematic than the lack of experience at any level. Indeed, if an experienced foreign investor acquires a company that is experienced in the region, considerable synergies may emerge and lead to a rapid growth.

Thus, a subsidiary deserves an extensive strategic mandate if its experiential knowledge is either complementary or superior to the experience of its foreign owner. On the basis of this theoretical background we will now analyse two cases of Estonian banks. Both companies can be described by extensive inward-outward connections with their Swedish owner companies on the inward side and nearby Baltic markets on the outward side. Yet their development paths have been very different.

The roles of Estonian banks as corporate subsidiaries

Case 1: The Hansabank Group and FöreningsSparbanken (Swedbank)

A short history of Hansapank and its internationalisation experience

In June 1991 Hansapank was founded by a group of 9 founders as a branch of Tartu Kommertspank. At the beginning of 1992, it started independent operations. The financial crisis in Estonia in 1992 consolidated the country's banking industry and Hansapank emerged from it with much stronger positions than it had had before. In summer 1993 Hansa Capital was founded. In August 1994 Hansapank issued its first international shares. Between 1992 and 1994 Hansapank rapidly increased its list of provided services. In 1992 it started with retail banking, but the subsequent years added leasing and forward transactions, telebanking, SWIFT connection, overnight deposit facility, factoring, and future trading. In 1995 Eurocard/Mastercard was launched, and major developments in computer software were made. All these steps were necessary in order to create specialised know-how — a precondition for expansion to foreign markets. (Hansabank Group. About…, 2005)

In the internationalisation process Hansapank used three strategies:

1. setting up subsidiaries and branches (greenfield);
2. buying up local banks (complete takeover)
3. acquiring significant stakes in some local banks.

Internationalisation started with small investments into a representative office in Latvia and the establishment of leasing and life insurance providing firms. In June 1996 Hansapank entered the next stage of internationalisation by acquiring 100% of Deutsche-Lettische Bank in Latvia, which had defaulted. The former name of the bank was changed into Hansabank-Latvija, the shares of the former shareholders were exchanged for the shares of Hansapank, and the management of the subsidiary was replaced. Owing to its good reputation, Hansapank helped restore the weakened credibility of the Latvian banks and in the second half of 1997 Hansabank-Latvija was already showing a profit. Later on its name was changed to Hansabanka and the bank started to grow rapidly. (Hansabank Group. About…, 2005)

In July 1998 further expansion of Hansapank occurred inside Estonia by merging with Hoiupank. As a consequence, Hansapank got a subsidiary in Latvia — Zemes banka, which merged with Hansabank-Latvia in 1998.

The Asian and Russian crises caused significant changes in the global financial markets towards a much more conservative approach. Estonian banks seriously suffered from the squeeze. The changes on the global scene combined with the quick internationalisation and acquisition of Hoiupank in Estonia created financial difficulties for Hansapank. Already in 1997 Swedbank had purchased a minority share in Hoiupank. Now they took advantage of the opportunity and in 1998 they were able to acquire without resistance a significant part of Hansapank's share capital. Since August 1998, Hansapank has had FöreningsSparbanken AB (Swedbank) as a strategic partner , who holds 60.1% of Hansapank's share capital.(Ibid.)

The financial strengthening allowed Hansapank to continue the internationalisation process. It resumed its efforts to establish a subsidiary in Lithuania despite the failure of the first two. On 7 July 1999 Hansabankas Lithuania opened its doors to the clients in Vilnius as typical greenfield investment. The subsidiary had only 200 clients but it expected to seize 5% of the Lithuanian banking sector in the next three years. In reality the year 2001 marked the beginning of Hansapank's rapid expansion on the Lithuanian market. In addition to strong organic growth, the Hansabank Group also completed the acquisition of the largest retail bank in Lithuania, Lietuvos Taupomasis Bankas (LTB), after a long privatisation process. Hansapank paid € 43 million for its holding of 99.3% of the share capital of LTB. This acquisition significantly strengthened its position both in Lithuania and at the whole Baltic market. Therefore the market share of the Hansabank Group in Lithuania comprising two banks - LTB and Hansabankas - increased by over 32 % its total assets, 36 % deposits and 48 % personal deposits. With this transaction Hansapank doubled its customer base and workforce — at the end of 2001 the Group had over 2.7 million customers. (Ibid.)

Meanwhile also further expansion of the Latvian market was executed. In the year 2000 Hansabanka, Hansapank's subsidiary in Latvia, merged with the Ventspils United Baltic Bank (VABB). This deal strengthened the positions of the Hansabank Group in one of the most developed regions of Latvia — Ventspils —, which has one of the biggest harbours in the Baltic Sea region concentrating on the transit of Russian oil products.

As a result of active internationalisation, the Hansabank Group has established itself as the largest financial institution in the Baltic countries, serving 3.5 million customers, its total assets exceeding 5.7 billion EUR and shareholders' equity being over 0.6 billion EUR. It has 565 branches and over 6,000 employees. At the end of 2001, Hansapank was ranked 16th among the 100 top banks of the Central European transition countries by The Banker, the

British agency of banking information (see Table 3). The position of the Hansabank Group is much better than that of Estonia's second biggest, Eesti Ühispank , (rank 45) or of Parex Bank in Latvia (rank 47) (The Banker, 2004).

A short history of Sparbanken (Swedbank) and its internationalisation experience

Sparbanken Sverige was the result of the mergers of 500 savings banks over the period 1820-1995. Föreningsbanken (Agricultural Bank) was the result of mergers of over 50 cooperative banks between 1915-1994. In 1997 these two conglomerates merged into FöreningsSparbanken, which is also known by the name Swedbank. Until the merger, the bank had had no experience in serving multinational customers. After the merger, its strategy changed and it started to internationalise, entering into strategic alliances with strategic partners in different Nordic and Baltic countries. Strategic alliances are typically followed by the acquisition of interests in the allied banks (see Lönnborg, 2003).

Table 3: Baltic banks in the list of Top 100 Central European banks by The Bankers

Position in The Banker's Ranking		Bank	Country	Size of assets	Sound-ness (capital/ assets)	Pre-tax profit	Return on assets
Latest 2001	Previous 1999			$ m	latest %	$ m	%
16	16	Hansapank	Estonia	4071	9.6	99	2.43
45	33	Eesti Ühispank	Estonia	1016	9.22	9	0.9
47	58	Parex Bank	Latvia	898	8.53	21	1.99
52	53	Latvijas Unibanka	Latvia	927	7.56	24	2.56
58	60	Vilniaus Bankas	Lithuania	1550	6.27	24	1.56
78	77	Bankas Snoras	Lithuania	222	18.17	1	0.57
95	89	Lietuvos Zemes Bankas	Lithuania	474	6.5	4	0.82

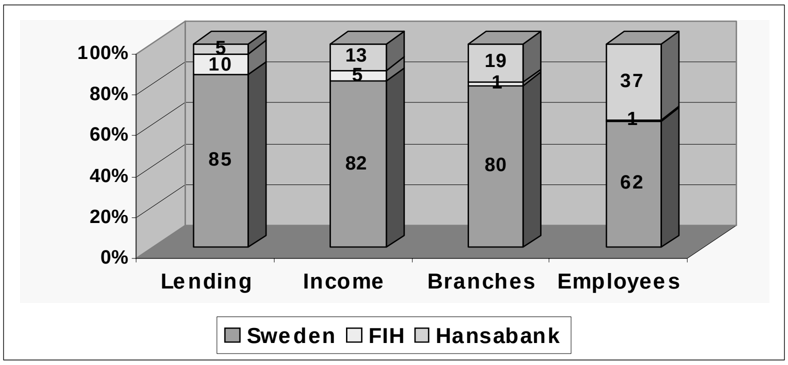
Source:http://www.thebanker.com/news/categoryfront.php/id/289/Top_100_CEE_Banks.html

The first entries of Swedbank abroad were in 1997, when they acquired around two fifths of Eesti Hoiupank and around 6 % of Polish Bank Handlowy. In 1998, Hansapank and Hoiupank merged and Swedbank obtained 7 % of the shares of the new Hansapank. By the end of 1998, Swedbank had gradually increased its share in Hansapank to 55 per cent. But it was still hesitant about keeping such high stakes and planned to reduce its share to 30 % by selling part of its shares to its strategic partner Polish Bank Handlowy. However, in 1999

Swedbank decided to remain the majority owner of Hansapank, gave up its partnership with Bank Handlowy and obtained their share in Hansapank. In 2000, Swedbank sold its shares of Bank Handlowy to US Citibank. With these steps it finalised its strong commitment to Hansapank.

In the late 1990s and early 2000, Swedbank developed itself as a regional bank, concentrating its business into Scandinavia and the Baltic countries. In 1999, it bought a majority in Denmark's FIH bank and established a strategic alliance with SpareBank 1 Gruppen in Norway. By the end of third quarter 2004, Swedbank had 1427 branch offices around Sweden, Denmark, Norway, Finland and the Baltic States. The Group had then a staff of about 15,289, of which 9191 working in Sweden (FöreningsSparbanken. Facts…, 2005). The speed of internationalisation of Swedbank is vividly illustrated by the fact that in early 1998 almost 99% of its employees worked in Sweden. The Group's total assets amounted to 1,241 billion SEK and it had around 11.8 million customers (Ibid.). But Figure 4 reveals that in 2002 Swedbank's lending activities were still very much concentrated into Sweden (85 % of the total). 80% of the branches and income were also Sweden-based.

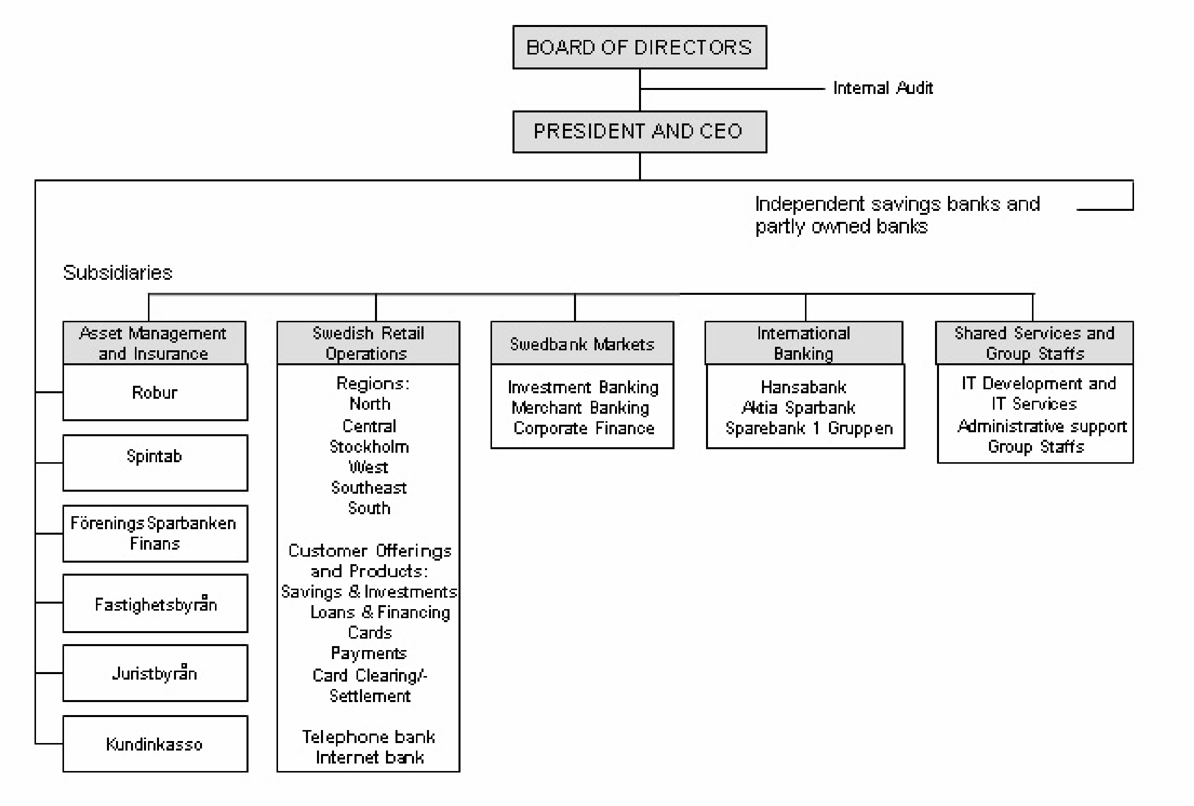
Figure 4: The role of international divisions in Sparbanken (% of total, end of 2002) (source: based on FöreningsSparbanken Homepage)



The position of the Hansabank Group in the organisational structure of the Swedbank Group

As mentioned above, Swedbank expanded abroad by using strategic alliances in combination with acquisition of shares in key banks as a way of establishing a regional platform (Lönnborg, 2003). In 1998, when Swedbank became interested in establishing a strategic alliance with Hansapank, the latter had already begun to expand into Latvia and Lithuania. Therefore Swedbank decided to use the expertise collected by Hansapank in these markets and exploit the existing network of Hansapank (the Hansabank Group) in order to enter all three Baltic countries. This approach was clearly reflected in the future role of the Hansabank Group in the organisational structure of Swedbank (see Figure 5 below). The Hansabank Group belongs to the international banking division alongside Danish, Norwegian and Finnish banks.

Figure 5: Swedbank ‘s organisational structure (FöreningsSparbanken. Facts…, 2005)



Swedbank has given to the Hansabank Group great autonomy with regard to their activities in the Baltics. This is also reflected in the mission of the Hansabank Group as the leading financial institution in the Baltics (Hansabank Group. About… 2005). This clearly indicates the international dimension of the Hansabank Group’s activities. The pan-Baltic approach is also stressed in the main future tasks of the group, which emphasise the need to introduce pan-Baltic employee development and exchange programmes: “In order to become a truly international company, with know-how exchange and career opportunities throughout the Baltic countries, a systematic incentive exchange programme has to be developed. For the same purposes, opportunities should be developed to work within Swedbank” (Hansabank Group. Management Principles, 2004). The cooperation and exchange of know-how programme within the Group and with Swedbank is written in the form indicating that the Hansabank Group is highly independent of Swedbank.

Results of the Hansabank Group

By now Hansapank has developed into a universal bank, which provides its clients with a wide range of services ranging from retail banking and corporate financing to life insurance, leasing and investment banking. The Hansabank Group's operations are divided into the following business units:

1. banking in Estonia (Hansapank);
2. banking in Latvia (Hansabanka);

3. banking in Lithuania (Hansabankas) and Lietuvos Tautomasis Bankas
4. pan-Baltic leasing and factoring (Hansa Capital);
5. corporate and investment banking (Hansabank Markets)
6. life insurance (Hansapanga Kindlustus)
7. investment management (Hansa Assets Management).

Starting from 2003, the Group also provides assets-based financing to companies in the Russian transport sector (railway and ports).

Hansapank operates as the largest bank in Estonia and as the second largest commercial bank (by deposits) in Latvia. In Lithuania, after the acquisition of Lietuvos Tautomasis Bankas , Hansapank also became the second largest bank. From the total Baltic market, the Hansabank Group now owns 31 % of deposits and 31 % of loans including leasing (see Table 4). Among the business units, the most rapidly growing one is the leasing and factoring unit, the Hansa Capital Group, which is a strong market leader in all the three countries with an estimated market share of 40%. Hansabank Markets, the corporate and investment banking division of Hansapank, covers the financial markets of all the Baltic countries, providing a wide range of investment banking products.

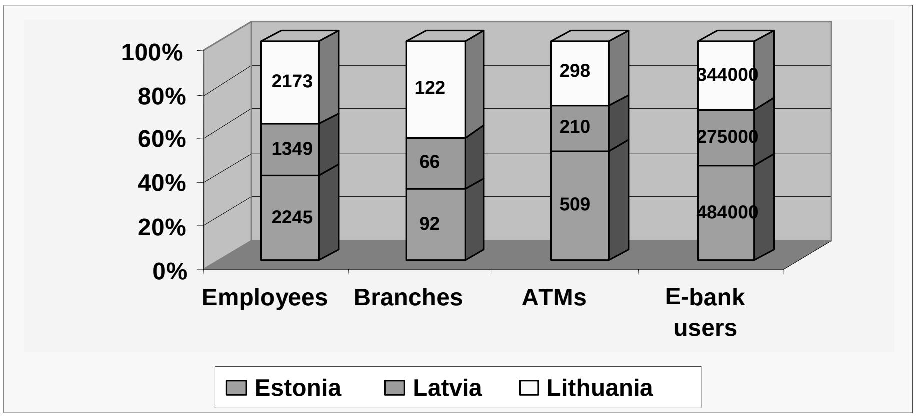
Table 4: Market share of the Hansabank Group in the Baltics by the end of June 2004(%)

	Deposits	Loans with leasing
Hansabank Group	31	31
SEB	22	30
Others	47	39

Source: Hansabank Group. Corporate…, 2004.

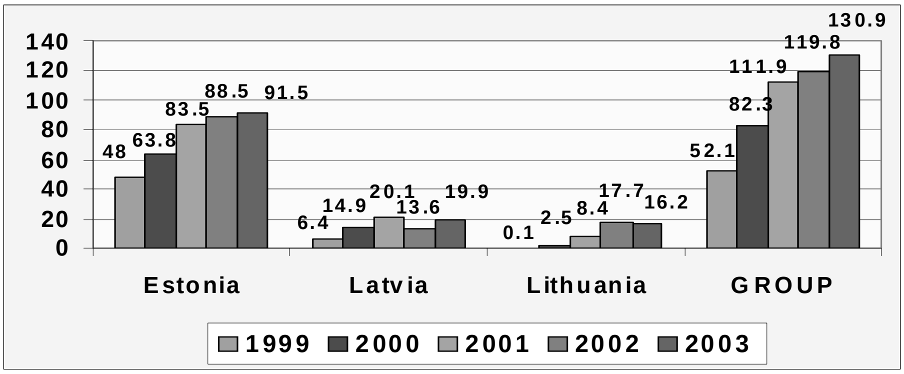
By now the Hansabank Group has increasingly become an international company, the last shift having been the acquisition of LTB. This is also shown below by Figure 6 illustrating the geographical distribution of employees, branches, ATMs and e-bank users of the Hansabank Group among the three Baltic countries. The dominating role of Estonia is disappearing and the distribution is more in line with the size of the markets.

Figure 6: Geographical distribution of some key indicators about the Hansabank Group's activities in the Baltic countries in Dec.2003 (source: Hansabank Group. Annual report, 2003)



The internationalisation of the Hansabank Group has also been associated with the permanent increase in profitability. The geographical distribution of its net profit is illustrated by Figure 7. Within the period 1999-2003, the Group's annual total net profit increased from 52 to 131 mill. EUR. The role of Latvia and Lithuania in the profit making has improved and the last results indicated that in the first half of 2004 the Lithuanian subsidiary of Hansapank produced 15.3 mill. EUR net profit, which was 94 % of their total profit last year. (Hansabank Group. Online News, 2004).

Figure 7: Geographical distribution of net profit in million EUR produced by the Hansabank Group 1999-2003 (source: Hansabank Group. Annual report, 2003)



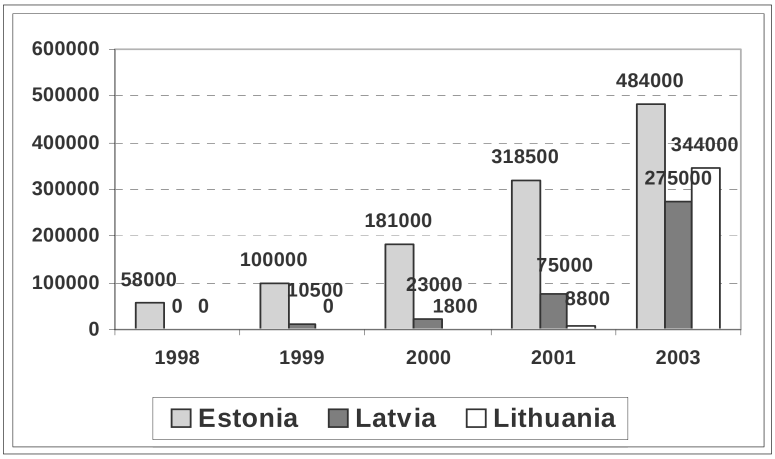
The Development of Hansapank's Internationalisation capabilities

The takeovers of Deutsche-Lettische Bank in Latvia in 1996 and Lietuvos Taupomasis Bankas in 2001 in Lithuania provided valuable internationalisation experience to the key personnel of Hansapank. An especially demanding task was the reorganisation of Lietuvos Taupomasis Bankas, a former state-owned inefficiently managed bank with an extremely poorly developed IT department. In order to complete this ambitious task and reorganise the bank within 24 months the Hansabank Group assembled an integration team comprising the Group's employees who worked permanently in Lithuania and could transfer the experience gained from similar mergers in Estonia and Latvia. The most important task of the integration team was to replace the outdated IT system, unify LTB's and Hansabankas' organisations and create an organisation based on Hansapank's core values and culture, outsourcing of non-core activities as well as reorganisation of the risk management function. Here it was clearly seen that Hansapank transferred its own values and not the values of Swedbank. The main role of Swedbank as the strategic owner of Hansapank only consisted in giving better negotiating powers to the Estonian bankers when finalising the acquisition with the Lithuanian Government.

Having become a truly international bank, Hansapank's managers have acknowledged the need to change their management style. They believe that through stronger management capacity and rotation they will be able to keep their main competitive advantages ─ the ability to create and implement new ideas and uphold the current dynamism. The employee rotation programmes as well as the growing internationalisation of the company have raised the cross-border information exchange to a new level. In order to exchange information and experience within the Group, retail and corporate banking committees were established. These committees have an important role in the organisation ─ to improve integration and reduce inter-country differences. (Hansabank Annual report, 2003). Certain functions have been centralised at the level of the Group, such as IT and product development, financial, risk and liquidity management, and foreign funding, which are mainly developed by the forces located in Estonia. As a result of these developments, the Estonian team of Hansapank serving the whole Group has developed capacities which allow them to accomplish rigorous tasks. For example, the Estonian IT staff of Hansapank together with their Lithuanian partners succeeded in raising the number of internet banking users in Lithuania from 8,800 in 2001 to 344, 000 by the end of 2003 (see Figure 8.).

A good indicator of sustainability of dynamism was the launching of the Russian project after the successfully accomplished takeover of Lietuvos Taupomasis Bankas. In November 2002, Hansa Capital and EBRD signed the establishment agreement of Hansa Leasing Russia, which focuses on financing the Moscow and St. Petersburg regions of the Russia-related transit sector ─ ports and the railway. Having been extremely successful and having increased their portfolio from zero to 171 million dollars within a year, the Hansabank Group decided to finance new product groups, such as real-estate and equipment. Despite the good start, however, it has now announced that it is currently neither engaged in negotiations to buy a bank, nor in the process of establishing a bank in Russia. But this may be the next logical step in their internationalisation process rather soon.

Figure 8: E-banking users of the Hansabank Group, 1998-2003 (source: Hansabank Group. Interim…, 2004)



Factors of success in the internationalisation of the Hansabank Group

What were the strengths of Hansapank creating a potential for this small Estonian greenfield bank to grow into the strongest Baltic bank? First of all, it is managers' vision and early commitment to the strategy of internationalisation. Hansapank was able to create very rapidly, within the period 1991-1996, ownership-specific assets which consisted of service-specific aspects combined with trust. Secondly, provision of banking services requires high levels of professional skills, specialised know-how, and customisation. Hansapank was able to fulfil these requirements earlier than its competitors in Latvia or Lithuania. Thirdly, the managers of Hansapank succeeded in working out strong and contemporary business culture, which helped them to build up confidence, the most needed asset in the banking sector. Fourthly, Hansapank has always been open to technological innovation. In the early 1990s it used the opportunities offered by the Internet, creating modern innovative services.

Case 2: Eesti Ühispank and the SEB Group

A short history of Eesti Ühispank and its internationalisation experience

In December 1992 ten independent landbanks merged into Eesti Ühispank. In the subsequent years, the bank developed different retail banking functions. In 1994, Ühisliising (leasing company) was opened. Since 1994 Ühispank has been the second biggest bank in Estonia after Hansapank. In 1995, Eesti Ühispank was granted the right to purchase the shares of the state-owned Põhja-Eesti Pank and the merger was accomplished in early 1997.

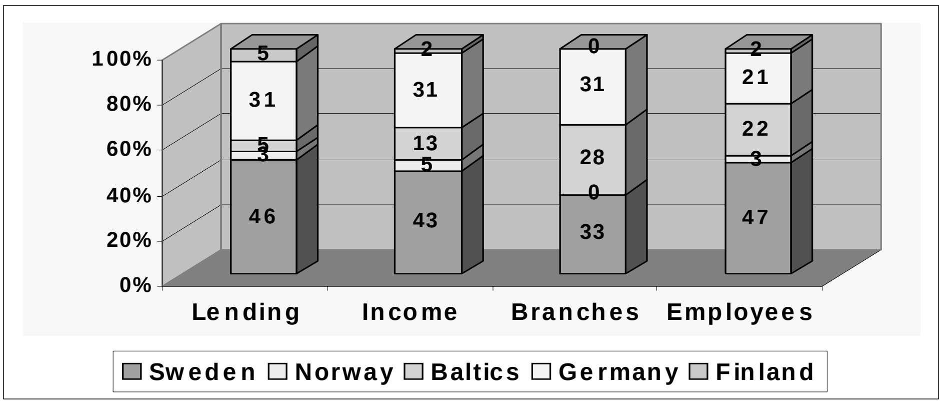
After the success of Hansapank's entry into Latvia became known, the other competing Estonian commercial banks began to make plans for buying up banks in the markets of Latvia, Lithuania, Russia and the Ukraine. Eesti Ühispank had especially far-reaching plans. In April 1997, in cooperation with Neva-Rus Ltd., they established a leasing company in St.Petersburg. In autumn 1997, the bank announced its plans to establish a subsidiary bank with total assets of 1.5 billion EEK in St. Petersburg (the total assets of Eesti Ühispank at that time were around 9.5 billion EEK). The growth of the Eesti Ühispank Group was rapid and by the end of 1997 it had become the largest bank in the Baltic States. In early 1998, the Eesti Ühispank Group merged with Tallinna Pank and as a result also obtained Saules Banka from Lithuania, which was majority-owned by Tallinna Pank. At the beginning of 1998, Eesti Ühispank was also planning to spend a billion kroons on opening a branch in Helsinki and a bank office in Stockholm. In order to expand further in all three Baltic countries, in March 1998 Eesti Ühispank, Latvijas Unibanka and Vilniaus Bankas agreed on strategic cooperation in the fields of cross-border customer service, joint investments and development projects, syndicates and interbank funding. But the plans of future cooperation and enlargement were overly ambitious as the financial situation started to worsen quickly after the Russian crisis hit in August 1998. The net profit of Eesti Ühispank in 1998 was 25 mill. EUR (see Table 5 below) and there was no sign of support from the Estonian Government. Consequently in November 1998 negotiations were started to find a strategic partner from abroad. Within three weeks, on November 26, a resolution was passed to issue the SEB Group with 15 million and the IFC (International Financial Corporation) with 7 million shares, thus strengthening the capital basis of the bank by nearly 1 bn. EEK . As a result, the net worth of Eesti Ühispank increased to 2.6 bn. EEK. The new shareholders acquired, respectively, a 34 % and a nearly 10 % stake. In the next two years SEB increased its stake and by the end of 2000 held 96.4 % of Eesti Ühispank's shares. Between 1999 and 2002, the SEB Group started to create the Baltic network of SEB subsidiaries. Further internationalisation of Ühispank was stopped and the existing network in Latvia and Lithuania was abolished. In December 1999, Eesti Ühispank sold Saules Banka, the Lithuanian banking arm. Eesti Ühisliising (a leasing company) finished its business in Latvia and Eesti Ühispank focused its activities on the home market in Estonia. (Eesti Ühispank. About…, 2005)

A short history of the SEB Group and its internationalisation experience

The history of the SEB Group goes back to 1856, when A.Wallenberg founded the first private bank in Stockholm. The bank developed quickly and already in 1936 had 15 branches and 450 employees. From the very beginning, the bank was oriented towards serving the Swedish industry and big business clients in particular. A long-standing relationship with Swedish multinationals has remained characteristic of the bank throughout its existence. Therefore the SEB Group has been involved in international business through their multinational customers for more than a hundred years. Since 1969, SEB has been operating in London, having also expanded into France, Luxembourg, Germany and other European countries. Since 1979, it has been active in Singapore, since 1982 in New York and since 1983 in Bahrain, Beijing, Hong Kong and Sydney. In order to coordinate its activities abroad, in 1982 SEB International was formed. In 1990, branches were opened in Bangkok, Berlin, Budapest, and Warsaw. (SEB. About…, 2005)

During the 1990s, SEB identified itself more clearly as a North-European financial banking group that is focused on large companies. In 1994, a branch was opened in Oslo, in 1996 in Helsinki and in 1999 the fifth biggest German bank BfG was purchased, which became SEB AG. A strong entry into the Baltic market was performed in November 1998, when SEB signed cooperation agreements with Eesti Ühispank (Estonia), Latvijas Unibank (Latvia) and Vilniaus bankas (Lithuania), and before the end of 1998 SEB had acquired a minority in all these banks (Lönnborg, 2003). In the next two years SEB acquired full control in all these companies and SEB Baltic Holding was formed. In 2000, SEB increased its share in the Polish bank BOS (Bank Ochrony Srodowiska) and Polish and Baltic operations were brought together under the Baltic and Polish division. By the end of 2004, SEB had 670 branch offices around Sweden, Germany and the Baltic States. It now operates altogether in some 20 countries around the world and has a staff of about 18,000 (SEB. About…, 2005). From the total number of employees less than a half (47 %) worked, in 2002, in Sweden, 22 % in the Baltics, 21 % in Germany and 2 % in Finland (see Figure 9).

Figure 9: The role of international divisions in the SEB Group (%, end of 2002) (source: based on SEB Homepage)



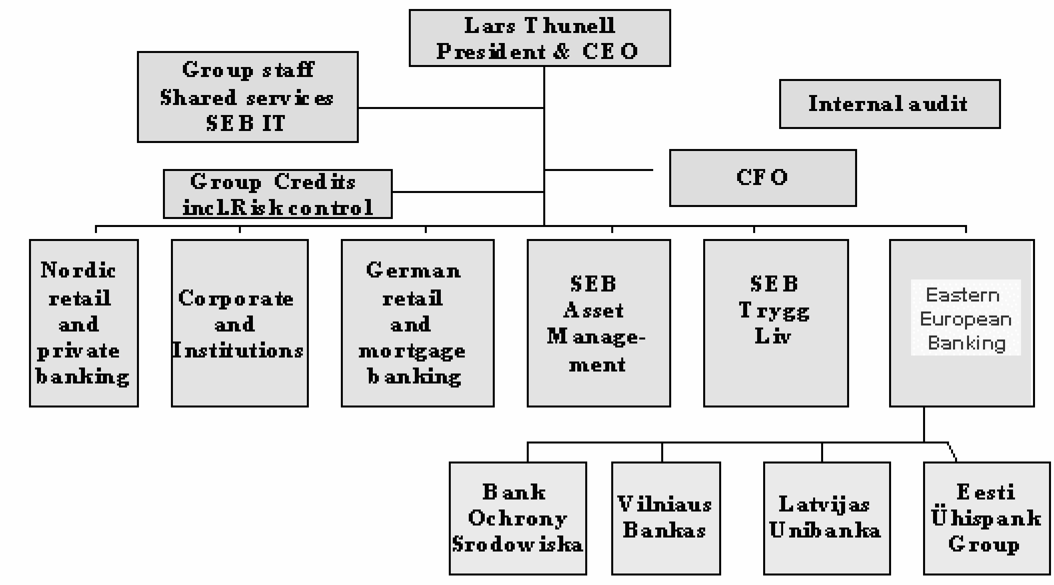
The lending portfolio is also highly international as only 46 % was in 2002 located in Sweden. The SEB Group has more than 4 million customers, 1.3 million of whom are e-banking customers (SEB. About…, 2005). On 31 December 2004, the Group's total assets amounted to 1,591 billion SEK, while its assets under management totalled 886 billion SEK. (SEB Annual report, 2004)

The position of Eesti Ühispank in the organisational structure of the SEB Group

The SEB Group entered into the Baltic market, having gained internationalisation experience in several countries. Therefore they were much more confident of their knowledge about doing business abroad and consequently took a much more centralised approach towards their subsidiaries in the Baltics. The following Figure 10 describes the role of Eesti Ühispank in the SEB Group as part of its Eastern European Banking division. As the SEB Group's entry into the Baltic market was realised through three banks ─ Eesti Ühispank (Estonia), Latvijas Unibanks (Latvia) and Vilniaus Bankas (Lithuania), the role of each individual bank was limited to their home market and the centralised functions (IT, product development, financial, risk and liquidity management) were centralised at the SEB Group level. After the latter's successful increase of its share in the Polish bank BOS (Bank Ochrony Srodowiska) in 2000, the Polish and Baltic operations were brought together under the Baltic and Polish division, which reduced the autonomy of Eesti Ühispank even more. The Chairman of the SEB Baltic and Polish Division is at the same time also Chairman of Eesti Ühispank's Supervisory Board. The relatively weak negotiating power of Eesti Ühispank is also illustrated by the fact that from 2002 to 2005 no representative from Ühispank was included among the five members of the Supervisory Board of Eesti Ühispank.

In conclusion one could say that the SEB Group has taken over the role of a strategic expansion planner and they are working hard to create a Baltic banking network, which would include all the banks in the three Baltic States controlled by SEB.

Figure 10: Organizational structure of the SEB Group (source: SEB. About…, 2005)



The Results of Eesti Ühispank

As a result of more than ten years of development, Eesti Ühispank with its total assets of around 2.2 billion and shareholders' equity of 0.24 bn. EUR (see Table 5) is the second biggest bank in the Baltics. It is a universal bank focused on the Estonian market, offering full financial services. By the end of 2004, the bank had 629, 000 customers. The number of customers of Internet banking exceeded 339, 000. At the end of 2004, Eesti Ühispank had 1,396 employees (Eesti Ühispank. Reports, 2005).

Table 5: Main financial indicators of the Eesti Ühispank Group (1998-2004)

	1998	1999	2000	2001	2002	2003	2004
Results (millions of EUR)							
Net interest income	41.5	34.7	32.7	39.9	49.7	52.3	55.8
Profit / loss before taxes	-25.2	6.5	-6.1	10.4	24.3	34.7	45.5
Efficiency							
Average return on shareholder's equity (ROE)	-29.5%	5.1%	-5.0%	8.0%	16.6%	19.7%	21.1%
Average return on assets (ROA)	-2.8%	0.6%	-0.6%	1.0%	1.9%	2.3%	2.3%
Operating cost / Total income (excl loss on securities for 1998)	65.1%	78.8%	72.6%	63.1%	55.7%	52.6%	49.8%
Balance Sheet (millions of EUR)							
Total assets	1054.5	956.7	1014.3	1148.6	1373.2	1634.7	2217.9
Shareholder's equity	122.6	129.9	123.7	134.1	158.3	193.2	238.3
Capital Ratios							
Capital adequacy	12.5%	13.4%	11.3%	13.4%	13.6%	13.6%	13.6%

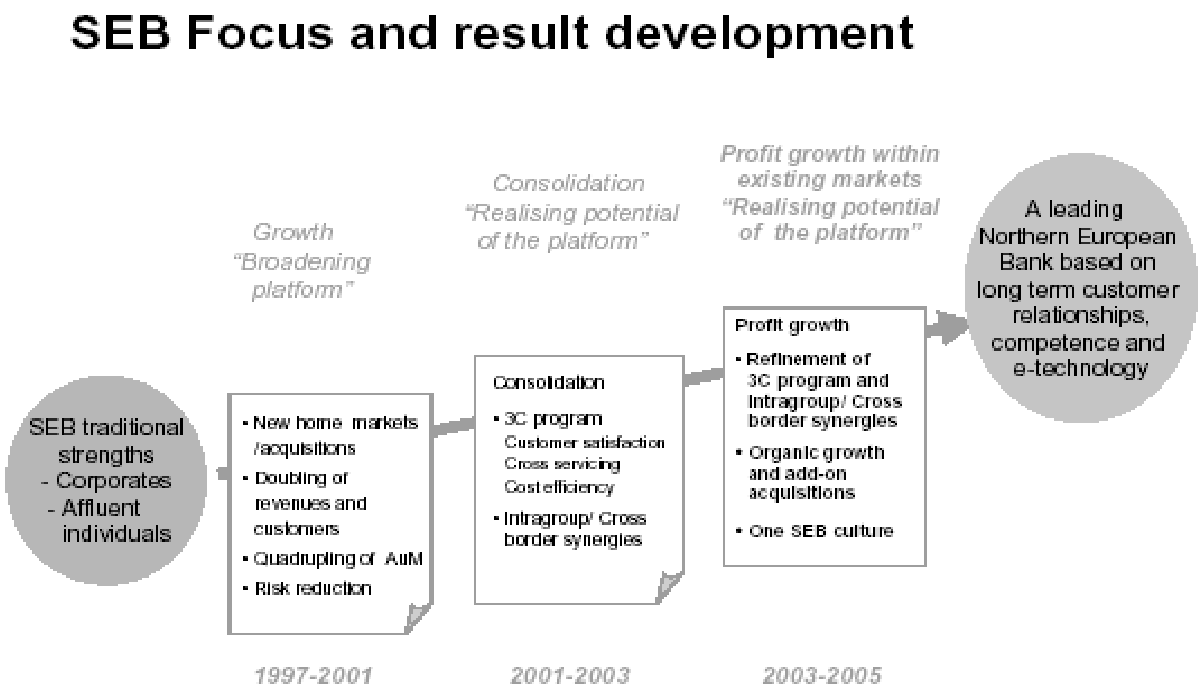
Source: Eesti Ühispank. Reports, 2005 http://www.eyp.ee/?page=130510

As a member of the SEB Group, Eesti Ühispank is a customer-driven Estonian bank. During the period of being under SEB control, the profitability of the bank improved from 25 mill. EUR loss in 1998 to 45.5 mill. EUR profit in 2004. Its return on equity (ROE) and return on assets (RAO) figures have quickly improved as well. The year 2004 was marked by further growth of net profit earned. Also in 2005, Eesti Ühispank expects the trend to continue.

Development of the internationalisation capabilities in the Eesti Ühispank Group

The entry into the Latvian market with a leasing company and also activities in Russia and Lithuania gave certain internationalisation experience to Eesti Ühispank's staff. But their commitment abroad was much smaller than had been that of Hansapank before the Swedish banks acquired the majority interest in both of them.. The SEB Group is using more defined long-range planning and adopts a more centralised way of management than Swedbank.(see Figure 11). They plan to use the synergy of the existing banks in different countries, combining it with the implementation of uniform SEB culture in order to guarantee growth of profits at the existing markets in the period 2003-2005. The ambitious task to create "one SEB" by facilitating common values means that the cooperation between local banks and parent company must intensify even more.

Figure 11: SEB's strategic planning for the period 1997-2005 (source: Thunell, 2003)



Consequently, inside the SEB Group, the Eesti Ühispank Group was given a role to grow efficiently and gain a market share in Estonia alone. Therefore its previously gained knowledge of internationalisation was irrelevant for fulfilling the new tasks. This was especially discouraging for Eesti Ühispank's leasing division and IT group, which both had strong capabilities to use their knowledge outside Estonia as well.

However, after Eesti Ühispank's financial situation stabilised by the year 2000, its autonomy was increased in the area of IT. In 2001, SEB IT Partner Estonia was established with the aim of producing solutions in this area for the whole Group. As a next step in better use of the capabilities available in Eesti Ühispank, SEB Russian Leasing also started to work more actively in 2003 with the aim of doing practically similar business to that of Hansabank's leasing company in Russia. Finally the East-European Competence Centre of Eesti Ühispank's Assets Management is planned to be launched. (Eesti Ühispank. Public Interim Report of 6 Months 2004, p.6)

Discussion and conclusions

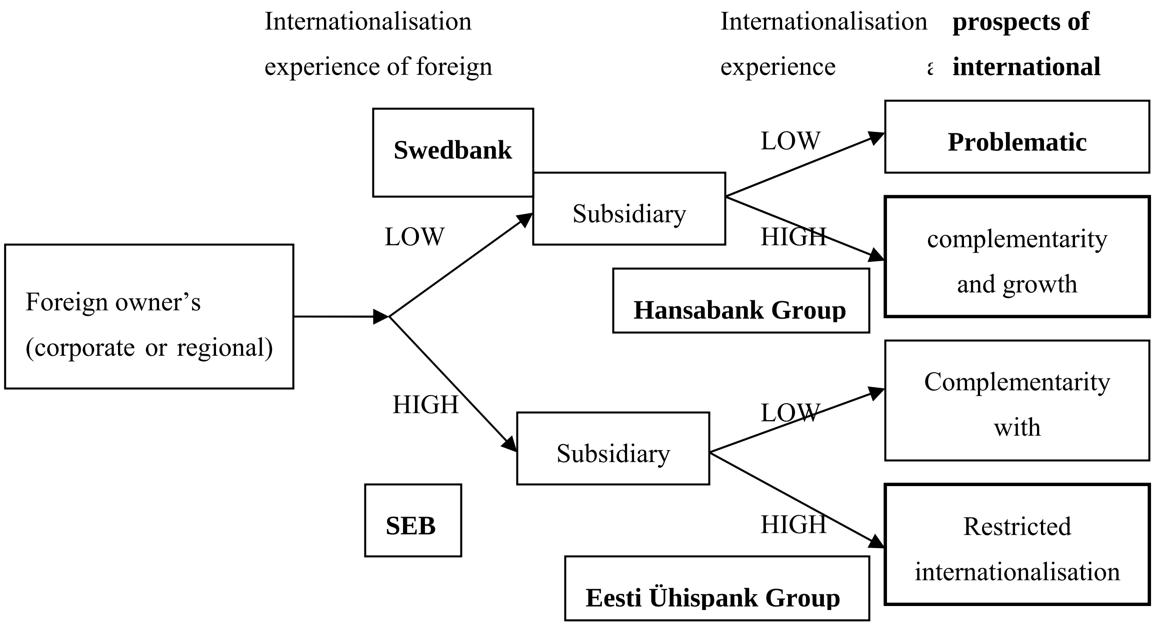
These two cases characterise two differing types of approach by Swedish banks to internationalisation in general and to their entry into the Baltic markets in particular. The first type of approach has been followed by Swedbank, the majority owner of the Hansabank Group. They have basically used a largely decentralised "hands off" approach, by which the managers in Estonia are still developing and executing their plans of expansion to foreign markets. In contrast, an alternative approach has been used by Skandinaviska Enskilda Banken (SEB), the majority owner of Eesti Ühispank. They took over the role of the strategic expansion planner and are working hard in creating a Baltic banking network, which would include all the banks in the three Baltic States that are controlled by SEB. The issue here is whether foreign firms, which could be called indirect investors, have a better competitive position by comparison to local Estonian ones. Do they have a more global perspective? Do they have more experienced managements? Do they have more flexibility in using and reallocating funds? If the answer is ”Yes”, this means that the inward flow of foreign investments will improve the competitiveness of the Estonian banking sector in other markets and will also give positive feedback to the banks in the home country. This is a really interesting interplay of the background of foreign owners.

Swedbank was not experienced in working abroad and looked at the purchase of majority stakes in Hansabank Group rather as an investment into a well working institution, which did not require outside intervention and restructuring. Therefore the local managers were given autonomy in deciding about the future internationalisation strategy as long as success continued. An opposite case is Skandinaviska Enskilda Banken, which had had copious internationalisation experience and after obtaining majority shares in Eesti Ühispank started to implement SEB’s vision of internationalisation. In the light of the theoretical framework featured by Figure 3, the cases can be interpreted as shown in Figure 12.

As a result, Hansapank enjoys a high level of autonomy at the Baltic markets, while Eesti Ühispank is far less autonomous. It must be mentioned, however, that the Estonian subsidiary has assumed the role of a specialised contributor in the fields of IT services and investments to the CIS markets. Given that in 1998 the starting positions of the two Estonian banks were quite similar, it is obvious that power distribution has been determined by the international experience of foreign owners rather than by the experience of the subsidiary.

The inward-outward connections in the internationalisation of financial service companies are mostly reflected in the autonomy of the host country subsidiary to make its internationalisation decisions. In some cases, the foreign owner is likely to restrict that freedom and pre-determine the nature of indirect FDI, while in other situations the complementarities are realised by retaining the strategic autonomy of the acquired company. The scenario implemented depends on the capabilities of the parties, especially on their internationalisation experience. If the corporate headquarters are less experienced than the subsidiary, then the latter is likely to remain highly autonomous.

Figure 12: Inward-outward connections of Hansabank Group and Eesti Ühispank Group



Estonian banks started internationalisation at their neighbouring markets –Latvia, Lithuania, Russia, benefiting from their competence obtained from the domestic market and the weak competition at host markets. The Asian crisis followed by the Russian crisis and the stock exchange crisis in Estonia forced Estonian banks to find strategic investors from abroad. The entry of Swedish banks had a different impact on the internationalisation of two leading banks of Estonia. In case of Hansapank inward-outward connections mean that they started to control FöreningsSparbanken's activities in the Baltics. Inward-outward connections in case of Eesti Ühispank, on the other hand, mean that they lost all their activities in the other two Baltic countries and have to a great extent been pushed back to domestic activities. These differences in strategies between the Swedish banks could be explained by the historical background of these companies, which led to their different internationalisation experience and different strategic goals reflected in their organisational structure.

The current study has several limitations. The inward-outward pattern described may be somewhat market-specific. Therefore further comparative studies are needed in order to control the framework shown in Figure 3 in different settings. It is also industry-specific, because banking services are in many respects different from manufacturing operations or traditional services. Nevertheless, case studies are good for gathering exploratory insights into the research issue, while the methodological and data triangulation helps build a more rigorous understanding of these inward-outward links.

The most important implications of this research to international business theory are related to the experience allocation framework presented in Figure 3. This framework additionally introduces possible outcomes of different patterns of experience distribution between the headquarters and the host-country subsidiary. In terms of management practice, our research points to the need to monitor history, and especially the curricula of strategic choices made by a potential foreign investor, in order to successfully predict the chances for autonomy. It is equally important to build up international experience prior to becoming an FDI recipient. In the light of a host country's economic policy, it would be more beneficial to support foreign acquisitions by companies whose strategic posture favours the use of quasi-autonomous subsidiaries and loosely integrated business models. However, in this case there are likely to be certain trade-offs between the strategic freedom of foreign-owned local companies and the technological and knowledge transfers received in support of outward internationalisation.

Further research should concentrate on finding more elaborate survey evidence of similar inward-outward connections and investigate more traditional (service) industries. In widening Europe these connections have very important integrative influence on the knowledge transfers between old and new member countries. After fifteen years, in 2020, these connections will probably have much more elaborate forms in shaping the role distribution not only within multinational companies, but within the entire European region. Therefore, inward-outward linkages should also be researched as regional development phenomenon.

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DEVELOPMENTS IN THE TRANSPORT SECTOR OF THE BALTIC STATES

Lauri Ojala, Cesar Queiroz and Tapio Naula

Abstract

EU accession had a significant impact on day-to-day trade practices of the new member countries. This was the case especially in trade with other EU countries, as the previous customs borders vanished overnight. Simultaneously, the previous trade regimes with non-EU countries, notably those with Russia, USA and East Asia were replaced by the EU regime.

While customs practices had to be switched in one day, EU membership did not dramatically change the new members' trade or Foreign Direct Investment (FDI) patterns because they had integrated to the world economy already during the past five to ten years.

After joining the EU Customs union, many customs, customs brokers and freight forwarding staff have become redundant. Very few problems with trade and border crossing practices in intra-EU trade were reported in Estonia, Lithuania, but more so in Latvia.

In an international comparison, the restructuring of the transport sector that has taken place in the Baltic States since these countries regained their independence in 1991 has been remarkable, and overall, highly successful.

Among the notable recent trends in the Baltic States is the rapid increase of demand for transport, which has grown at a rate higher than that of the gross national product. Each of the Baltic States has experienced substantial growth in the volume of merchandise exports and imports. This trend is partly a reflection of the rapid growth of transit traffic.

Keywords: Transport, Logistics, EU Accession, Trade facilitation

The Logistical Impact of EU Enlargement

The first Chapter outlines the broader picture of the impact EU membership has brought about to new Member States. In subsequent Chapters, this picture is narrowed down to the three Baltics States transport sector based on the latest information available.

On May 1, 2004 ten new countries joined the European Union, increasing EU's population by 17 %. Subsequently, EU's Gross Domestic Product grew 8 % at Purchasing Power Parity basis but only 4 % at market rates. Looking from the macro economic perspective, the "old" EU 15 had no difficulty absorbing the "new" EU 10.

First, accession had a significant impact on day-to-day trade practices of the new member countries. This was the case especially in trade with other EU countries, as the previous customs borders vanished overnight. Simultaneously, the previous trade regimes with non-EU countries, notably those with Russia, USA and East Asia were replaced by the EU regime.

Second, while customs practices had to be switched in one day, EU membership did not dramatically change the new members' trade or Foreign Direct Investment (FDI) patterns. This is because the acceding countries – generally speaking - had rapidly integrated to the world economy already during the past five to ten years.

Third, after joining the EU Customs union, many customs, customs brokers and freight forwarding staff have become redundant. Morale and motivation in these activities was often low in accession countries, and persistent borders crossing delays affected the EU trade in late 2003. However, very few problems with trade and border crossing practices in intra-EU trade were reported in Estonia, Lithuania, Hungary, Czech Republic and Slovenia after May 1, 2004.

New Member States have experienced substantial growth in the volume of merchandise exports and imports. For Hungary, Czech Republic, Slovenia and Poland this reflects the rapid opening of the markets and substantial FDI, while for the Baltic States this trend is partly a reflection of the rapid growth of transit traffic.

The new Member States' foreign trade generally shifted toward the EU during the 1990s. Roughly 70 percent of foreign trade in Hungary, Czech Republic and Estonia was with the 15 EU countries in 2002. The corresponding figure for Latvia, for example, is 60 percent and for Lithuania it is 50 percent.

The relative share of trade with Russia has declined, while its absolute volume has increased. While the overwhelming part of new Member States' trade is directed towards the EU, the trade with the non-EU countries still remains an area of potential source of prosperity for these countries.

Poland and the Baltic States, with substantial (transit) trade with Russia, experienced considerable trade, transport and border crossing problems with Russia, and with some other CIS countries. These problems tend to have a political background, and as a rule, solutions require negotiations between the EU and Russia. Fundamental solutions are also beyond the means of national Governments or their transport and trade authorities.

Transport demand grows rapidly

In 2002, up to 15.5 % of the Gross Value Added (GVA) in the Baltic States was produced in the transport, storage and communications sector, whereas the figure is below 10 % for other EU countries (see Table 1.). Typically about 35% of the sector's GVA is produced in transport, 35% in storage and the remaining 30% by communications. In other words, transport and storage contributed 10% to 11% of the Baltic States' GDP and approximately 5 to 6 % of the Polish, Hungarian and Czech GDP in 2002.

Table 1: Transport sector in selected new EU members in 2002, GDP in USD at market rates. Sources: The World Bank and national statistical offices.

	Estonia	Latvia	Lithuania	Poland	Hungary	Czech Rep.	Finland
Transport, storage & communications (% of GDP)	15.5	14.5	13.7	7.8	8.4	9.0	10.9
GDP: USD billion	6.5	8.4	13.8	189	71	69	125
Transport, storage & communications in USD million	1,000	1,200	1,900	14,800	6,000	6,300	13,600

The demand for transport grows rapidly in new Member States. There has also been increasing demand for consolidated transport related support services. Moreover, privatization has been widely used as a vehicle to restructure transport and transport infrastructure markets. Public-private partnerships have been introduced as a mechanism for providing good quality transport and infrastructure services at a reasonable cost.

Among the notable transport trends in new member states is the rapid growth of demand for transport, which grows faster than the rate of GDP. There has also been increasing demand for consolidated transport related support services. Moreover, privatization has been widely used as a vehicle to restructure transport and transport infrastructure markets. Public-private partnerships have been introduced as a mechanism for providing good quality transport and infrastructure services at a reasonable cost.

Traders' Views on EU Enlargement

A number of recent studies highlight how logistics users evaluate the logistics environment in the enlarged EU. Three of these are briefly summarized here (see also Angerer et al. 2003, Ojala 2004). The first study (AdLog) concerns international manufacturing and trading firms that have established operations in the Baltic States (Ojala and Naula 2002). The second one covers the impact of the EU enlargement on European firms' operations (Pfohl and Mayer

2004). The third section addresses consultancy reports on Regional Distribution Centers in Europe.

Findings of the AdLog study

In the early phase of market entrance international firms preferred to operate from outside the Baltic States when distributing their products to the Baltic States markets. Exporting individual shipments via customs terminals seemed to be a suitable pattern for market entry, but much less used in later business stages.

When establishing market position, some of the case firms moved slightly more into warehousing on Baltic regional and country level. In the EU time the case firms prefer direct physical distribution often directly from factories and central European warehouses. Such patterns have significantly increased in the very recent years.

Faster border crossing enabled firms to distribute from one Baltic regional stock in the mid 1990s, but customs documentation was very complicated and expensive and therefore it was little used. Customs rules in intra-EU trade reduced the steps in this process from 15 to eight.

Import cargo volumes are highly concentrated in the capital regions in Latvia and Estonia. Harju region around Tallinn is the most important cargo destination in Estonia for all the case firms (70 % on average) followed by Tartu and Parnu.

Riga's dominance is striking: roughly 80 % of the case firms' Latvian import volumes were destined here. Lithuanian volumes are distributed more evenly between Vilnius, Klaipeda and Kaunas. Their volumes average 49 %, 23 % and 18%, respectively.

The high concentration leads to inefficient domestic distribution. The case firms have typically outsourced domestic transportation to logistics service providers. These consolidate several consignments in one transportation unit. Especially in Estonia and Latvia the volumes destined outside the capitals Riga and Tallinn may not be sufficient to offer affordable and frequent distribution services.

Already prior to the EU membership, international firms tended to centralize their logistics organizations into Regional and European distribution centers (RDCs and EDCs, respectively). The motives were mostly business driven, such as altering business culture of the firms, changes in market demand and efforts to reach cost efficiency.

In mid-1990s, all business functions (sales, administration, warehousing, and logistics) were typically present locally, and often a local agent was used. This is feasible when entering a small, new market. A shift towards a more centralized organization followed. Nine out of the 15 case firms considered centralizing all functions other than operational sales outside the Baltic States in the anticipated EU time.

The development of the logistics organization was also closely linked to the distribution channel in general. In some cases a firm needed to have certain functions present locally because of a relatively fragmented customer base with large number of customers.

As reported by the level of transport and telecommunications infrastructure is no longer a hinder for logistics users. In the early 1990s the key issues in logistics was to find the access to transportation capacity and how to cope with border crossing formalities. Today, the focus is clearly on adopting efficient logistics solutions powered by reliable and high-quality IT and logistics services.

International logistics users still perceive the regulatory environment somewhat hindering logistics in Latvia and Lithuania but not in Estonia. Small and medium sized firms also see these issues more as an impediment to their business than the internationally operating ones; two thirds of the studied SMEs considered the regulatory environment still as hindering.

EU membership has facilitated logistic operations and favored firms, which are already familiar with doing business in the EU. However, EU membership substantially increased regulation and bureaucracy for domestic firms. Firms in the new Member States have typically been accustomed to very low level of regulation in, for example, social, health, safety and competition issues.

Findings of the ELA study

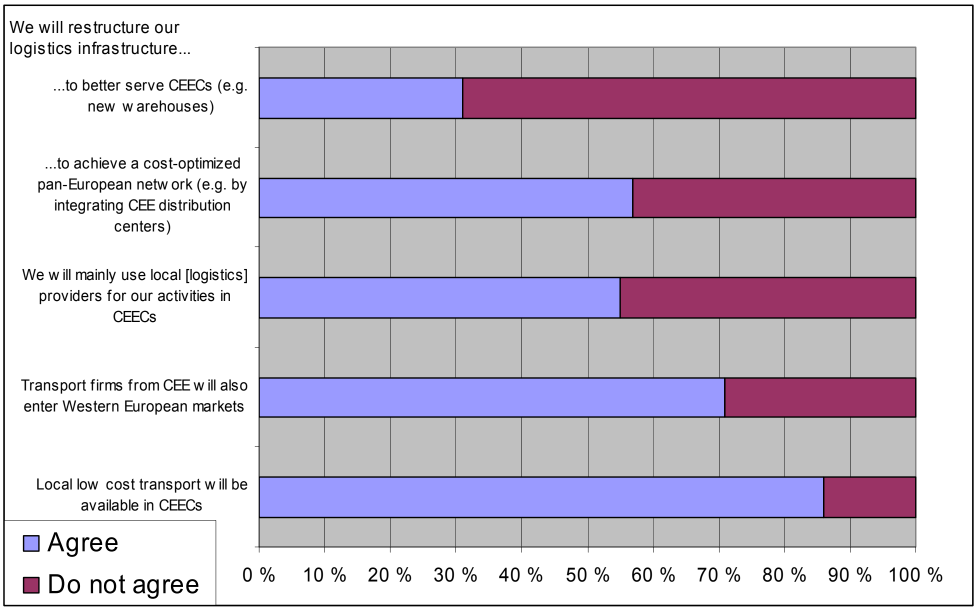
European Logistics Association (ELA) and A.T. Kearny, a consultancy, have conducted European logistics surveys every 5 years since 1982. The 2003 study by Pfohl and Mayer (2004) included a section on firms' views on EU enlargement, which is briefly summarized here. The bottom line is that the survey respondents expect little impact from the EU enlargement on their logistics. Furthermore, the potential impact of Poland, Hungary, Slovakia and the Czech Republic is far larger than that of the Baltic States. Pfohl and Mayer (2004) cite:

"…this opportunity was realized already by tier 1 suppliers, but now smaller companies and suppliers, e.g. tier 2 and 3 will go east as well…overall no big change expected."
"Transport handling and organization will be easier, and some transport price reduction is likely, but no quantum leap is expected."
"This is only of relevance to our suppliers; they have to take advantage and have to realize the effects/potential in sourcing."
"Our competition is already there."

20 % of respondents in the ELA 2003 survey had plans to significantly increase business activities in Eastern Europe within one year, and another 16 % had plans to do so in 1-3 years. 28 % had no such plans, while 36 % anticipated such a development in 3 to 5 years. ¾ of the respondents identified (i) new markets and (ii) new suppliers as the most significant opportunity that the EU enlargement will bring about.

Many respondents believed that local logistics service providers (transport, warehousing etc.) will provide cost advantages, but relatively few (31 %) were planning to restructure their logistics infrastructure through establishing new warehouses in the new member countries. (Figure 1.)

Figure 1: Anticipated changes in logistics services due to EU enlargement in ELA 2003 survey, N=100 (Based on Pfohl and Mayer 2004)



Survey on Regional Distribution Centers in Europe

It is likely that EU enlargement will set about significant changes in regional distribution structures, and some of these changes have already been seen. Regional Distribution Centers (RDC) generally refer to entities that serve a certain geographic market (such as Northen Europe and The Baltics) for a particular firm. RDC's are very widely used by big firms in e.g. electronics and consumer goods industries and in all types of spare parts distribution.

The RDC's can be operated by the firms themselves, or they may be run by dedicated logistics operators. Such arrangements are often called Third Party Logistics solutions. (See e.g. Langley et al. 2004)

Not all changes in RDC localization are directly attributed to EU. In Russia, a number of big multinational consumer goods firms have already started to establish their distribution centers e.g. around the ring roads of Moscow. This reflects more the fact that such firms increasingly see an economic trade-off of establishing themselves inside Russia, despite the still complicated customs rules and procedures. However, such options seem to be available only for the biggest operators which sell large quantities of internationally recognized brands.

Cap Gemini Ernst&Young, a consultancy, ranked in September 2003 the attractiveness in locating regional distribution centres (RDC) in Northern Europe as follows: 1. Denmark; 2. Lithuania; 3. Latvia; 4. Finland; 5. Estonia; 6. Sweden. (Cap Gemini 2003).

Lithuania and Latvia were ranked high, while Latvia was also seen as an excellent starting point for export to the Russian market. Finland is likely to keep an important position mainly because Sweden and Norway are not easy to reach from the Baltic States.

This is only one ranking of many, and as such only indicative. Nevertheless, it is clear that during the next few years, the location pattern of RDC's in Northern Europe will become fixed for many more years to come.

The EU membership is bound to increase intra-EU trade and regional cooperation in distribution. It is yet unknown to what extent firms will centralize their logistical business activities to distribution centers outside the new Member States. At any event, centralized logistics solutions seem to gain ground across industries, including that of logistics providers.

During the past decade, Finland has been successful in attracting a broad spectrum of value-adding logistics services that serve North-Eastern Europe in general and North-Western Russia in particular. EU enlargement will gradually affect Finland's comparative advantage as a reliable and cost-effective Regional Distribution Center (RDC), too.

But it is too hasty to conclude that the Baltic States, for example, would be able to take Finland's position as a reputable RDC. This position depends ultimately on how well Russia can implement its new Customs Code, and how quickly Russia can put its own house in order in this respect.

Findings of the Trade and Transport Facilitation Audit (TTFBS)

A comprehensive analysis of the transport sector restructuring in the Baltic States is found in Ojala, L., Naula, T. and Queiroz, C. 2004. This report was also the proceedings of the 2nd Transport Minister Seminar of the Baltic States held in November 2003 in Pärnu, Estonia. The 3rd such seminar was organized in February 2005 in Vilnius, and the updated report of that meeting is expected to be available in Spring 2005 by the same authors.

In the meantime, this Chapter summarizes the key findings of another extensive study on the Baltic States for the World Bank (Ojala, Naula and Hoffmann 2005)[1]. The data collection was mainly conducted in April-September 2004, and the final report was published in February 2005 after additional comments had been received from the three countries as well as from experts of The World Bank.

Key Findings in a nutshell

Joining the European Union had a significant impact on day-to-day trade practices with other EU countries and with non-EU countries, notably that of Russia. In relation to the EU, the major changes were the removal of national customs borders and trading without customs clearances. As a result, traders save time and money in clearances and border crossings, which has reduced transaction costs.

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[1] The report is also found in its entirety at World Bank's transport website. The report is easiest to find through a search by Google using search words "TTFBS Ojala"

On the other hand, EU membership has affected the regulatory burden on firms, which were used to the relatively liberal regulatory environment. In CIS trade, bilateral trade agreements were largely replaced by the common EU trade policy. The three Baltic States have rapidly integrated to the world economy, and the EU membership did not dramatically change their trade or FDI patterns.

Transport sector relies on transit traffic. A clear majority of the transport work by rail is transit of oil and oil products via Baltic ports. The oil pipeline to Ventspils remains unused due to Russia's policy to favor its own ports. Transit volumes by rail are growing especially via Estonian ports. Road transport market was heavily affected by EU membership especially in Lithuania, where international road hauliers suffer from up to 25% overcapacity caused by faster transport times in the EU. Demand on air transport is growing, but limitations on aircraft size and airport equipment do not allow the industry to fully meet the demand.

Very few problems with trade and border crossing practices in intra-EU trade were reported in interviews for the TTFBS study, despite the fact that the interviews took place right before or after the EU accession.

The main trade, transport and border crossing problems are with Russia and Belarus. These problems have a political background, and as a rule, solutions require negotiations between the EU and Russia. Fundamental solutions are also beyond the means of national Governments or their transport and trade authorities. Some border crossing problems remain with countries such as Ukraine, Moldova, Kazakhstan and Georgia. A considerable part of transit traffic through the Baltic States originate from these countries.

Macroeconomic issues

The Baltic economies have grown rapidly during the last several years. After the Russian economic crisis in autumn 1998, the annual growth rates have exceeded the EU's average growth rate by 4-5 percent units. In addition, the Baltic economies have grown faster than other acceding countries. In 2003, the largest growth was observed in Lithuania and Latvia. In Estonia, after a short recession, GDP growth accelerated again in the late 2003. According to latest forecasts, the Baltic States' strong growth is expected to be continuing within the next two years.

Growth has been generated by almost all sectors of Baltic economies. In Estonia, annual GDP growth in 2002 and 2003 reached 7.2% and 5.1 %, and forecasts for the years 2004-2005 vary around 5.2-6.0%. In 2003, Latvia's GDP grew by 7.5% compared to 2002. Since the year 2000, Latvia's economy has expanded more than 6% year-on-year. In 2003, Lithuania's GDP expanded by 9.7% from the previous year. The annual growth rate was the sharpest among the EU countries.

The structure of economy has changed substantially during the transition period. In Latvia and Lithuania, over 15% of employees are still working in agriculture and forestry, though the share has declined during the transition period. After the collapse of the Soviet Union, the former Soviet Union's (CIS) share in the Baltic States' foreign trade has dropped, and at the same time the EU countries' share has grown sharply. In Estonia the relative share of foreign trade is significantly larger than in Latvia and in Lithuania.

Trade Issues: EU is the Main Economic Partner

EU is the main trading partner. In the first quarter of 2004, the share of EU-15 trade was the largest in Estonia. In exports, the share was 68% and in imports 52% of total. In Latvia, the corresponding share in exports was 61% in imports 49%. In Lithuania, the EU trade covered only 43% of exports 41% of imports.

Estonia's economy is orientated towards the Nordic Countries. Latvia's most important trade partners are Germany, UK and Sweden in exports, and Germany, Russia, Lithuania and Estonia in imports. Lithuania's main export countries are Switzerland, Russia, Germany and Latvia. Main import countries are Russia and Germany, covering nearly 40% of total imports.

FDI has reached a high level. Estonia's FDI inflows per capita and the ratio of FDI to GDP are among the CEE's highest. Estonia's inward FDI stock has tripled in 1998-2003, reaching USD 6.5 billion. FDI inflows to Latvia reached USD 3.3 billion in 2003. In Lithuania, inward FDI stock reached USD 4.8 billion. While most FDI originates from EU countries, Russian FDI in the Baltic States has grown rapidly in the energy and related oil transit traffic operations.

In 2004-2006, the Baltic States get USD 8 billion of structural support from EU. Estonia gets euros 505 per capita (USD 610), the highest figure of all accession countries. Latvia gets 494 euros (USD 590) and Lithuania 438 euros (USD 530) per capita. However, this is less than normal influx of FDI. Structural transfers from EU cause heavy pressure on national budgets due to required co-financing. Approximately 20 per cent of EU's structural support goes to the transport sector.

Customs were well prepared for EU in Estonia and Lithuania, less so in Latvia. The principal areas needing improvements are: (a) border crossings with Russia and Belarus with excessive delays such as at Terehova and Grebneva; (b) data exchange systems between ports and custom warehouses; and (c) customs relations between Baltic countries and Russia.

Much of customs clearance work disappeared in intra-EU trade. As a consequence, many customs, customs brokers and freight forwarding staff have become redundant. Persistent borders crossing delays affected EU trade in late 2003, but the change to EU customs procedures on May 1, 2004 took place with relatively small disturbances in Estonia and Lithuania.

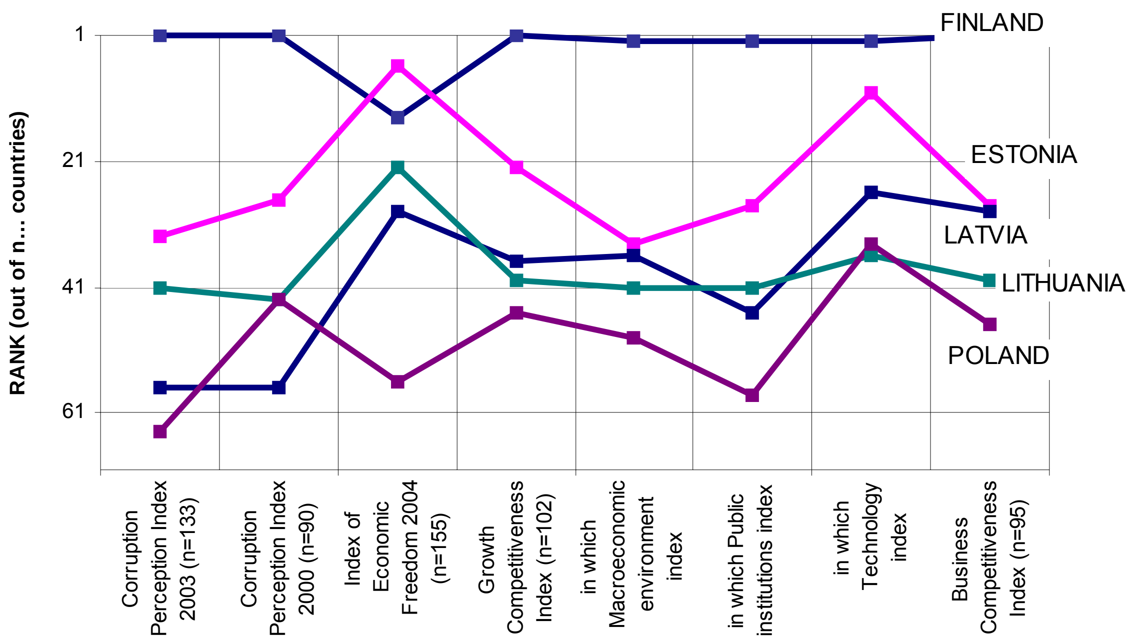
The key logistics problems of EU-Russian trade relate to administrative procedures, involving Russian authorities. The key problems relate to) customs clearances, goods inspections, and border crossings. Russian customs clearance procedure is generally perceived by traders as complicated, time consuming and expensive, which affects the whole supply chain.

Overall, the new customs code in Russia seems to fulfill the basic requirements for transparency, predictability and legal protection. However, it remains to be seen how well the reform will be implemented throughout the Russian Customs Service organization, which employs approximately 63,000 customs officers.

Business Environment is Already Good and Improving

In business environment comparisons the three countries score well. Estonia qualifies significantly better than Latvia and Lithuania, see Figure 2.

Figure 2: Ranking of countries; selected development indicators. Source: Ojala et al. 2005. Data gathered by Mr. Hannu Pirilä; Original data from: The Heritage Foundation (Economic Freedom), Transparency International (CPI), World Economic Forum (all others).



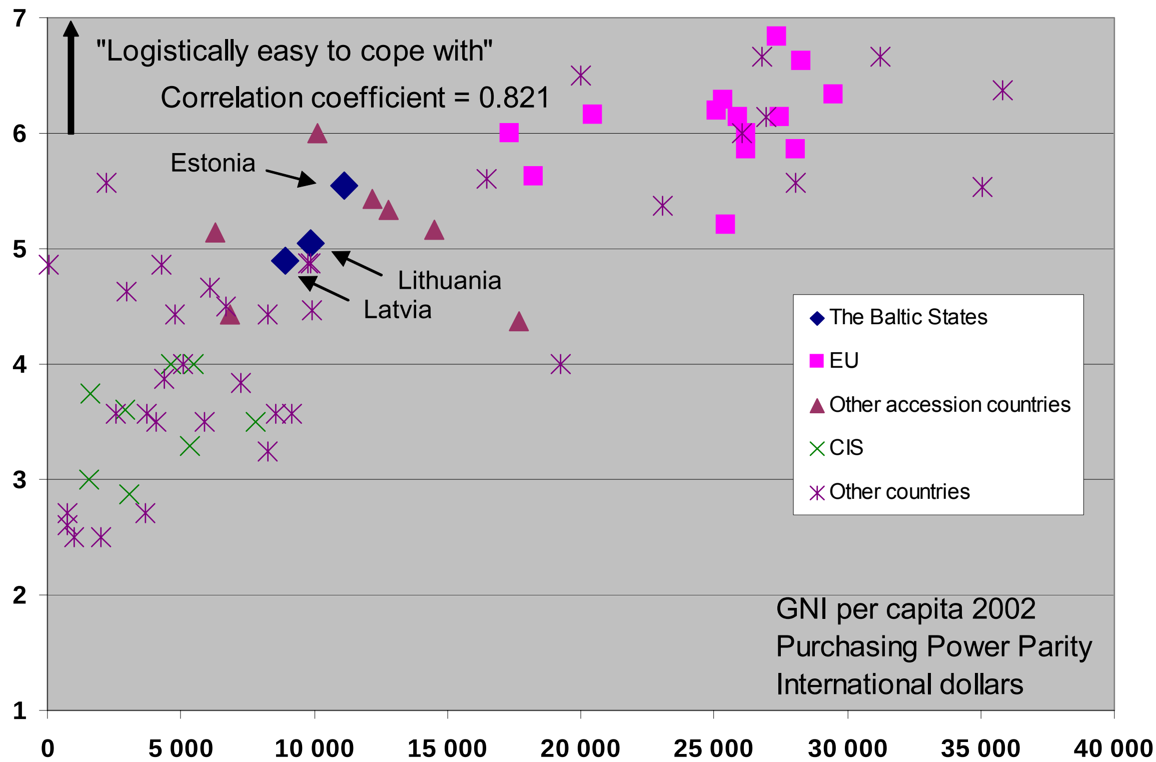
As is typical for rapidly growing economies, inefficient bureaucracy and the lack of skilled people is a genuine problem in the Baltic States. In Latvia and Lithuania this is combined with corruption The World Economic Forum's survey in 2003 listed the most problematic factors for doing business in the Baltic States as shown in Table 2.

Table 2:. Top 5 - The Most problematic Factors for doing Business in The Baltic States. Source: Ojala et al. 2005. Data gathered by Mr. Hannu Pirilä; data from : World Economic Forum, Executive Opinion Survey (2003)

Rank	Estonia	Latvia	Lithuania
1.	Inadequately educated workforce	Corruption	Tax rates
2.	Inefficient bureaucracy	Inefficient bureaucracy	Inefficient bureaucracy
3.	Access to financing	Tax rates	Tax regulations
4.	Inadequate infrasturcture	Tax regulations	Corruption
5.	Poor work ethic	Access to financing	Access to financing

Logistics Friendliness Survey rate the Baltic States as easy countries. Compared against the GNI/capita data, the Baltic States rank at par with other accession countries, but substantially higher than CIS countries. The Baltic States lag somewhat behind the EU15 countries. (Figure 3.)

Figure 3: Logistics Friendliness Survey 2003 and Gross National Income in 2002 (PPP adjusted, in International Dollars). Source: Ojala et al. 2004, Statistical data from The World Bank



Access to high quality banking, and insurance and legal service is good. Financial and insurance markets have undergone a rapid restructuring and these markets have been consolidated substantially. According to law firms, the legal environment and court processes are not a substantial barrier to trade in the Baltic States. In domestic business, corruption is an issue that needs to be considered especially in Latvia, and to a lesser degree in Lithuania.

Access to business information has improved significantly in the Baltic States. Transport issues are widely discussed in the major business journals and are well covered by news agencies. A wide variety of specialized transport and logistics journals and periodicals are available. Access to statistics and transport data is excellent in Estonia, good in Lithuania, but somewhat problematic in Latvia.

Transport Sector: Highest GDP Share of EU-25

In 2002, 15.5% of the Gross Value Added[2] in Estonia, 14.5% in Latvia, and 13.7% in Lithuania was produced by the transport, storage and communications sector. These are the highest figures of all EU. About 35% of the sector's GVA is produced in transport, 35% in storage and the remaining 30% by communications. In other words, transport and storage contributed from 10% to 11% of the countries' Gross Value Added or GDP in 2002.

Transport services trade is important for the Baltic States. Latvia has the highest net cash flow from trade in transport services, a situation mainly attributable to transit flow of oil and related products by railways and pipeline. In 2003, transport services trade generated USD 595 million foreign currency for Latvia, USD 470 million for Estonia, USD 414 million for Lithuania.

The demand for transport is growing rapidly in the Baltic States. There has also been increasing demand for consolidated transport-related support services. Moreover, privatization has been widely used as a vehicle to restructure transport and transport infrastructure markets. Public-private partnerships have been introduced as a mechanism for providing good quality transport and infrastructure services at a reasonable cost.

The three countries have invested substantially in their TEN-T transport infrastructure. In 1996-2001, Estonia invested 235 million euros, of which almost half in ports. In the same period, Latvia invested almost 370 million euros, 2/3 of which into railways. Lithuania invested 270 million euros, half of which in roads. This amounts to about 900 million in the three countries.

For the period 2002-2010, Estonia intends to spend over 550 million euros, mostly on roads and ports. Latvia plans to invest approximately 500 million euros, half of which will be spent on roads. Lithuania plans to invest up to 1,250 million euros mostly on railways and ports. This totals to 2,300 million euros until 2010 even without the proposed Rail Baltica project.

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[2] Gross value added (GVA) is a measure of the contribution to GDP made by an individual industry.

Transit of oil and oil products remains a major activity

The volume of transit oil and oil products handled at Baltic States and Russian Baltic Sea ports has increased from 50 million tons in 1997 to 100 million tons in 2003. Transit revenues represent 5 to 8 percent of gross domestic product of the three Baltic countries. Russian firms, recognizing the importance of the transit revenue through the Baltic States, have tried to obtain controlling stakes in companies operating oil export facilities in the Baltic countries.

It is expected that Russian oil exports will rise substantially and that the Baltic States will benefit from this trade through transit operations. Russian money has also been used in new port constructions in Estonia.

Road Transport Increases while Traffic Safety Remains a Concern

There is an urgent need to enhance road safety, increase road maintenance and develop better highway links between poorer areas and main centers as well as to improve training for road transport operators. A number of national projects have been performed and are underway, notably that in Lithuania with ECMT (ECMT 2004).

Road traffic safety in the Baltic States has improved but the number of fatalities and accidents in relation to the number of vehicles are still among the highest in Europe. The number of vehicles has increased substantially, and fleet renewal has been profound.

The Baltic States have invested heavily in their main road network, and will do so throughout the decade. Projects related to Via Baltica have a high priority, but projects with secondary roads also receive more funds. As budgetary allocations are not fully sufficient to cover capital investments, road finance from external sources will be needed. The Baltic States spend now less money on maintaining their road networks than before.

Demand for road freight transport has grown very rapidly in Latvia and Lithuania. In Lithuania, road transport demand surpassed that of rail transport in 2002. In Latvia and Estonia, rail transport performs roughly twice the ton kilometers than road transport. In Estonia, there is a growing demand for short-distance domestic transports, for example, in construction, but in early 2004 also in international transport.

Ports Very Profitable and Maritime Transport Grows

Port services are available 24/7 in all three countries, which is exceptional in Europe. Availability of and competition in the port services market is good. Port services, especially loading and discharging of vessels and supporting functions, such as agency services, are available for traders seven days a week. Docking and dwell times at ports are normally not hindering trade.

The significance of Ro-Ro ferry and container feeder lines has become greater since each Baltic State is clearly oriented to the European Union in foreign trade, and Baltic transport companies operate widely in the European Union area. Liner shipping connections are well developed especially in Estonia and Lithuania. Vessels on the routes have successively been renewed, and sub-standard vessels have been phased out from the market.

Dry bulk flows in the whole Baltic Sea region amount to some 150 million tons. The main commodities are iron ore, coal, grain, fertilizers and limestone, which are suitable for large bulk ships up to 100,000 tons. However, a considerable part of Baltic States' bulk trade is carried on spot basis on small bulk vessels, generally in the 1,000 to 5,000 dwt range. While transit of oil and oil products is significant business in ports and railways in the Baltic States, practically none of this trade is carried by Baltic shipping companies.

Railways Rely on Transit Traffic

Railway restructuring needs to continue especially in Latvia and Lithuania. This includes efforts to separate commercial operations from rail administration, reduce over-capacity, rationalize tariffs, raise levels of safety, and improve railway service. Railways have been privatizated in Estonia. In Latvia a small part of freight and passenger transportation on state owned infrastructure has been performed by newly established private companies. Railway services in Lithuania are owned by the public sector.

Rail transport work grew between 23% and 33% in 1999-2002, propelled by oil transit trade. In the medium to long term, continued growth may be limited, as oil transport facilities develop in Russian territory. Over 80% of Estonian and over 70% of Latvian rail freight traffic is oil and oil product transit trade through ports.

Net profits of main rail operators have grown significantly in 2002-2003. Net profit of Estonian Railways Ltd. in 2003 presents an improvement of 65% compared to 2002. Also Lithuanian and Latvian Railways have turned profitable. The profit of Lithuanian railways was USD 5.1 million in 2003. In 2003, Latvian railways' net profit was USD 11 million.

The Russian tariff system is a significant problem for transit operations. The transit tariff to Baltic ports is three to four times higher than the tariffs to Russian ports, such as Kaliningrad. For the port of Klaipeda this resulted in a significant decline. In February 2004, Lithuania raised tariffs for rail transit to Kaliningrad by 11 % with the aim to ensure profitability of the railways. However, Lithuanian stevedoring companies claim that tariffs for transit trade should be increased even further to ensure future cargo flows to the port of Klaipeda.

European Commission (EC) considers ways for eliminating Russia's discriminatory railway tariff policy, e.g. by calling Russia accountable to the World Trade Organization (WTO). According to the EC, Russia's policy creates unequal competition between EU and Russian ports.

Transit traffic to Kaliningrad remains a substantial operation for Lithuania; in 2002, it accounted for 36% of the cargo volume carried by rail. However, Russia exercises heavy political pressure towards EU to improve rail connections to Kaliningrad, and to remove inspection of all cargo traffic, and later also those on passenger transport. This affects

Lithuania politically and economically, as the only viable rail connection is also the one serving the port of Klaipeda.

Rolling stock (except for tank wagons) is in rather poor condition in all the Baltic States. The interviewees agreed that more investment is needed. Poor funding for the maintenance and development has led to obsolete rolling stock, and the inability to timely renovate it.

Interoperability of CIM and SMGS legal regimes of great concern. The Baltic States are at the junction of two rail regimes. All Western countries as well as some African countries are working under COTIF (Convention concerning International Carriage by Rail) convention and using CIM Bill of Lading, while Eastern European countries, Russia, China, and CIS countries are working in SMGS (International Goods Transport by Rail) system. Lithuania joined COTIF convention in 1995 and Latvia in 1999, whereas Estonia has not yet joined the convention (www.otif.org).

Interoperability with other European railways is a major concern. The 2nd railway package set by the European Commission aims at putting an end to the physical and technical barriers in the European freight railway transport. The objective is to extend infrastructure access to rights to services within a member state and open up market for new railway operators. The agreed date for complete opening of the rail freight markets is January 1, 2007. The 2nd railway package also outlines a proposal for a directive on railway safety concerning the definition of the essential features of safety systems for infrastructure managers and railway undertakings.

Long Russian cargo trains create pressure for the Baltic marshalling yards. Russian railways tend to prefer to transport on long trains and for long distances as much as possible. However, Estonia has extended the marshalling yards and is able to receive trains as long as 72-75 cars. In Latvia, the new yard is being built as part of Rezekne II freight junction project.

Trans-Siberian route (TSR) is a business opportunity for Baltic rail operators. TSR, starting in Moscow and ending in Vladivostok offers possibilities for Baltic railways especially in containerized cargo. The TSR offers the shortest transit way from Asia to Europe. Compared to sea transport the TSR is 1-3 weeks faster, while the transport cost is approximately the same. Russian regional railway operators are looking for partners, which is an opportunity for Baltic railways.

Smooth Air Freight - Growing Passenger Volumes

Prior to EU membership, there were about 600,000 air passengers per year in each of the Baltic States, of which roughly ½ use national and ½ use foreign carriers. The volume has increased at all key airports after EU Membership mainly thanks to low-cost carriers, and the three countries' have reached 1 million passengers p.a. in 2004.

Cargo traffic is modest in each country, between 4,000 to 7,000 tons per year; however, much higher volumes are transported by trucks (RFS, Road Feeder Services) under air waybill.

Throughput times in all airports are very short. Throughput time for import goods range from 50 minutes to 2 hours from touchdown of the aircraft to the release of the goods, assuming that documentation is correct for customs clearance. This offers little room for improvement.

Phyto-sanitary inspection facilities required for the import of food and animals from non-EU countries is only available at Vilnius airport since mid-April 2004. In Tallinn, the closest inspection post is located at the harbor, (distance 10km) and in Riga there are no facilities available at all. However, these shortcomings were not seen as a major obstacle by traders.

Air infrastructure management remains the responsibility of the public sector in all three countries, but the ways in which civil aviation administrations and airport administrations have been organized differ to some extent among the three countries. The provision of air transport services has been partially privatized in Estonia and Latvia, where the airlines have been transformed to joint ventures with established international carriers and other investors.

Baltic airlines with valid operating licenses do not need a separate permission for flights within the EU, Iceland, Norway and Switzerland after EU accession. Air Baltic was quick to benefit from this, as it established a hub in Vilnius in June 2004.

Bilateral flight permissions to Russia are investigated for conformity with EU legislation. Permission to fly to other cities than Moscow requires a political agreement between the EU and Russia, and this may take time to materialize. Access to other Russian cities would improve the national carriers' competitive position. The Baltic States' major airports – or one of them - could also develop transit hubs for east-west passenger and cargo movements. In February 2005, however, little progress was seen in opening new routes to Russia, except that one or two lines to St. Petersburg could start operations later in 2005.

Air navigation charges in Vilnius are 30% higher than those in Tallinn. Competition between airlines drives airports to lower their fees, as was done in Riga in June 2004. Lower landing fees reduce the income of the airport, but growing traffic is likely to compensate for it.

Increasing price competition is occurring among airlines. All three Baltic flag carriers have started to introduce low-fare tickets, including the possibility to purchase one-way tickets with no minimum stay restrictions. The first low-cost airline has also entered the Baltic market, and they have restructured the passenger market considerably.

Airfreight rates are competitive, but small size of the aircraft keeps rates high. Over the past years competition has lowered the rates substantially. However, the relatively small size of the aircraft in scheduled traffic prevents the carriers to utilize economies of scale. Scaling up the fleet also requires additional investment in so-called high-loader equipment at around USD 0.5 million per airport. A number of investments projects are under way to develop aviation and airport infrastructure in order to meet the demands of increasing passenger and freight volumes.

Bottlenecks at Russian and Belarus Borders

EU membership has significantly changed both border control and customs practices. The Baltic States are now part of the common EU customs zone, but not yet part of the Schengen agreement. This means that the national border control check points still remain in operation, and passport checks and visa checks for non-EU residents continue on intra-EU borders. Before joining the EU, waiting times for trucks often exceeded 10 hours, especially at border crossing posts between Latvia and Lithuania, but these queues have practically disappeared. Due to the improved situation at the Intra-EU borders, only border crossing points (BCP) with Russia and Belarus are covered more detailed in the Facilitation Audit Report.

Problems were detected especially at Terehova and Grebneva between Latvia and Russia, where the waiting times for trucks are typically between 6 to 12 hours. For example, in June 2004, there were 266 trucks (a 7 km queue) and 134 trucks at Grebneva (a 3.5 km queue) waiting on Latvian side for access to Russia. The bottlenecks are on the Russian side of the BCPs, whereas the capacity on Estonian and Latvian sides is not in full use. According to local Estonian and Latvian border officials, the throughput could in some case even triple without causing problems.

The border congestions on Russian side are likely not to be resolved through technical IT projects due to the highly political nature of question. Negotiations between the EU and Russia are in key role, while some local issues could be resolved on sub-regional or even on a bilateral level. One possible vehicle for sub-regional co-operation is TEDIM[3], which is an international development forum of ministries of transport of the Baltic Rim countries and of which all the Baltic States and Russia are members.

The shortest route for Lithuanian exports to Russia especially from Vilnius is via the BCPs of Medininku and Salcininku through Belarus. However, road carriers are unwilling to enter Belarus because of numerous experiences of misconducts by Belarus officials: unofficial payments are required at the BCPs up to USD 500 per transit and shipments under TIR-transit are sometimes stopped and even confiscated for undisclosed reasons. Another reason to avoid Belarus as a transit country is the Russian customs (unofficial) practice at the Latvian-Russian border to customs clear trucks for a duty of USD 20,000 irrespective of cargo value. This urges shippers to load trucks with cargo way over USD 50,000, which is the limit for the use of TIR Carnet. Such cargoes can not be taken through Belarus without a convoy, causing extra cost and delay.

Significant investments have been made to modernize EU's external border crossing posts between the Baltic States and Russia/Belarus. In addition to the national funding, the European Union has allocated funds mostly through the PHARE program to develop the border control systems in accordance with the requirements of the Schengen acquis and facilitate implementation of the recommendations stated in EU's Integrated Border Management Strategy. The investments were made to upgrade the national BCPs, which

[3] Telematics, Education, Development and Information Management (www.tedim.com)

became the EU's external borders in May 2004. The second milestone will be in 2007, when Estonia, Latvia and Lithuania are planned to join the Schengen agreement. As a result, the BCPs on Estonian, Latvian and Lithuanian sides are modern and the infrastructure poses no hinder for border crossing.

Selected recommendations in the TTFBS study

Some of the issues encountered in the TTFBS study were of temporary nature, whereas the more persistent problems include, but are not limited to the following.

Veterinary and phyto-sanitary check points

Veterinary and phyto-sanitary check points need EU approval. All border checkpoints on railways in Estonia and Latvia stopped handling food imports from non-EU countries on May 1, 2004 because of the lack of certified facilities allowing authorities to conduct veterinary checks in accordance with EU requirements. Two veterinary checkpoints on railways in Latvia are to be certified by November, which forwarders regard as unrealistic. In Estonia a checkpoint in Narva is expected to be ready in summer 2004. Another checkpoint in Koidula is scheduled to be functioning in 2006.

Railway veterinary checkpoints are constructed by railway operators whereas on the roads the expenses for building these kinds of checkpoints are carried by the state. The lack of sufficient number of veterinary check point facilities constitute a hinder for traders but the problem is acknowledged by the governments and new facilities are under construction. It is suggested that the ongoing building projects are expedited.

In January 2005, there are five EU-approved veterinary checkpoints in Estonia[4], eight in Latvia and 12 in Lithuania. Phyto-sanitary control can also be conducted at most checkpoints. A detailed list of the veterinary and phyto-sanitary control posts is shown in Ojala et al. 2005.

Maritime and Port Community IT Systems Needed Quickly

Increased unitization of cargoes together with the global trend of containerisation in ocean transport lead to situations where ports and especially port authorities must be able to handle large amounts of scattered cargo information. This information is needed not only for compulsory statistical reports and commercial market analyses, but in order to fulfil the new safety and security rules imposed by the International Maritime Organisation and European Union. These new regulatory frameworks, the International Ship and Port Safety (ISPS) Code

[4] A critical evaluation report on Estonian border crossing posts by European Commission is available at: http://europa.eu.int/comm/food/fs/inspections/vi/reports/estonia/vi_rep_esto_7238-2004_en.pdf

and Container Security Initiative (CSI), require constant control of activities and cargo units in the port area.

Port IT development needs to be accelerated. In addition to the needs of security measures, information technology and developed software applications for handling cargo information can be used as tools to support strategic development and increase port throughput and efficiency. Especially all the ports in the Baltic States handling large amounts of unitized cargoes, i.e. trailers and containers, should accelerate their efforts in IT development.

A further step is to develop country-wide maritime information systems that link port operators, shipping companies, freight forwarders and other private sector operators to a number of authorities such as the Maritime Administration, Customs, and the Statistical Office.

Administrative Capacity in Spatial Planning

Among other development areas, the Baltic States need to enhance their administrative capacity in spatial planning and improve means to expropriate land for infrastructure projects of national importance. And environmental regulation on spatial planning imposed by EU does not make matters easier. The last notion, at least, should not come as a surprise to readers of this book.

In all three Baltic States major ports are landlord ports, where port authorities are responsible only for major infrastructure maintenance and development, and daily operations are handled by private companies operating under various land lease or rental agreements.

So far the governments, municipalities and port authorities have been reluctant to use expropriation or termination of lease agreements as a tool of guiding port development in a wider public interest. The large number of small lessees and operators in Tallinn, Riga and Klaipeda ports is likely to result in operational inefficiencies in the long term.

Similar problems have hampered the construction of logistics centers in all three countries too. In the medium term, the problem will be accentuated in airport expansion, especially with Tallinn airport, and to lesser extent with Vilnius airport. In Latvia expropriation has been used in some expansions of Riga airport and Riga port and in some road construction projects.

The land value is likely to become a major issue in the preparations for the Rail Baltica[5] project, on which a pre-feasibility study is expected later in 2005.

[5] Rail Baltica is a joint project between the Baltic States and Poland to connect Warsaw and Tallinn via Kaunas and Riga by a western gauge rail line. If realized, Rail Baltica's estimatesd cost is USD 5 billion, including construction works on the territory of Poland. Only 2 % of the cargo flows in the Baltic States are on the South-North (North-South) direction. Passenger traffic along the intended path of the rail is very small both by bus and by private cars transiting two or more countries. By the time the rail link would be completed, the average income per capita in the Baltic States will have risen substantially, and the value of (travel) time will increase for individuals. Low-cost airlines have already transformed the time-cost budgets of business and leisure travelers. In addition to mere rail construction, feasible operations require international agreements on access to operate the services and the infrastructure itself.

In all Baltic States there is a strong need to enhance administrative capacity in spatial planning and improve legal tools for expropriation. In particular, legislation should be amended so that the remuneration for expropriated land for infrastructure projects of national importance is less than market value.

Conclusion

In an international comparison, the restructuring of the transport sector that has taken place in the Baltic States since these countries regained their independence in 1991 has been remarkable, and overall, highly successful.

Among the notable recent trends in the Baltic States is the rapid increase of demand for transport, which has grown at a rate higher than that of the gross national product. Each of the Baltic States has experienced substantial growth in the volume of merchandise exports and imports. This trend is partly a reflection of the rapid growth of transit traffic.

On the other hand, the three Baltic States have rapidly integrated to the world economy, and the EU membership did not dramatically change their trade or FDI patterns.

While the overwhelming part of the Baltic States' trade is directed toward other EU countries, the trade with the non-EU countries still remains an area where trade and transport facilitation is a potential source of prosperity for the Baltic States.

In the near future, the new Member States need to strengthen their administrative capacity in the Ministries and authorities in the field of transport and trade. In addition, they need to initiate monitoring their logistics environment and firms' logistics efficiency on a regular basis. A periodically conducted survey would serve as a valuable source of information for identifying needs for further improvement.

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Acronyms

BCP	Border Crossing Point
BEEPS	Business Environment and Enterprise Performance Survey (EBRD and WB)
CIS	Commonwealth of Independent States
COTIF	Rail transport Convention of OTIF of western European countries (-> CIM)
CPI	Here: Corruption Perception Index
CSI	Container Security Initiative
ECMT	European Conference for Ministers of Transport
EDC	European Distribution Center
ELA	European Logistics Association
EU (10;15;25)	European Union; 15 member states before May 1, 2004, and 25 states after it.
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
GNI	Gross National Income
GVA	Gross value added; it measures the contribution to GDP made by a sector
ISPS	International Ship and Port Facility Security Code
NCTS	New Computerized Transit System
PPP	Purchasing Power Parity
RDC	Regional Distribution Center
SMGS	International Goods Transport by Rail system of mainly CIS countries
SME	Small and medium-sized enterprises
TEDIM	Organization of the Ministries of Transport around the Baltic Sea
TEN-T	Trans-European (Transport) Networks

TEU	Twenty feet equivalent unit, a measurement for unitized cargo
TINA	Transport Infrastructure Needs Assessment of the CEE Countries
TPL	Third Party Logistics, a form of advanced logistics provision
TTF	Trade and Transport Facilitation
USD	American dollar
WTO	World Trade Organization

COMPETITIVENESS IN AN ENLARGED EUROPE: OPPORTUNITIES AND CHALLENGES FOR THE ROMANIAN STEEL INDUSTRY

Oana Canila

Abstract

The EU Member States and newly accessing countries are both concerned about the consequences of the EU enlargement for the competitiveness of business firms. In Member States, the concern is about loss of market shares and intensified competition from lower-cost firms. In accession countries, the worries are about productivity improvement, environmental protection, work safety and harmonisation with EU legislation and standards.

Although there are several studies analysing competitiveness, very few of them focus on business competitiveness in the context of the European integration. This paper analyses the impact of implementing EU requirements on the competitiveness of the iron and steel industry in Romania. Statistical data, financial indicators and other relevant information concerning the main companies in the sector and comparisons of steel plants in European countries are analysed.

This study finds that despite transitional problems, favourable opportunities for restructuring processes may countervail adverse effects and enhance the competitiveness of East European firms in the European single market. Privatisation, FDI, new environmental standards, the emission trading market and the Romania's position as a potential seller on this market, cost and productivity differentials are some of the factors identified which contribute significantly to the positive development of industrial competitiveness in the heavy industry segment.

Keywords: competitiveness, steel industry, European integration, environmental protection.

Introduction

In May 2004, ten new members joined the European Union (EU). Romania and Bulgaria are expecting to integrate in 2007. For the purpose of this research, the accessing countries refer to the Central and Eastern European Countries (CEECs), including the most recent members of the EU.

At the micro-level, the benefits associated with EU enlargement consist, among others, of market liberalisation and free movement of capital and labour, sustainable development, harmonised legislation and stable environment. However, the integration is a process of adaptation and therefore associated with both benefits and shortcomings. The EU Member States and newly accessing countries are both concerned about the consequences of the EU expansion for the competitiveness of business firms. In Member States, the concern is about loss of market shares and intensified competition from lower-cost countries. In accessing countries, the worries are about extra costs required by productivity improvement, environmental protection, work safety and harmonisation with EU legislation and standards.

The earlier research has seldom addressed competitiveness from the perspective of East European countries. Particularly noteworthy is the study by Havlik (2001) with a broad and sectorial analysis of the CEECs industrial competitiveness. It covers ten candidate countries and all the branches of the manufacturing industry. The purpose was to identify the differences in the degree of preparedness for different manufacturing branches. Based on competitiveness measures, the study provides "competitive maps" for each industry. The Commission Staff Working Paper (2003) analyses the industrial competitiveness both in accessing and Member States and points out the difficulties faced during the restructuring as well as on the remaining challenges for the industry of accessing countries. Resmini (2003) presented a regional perspective on the impact of European enlargement on the manufacturing industry and economic growth. He found an influence of the type of region on the development of manufacturing industry located in that area. Manoleli et al. (2002) give a governmental perspective on the impact of environmental *acquis*, pointing out the polluting technological processes and on the environmental issues in five Romanian industries, including the steel industry. The current state of industrial assets is reviewed and the costs of implementing the European environmental standards are evaluated. Similarly, estimations of required costs for compliance with the EU environmental legislation have been made for various countries, such as Hughes and Bucknall (2000) for Poland, Dziegielewska (2000) for the Czech Republic, Hungary, Poland and Slovenia and De Nocker (1997) for the CEECs.

The above-mentioned studies analyse various aspects of industrial competitiveness but little attention has been paid to the opportunities of the CEECs' industry on the extended market. This article intends to cover this gap. Starting from Havlik's (2001) sectorial perspective, the present article addresses the competitiveness from the perspective of accessing countries and for the specific case of Romania. It focuses on the steel industry and analyses its competitiveness as well as the challenges that remain to be faced and the opportunities countervailing the integration difficulties.

The study is organised as follows. The main concerns threatening the survival of the steel industry as a consequence of the European integration process are reviewed in the second chapter. Chapter three deals with the current state of steel industry in the EU Member States as well as in the accessing countries. The particular case of the Romanian steel industry is analysed through various dimensions of competitiveness. Chapter four reveals the main opportunities and perspectives contributing to improving competitiveness. Conclusions follow at the end of the paper.

European integration and the threats to steel industry competitiveness

The disparities and the different level of development between the accessing countries and the members of the European Union have been a subject of negotiations during the integration process and require considerable financial efforts and reform programmes.

Havlik (2001) mentions the factors of accession influencing the industrial restructuring: *acquis* implementation, free borders and changes in macroeconomic policies.

The implementation of the European legislation, the first main concern for businesses' competitiveness on the European market, has an impact depending on the restructuring that has been and remains to be done. At the industrial level, the requirements are for compliance with the environmental protection, employment and work safety regulations. The implications at the micro-level consist of extra costs for technological modernisation, structural changes and human resources-related investments. Estimates have been made for the costs that a particular country or industry has to bear as a result of accession to European structures. De Nocker (1997) concluded that candidate countries need to make investments amounting to ECU 100 - 120 billion in order to merely comply with the environmental protection legislation. Dziegielewska (2000) estimated the costs of compliance with the EU environmental directives for four countries in Eastern Europe: Slovenia, the Czech Republic, Hungary and Poland. Similar estimations indicate costs for environmental compliance amounting to 17.1 – 22% of the production in 2000 in the case of Romanian steel industry (Manoleli 2002). It is generally agreed that industrial companies will bear part of these costs. Investments and additional costs are to the benefit of future development and enhanced competitiveness, both at micro- and macro-level. The study by ECOTEC et al. (2001) evaluated both for the financial and non-financial benefits from adopting the European environmental regulations. For the industrial companies, the advantages consist of improving efficiency and productivity as a result of implementing higher-quality technologies.

Despite the above-mentioned benefits, there are concerns about the companies' ability to sustain the restructuring, to survive and to compete efficiently on the enlarged market.

A second important concern for heavy industry competitiveness is about the free market. Among the advantages of the single market are increased competition, enhanced mobility of goods, lower prices and a wider range of products and services (Eropean Commission 1996).

Concerns arise from the low readiness to compete with Western companies due to the qualitative gap at the technological and product level.

Considering the particular case of the steel industry, Havlik (2001) found one of the lowest readinesses to comply with EU requirements, with competition and environmental issues as the main factors having an impact on its competitiveness. Consequently, the present study focuses specifically on these topics.

Increased competition appears as a result of the European strategy for a single market and free movement of goods. In order to eliminate restrictions on mobility, the customs duties inside the EU area have been removed and the legislation of Member States has been harmonised. The accessing countries are expected to follow the same line. Agreements have already been signed with the candidate countries for a gradual reduction of the customs duties and other taxes.

From the environmental point of view, the legislation which has to be implemented by the steel industry consists of:

- the Council Directive 96/61/EC concerning integrated pollution prevention and control (IPPC Directive);
- best available techniques (BAT) in the production of iron and steel.

The IPPC Directive sets the basic rules for the authorisation of industrial installations. It introduces a system of permits that have to be obtained and which ensures the functioning in accordance with the environmental protection requirements. The BAT are established for certain categories of industrial installations and refer to the technologies which are the most effective, both in achieving superior productivity and a high level of environmental protection. Their implementation is recommended as ensuring a high correlation between the economic and technical conditions, the costs needed and the benefits obtained.

Implementing conditions for a single market has required a legislative harmonisation, which has been accomplished by majority of CEECs countries. More problematic issues are faced in the case of environmental protection.

The pollution in the steel industry affects the quality of air, water and soil but also the working conditions through heat, noise and vibration emissions. The most important issue relates to emission to the air of various pollutants, especially heavy metals. Sinter plants are the most polluting installations, followed by coke-oven plants. The most relevant emissions to the water consist of wastewater emissions from coke-oven plants, blast furnaces and basic oxygen furnaces. More than half of the input is converted during the technological process in off-gases and residual products. In order to achieve environmental protection, solid wastes and by-products need to be recycled and the off-gases need to be filtered. Nevertheless, the greatest efforts are directed to reduction of emissions to air, water and soil and less to health and safety. The costs supported by the polluting companies consist of updating the industrial installations and implementing the best available techniques. In addition, administrative costs are transferred to the industrial companies through a system of authorisation and renewal taxes.

This chapter briefly reviewed the main hindrances to steel industry competitiveness on the European market. Further insights on competitiveness are provided in the next chapter, through a broader investigation of the European steel industry.

The iron and steel industry

The production process

A brief description of the production process will follow in order to enable a better understanding of the steel industry and its economical aspects.

Two methods are mainly used nowadays in steel production: the electrical and the pure oxygen method. For oxygen production, the input includes mainly the iron ore. In the case of the electrical method, the iron ore is not used and recycled scrap and reduced iron substitutes are more common as inputs. Other production processes such as Thomas, Bessemer and Siemens-Martin were almost completely abandoned at the beginning of 1980s due to their poor quality. Nevertheless, the methods are still in use in the less developed countries.

The products resulting from the first processing step consist of pig iron and crude steel. The steel is transformed into ingots or continuous casting steel. For many decades, ingots used to be the main casting for crude steel but its proportion dropped in recent decades, being replaced by continuous casting steel. The new procedure of continuous casting is nowadays widely used due to a lower rejection rate during processing and to other advantages such as fast pouring, less wastage, uniform solidification and continuous strand cast. A small proportion of steel is supplied as liquid steel.

Crude steel, in its various forms, is transformed into two types of finished products: long and flat. Long products include railway track and fittings, heavy and lightweight steel sections, girders, wire rods, bars and reinforcing for concrete. Flat products are mainly represented by steel strips, sheets and bands. The most used technological process at this stage is hot rolling.

Features of the iron and steel industry in the EU and accessing countries

The iron and steel industry is a traditional industry in Europe. According to the new WIFO taxonomy of the manufacturing industry (Peneder 1999), the steel industry is placed among the capital-intensive industries, which requires low-skilled labour.

The industry evolved during the industrialisation period and played a key role in the economic development in the 19th century. Even in the contemporary information-based society, the steel industry continues to play an important role in the EU economy. The

European Commission (2002) estimated the EU production to be 19.3% of global crude steel in 2000, reaching first position worldwide.

For 50 years, starting in 1952, the rules of the ECSC Treaty (European Coal and Steel Community Treaty) have governed the market of coal and steel. The regulations fluctuated over time, from the interventionism of the 1950s to the flexible mechanisms of the European Union: free markets and privatisation (Eurostat 2002). The ECSC Treaty expired on 23rd July 2002 and consequently, the European legislation presently regulates the steel industry.

The last century was remarkable in growth and developments of industrial technologies and installations. However, new raw materials on the market caused a severe crisis in the 1970s, characterised by over-capacity and falling prices, which finally led to important structural changes. A quota system for production was introduced for a period of 8 years, followed by plant closures and cuts in production and labour.

A new recession period started at the beginning of 1990s, with overproduction in almost all the Member States. The trend was exacerbated by the collapse of communism in the East European countries and a consequent fall in exports simultaneously with an increase of imports from eastern markets. In addition, the Asian economic crisis affected the EU steel industry negatively. International changes affected the European market and led to restructuring activities and sharp competition as the main features of the steel industry in the economic area in the last two decades.

In figures, considering as a reference point the year 2000, the production capacity of pig iron in the 15 old members of the EU (EU-15) stabilised to little less than 100 million tonnes per year and the production of crude steel was around 160 million tonnes. Crude steel is transformed mainly into continuously cast steel. Only 3% of crude steel was cast into ingots compared with 98% in 1950s (Eurostat 2002). Liquid steel accounts for a small proportion: 0.5%. 140 million tonnes were produced as hot rolled steel products, accounting for 90% of total finished products.

Considering the production inputs, the consumption of iron ore per tonne of pig iron has changed over time. Generally, in the Member States the iron ore resources are limited and, as a consequence, many countries decided on an increased role of the electric production process. The pure oxygen method accounted for 60.2% of production and the electrical method for the remaining 39.8%. Pig iron as an input to crude steel followed the same trend and decreased over time, from 80% in 1952 to 62% in 2000.

The accessing countries in Central and Eastern Europe have during the communism period developed an important steel sector as part of their heavy industries. This tendency appeared as a consequence of important natural resources correlated with an economic self-sufficiency strategy. The industrial sector made a major contribution to the economy during communism, but the lack of investments and closed economy with restricted area of trade had a significant negative impact on its competitiveness. The fall of the East European market was the starting point for new challenges as the technologies and products were obsolete and inadequate for the highly competitive market of the West European countries.

During the transition period, restructuring was undertaken to some extent in most of the candidate countries and was conducted both by the state and by the private sector. The state closed some of the inefficient plants or installations, reduced the amount of labour and privatised the companies. The private sector contributed to the restructuring mainly by modernisations and investments in technologies and environmental protection. Even after significant downsizing, the steel sector in candidate countries remains significant. In 2002, the production in CEECs accounted for 5% worldwide, compared with 15% representing the share of EU production.

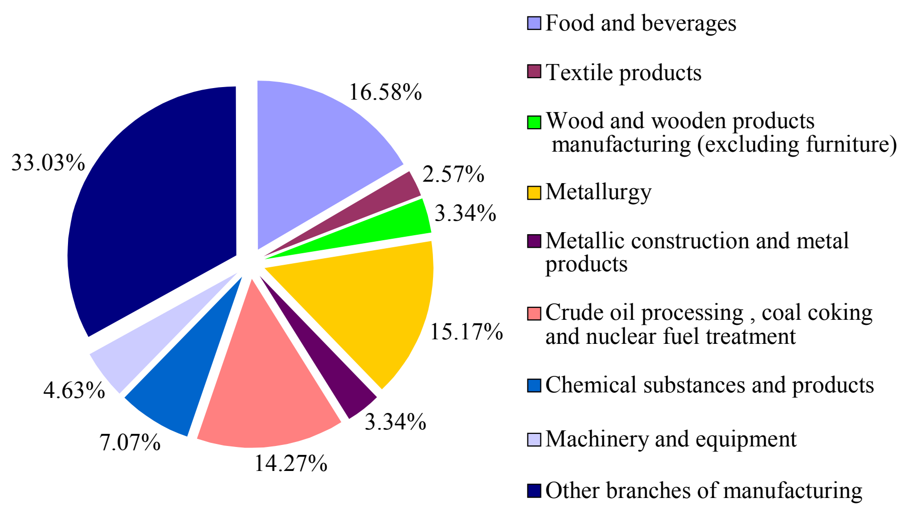
The circumstances of candidature for the European community have conducted the restructuring process towards a co-ordination of politics and programmes in accordance with the EU requirements. As in other sectors of activity, European Agreements have been signed with the accessing countries, establishing the conditions to be achieved during restructuring. The agreements provide a legal framework for the liberalisation of trade through a gradual removal of customs duties and for the abolishment of governmental aid as a preparatory stage for the final integration.

These are the main features of the steel industry in Europe, both in the European Union and in the accessing countries and they illustrate the framework for the current study. We shall now move forward and focus on the specific issues of the Romanian steel industry. Firstly, the subsection 3.3 will analyse the position of the steel industry related to the Romanian manufacturing industry, as well as to the steel industry in the East-European countries. Secondly, the subsection 3.4 will consider in more depth the issues of industrial competitiveness.

The Romanian iron and steel industry

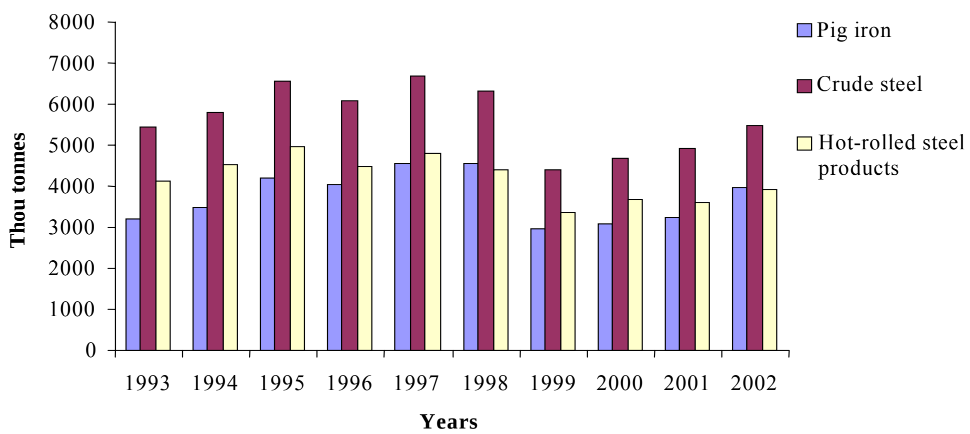
The similarities in the ideological perception of the economic and political strategies created similar circumstances for the industry of the ex-communist countries. Consequently, metallurgy has been a significant part of the Romanian manufacturing industries. In 1990, its share was almost 10% of industrial production and accounted for more than 16% of total Romanian exports. Due to a wide collapse of other industrial activities, the position of the steel industry consolidated during the transition, as shown in Figure 1.

Figure 1: Structure of Romanian manufacturing industries in 2002 based on production figures. (based on data from the Romanian National Institute of Statistics1)



In fact, the trend in the steel industry after 1990 was a continuous deterioration in production and export activities. In 2001, the production accounted only for 37% of the crude steel produced in 1990.

Figure 2: Evolution of production in the Romanian steel industry by its main components. (based on data from the Romanian National Institute of Statistics)



The structure of production reveals a preponderance of unfinished products, with pig iron and crude steel representing more than 60% of the production. The physical production of crude steel fluctuated during the transition period between 4000 and 6600 thousand tonnes (see Figure 2).

Considering the regional context, quantitatively significant production can be seen in Poland, the Czech Republic, Slovakia and Hungary. Table 1 shows the Romanian position among the most important countries producing crude steel in Eastern Europe and the production specialisation.

Table 1: The production of crude steel and hot-rolled products in 2003 in Eastern European countries (thousand metric tonnes). (based on data from International Iron and Steel Institute, 2004)

	Poland	Czech Republic	Romania	Slovakia	Hungary
Crude steel production	9.1	6.8	5.7	4.6	2
Hot-rolled steel production	6.8	5.7	4.8	…*	1.8
Hot-rolled flat products	2.3	1.7	3.6	…	1.5
Hot-rolled long products	4.5	3.6	0.9	…	0.3

* … - not available.

The biggest part of the crude steel is transformed into continuously cast slabs and billets, which consolidated their position consistently from 48% in 1995 to 83.6% in 2002. The crude steel as ingots followed the worldwide tendency, diminishing considerably from 50% in 1994 to 16.4% in 2002.

The processed steel is represented mainly by hot-rolled products. The production oscillated between 4 and 5 million tonnes until 1996, decreasing afterwards to less than 4 million tonnes. Quantitatively, Romania is among the most important producers of hot-rolled steel in Eastern Europe. Following the general tendency in Eastern Europe, Romania specialised in the production of flat steel products. By contrast, the Czech Republic and Poland produce mainly long steel products.

Technologically, Romania has used three installations for crude steel production: oxygen blown converters, electric furnaces and open-hearth furnaces. The last one has been used to some extent during the transition period, representing approximately 15% of the steel production. However, following the general trend, production by this method was discontinued in 2000. The installation is considered outdated but it is still in use in some emerging countries. As an example, Bosnia-Herzegovina is still producing around 70% of its steel in open-hearth furnaces. In Romania, more than 70% of the steel production was produced in oxygen blown converters.

Structural changes during the transition and the privatisation in the steel sector had a major impact on the technological process. As iron ore is scarce, the production process was reoriented to electric furnaces. In 2002, 47.3% of the crude steel was produced in electric furnaces.

Competitiveness dimensions for the Romanian iron and steel industry

The concept of competitiveness has been used in various approaches and meanings and as Porter (1990) admitted, there is no common definition. Traill and da Silva (1996) distinguish between three levels of competitiveness analysis: competitiveness of a nation, of an industrial sector and of an individual firm or groups of firms within an industry. In addition, they brought a dynamic approach to competitiveness, concluding that multinational enterprises' activity cannot be directly classified as beneficial or negative for industry competitiveness. This view is substantially different from the static concept of competitiveness of Porter (1990) and Dunning (1977). The former considers only the production of home-based companies as contributing to the competitiveness and excluding the activities of foreign or domestic companies which do not manage the strategic control inside the country. Dunning (1997) by contrast considers ownership as contributing to the competitiveness and not the location of the firms.

Similarly to the concept approach, the measures used to assess competitiveness have been various. We shall analyse competitiveness through two widely used dimensions: productivity and foreign trade. In addition, considering the specificity of economies in Eastern-Europe, we consider it important to assess the level of industrial restructuring as an indicator of competitiveness.

Competitiveness in terms of productivity

Productivity is usually assessed based on three main factors: labour, capital and technology. However, practical impediments in measuring the capital and technological contribution to productivity as well as the data availability often restrict the analysis of economic performance to labour inputs. Labour productivity analysis is used in this study but it should be mentioned that the contribution of capital and technology to Romanian industrial productivity is limited, due to a low foreign direct investment (FDI) inflow and weak efficiency of the obsolete technological equipment (for issues concerning investments, see 3.4.3).

Calculated as gross physical production per employee, labour productivity shows no major changes during the transition period, as Figure 3 indicates. The rate remained relatively constant, although reductions affected proportionally both production and employment. One cause of low industrial productivity in East European countries is considered to be the oversized level of employment (Commission staff working paper 2003).

A comparison of labour productivity in the steel sector in Eastern Europe has been performed by the European Commission (see Figure 4). Among the accessing countries, the Czech Republic, Poland and Slovakia stand out with the highest productivity in 2002. Nevertheless, compared to the EU-15's medium productivity, only the Czech Republic is relatively adequately positioned, achieving approximately 80% of EU productivity. In the case of the other East-European countries, the productivity is situated well below the productivity in the Member States. A decidedly low level can be noticed in Romania, compared both with the EU-15 and the accessing countries.

Figure 3: Labour productivity (gross production per employee) in the Romanian metallurgy industry. (own calculation based on various statistical data)

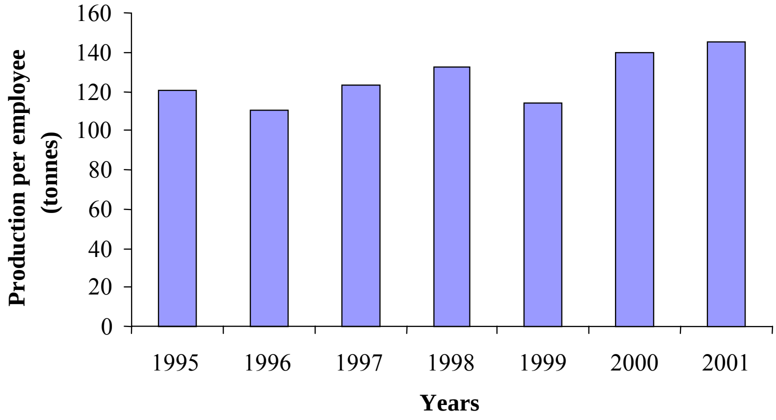


Figure 4: Labour productivity in CEECs (reference year 2002). (data retrieved from the European Commission)

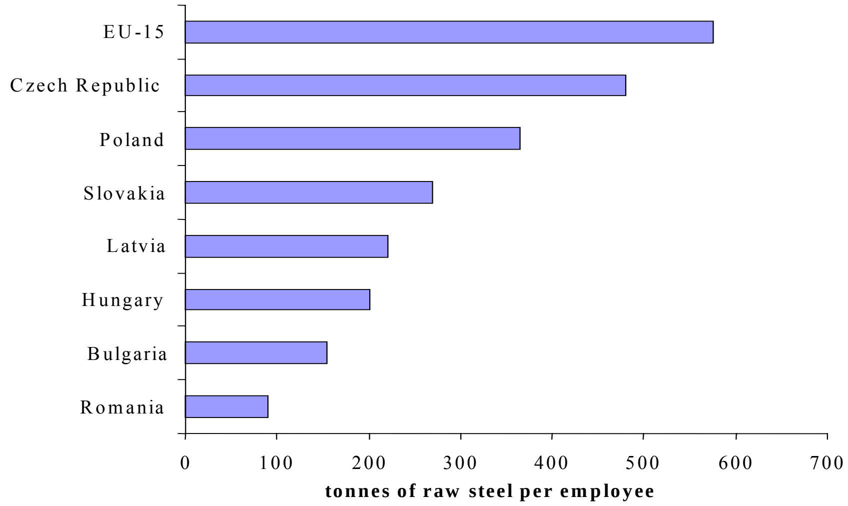
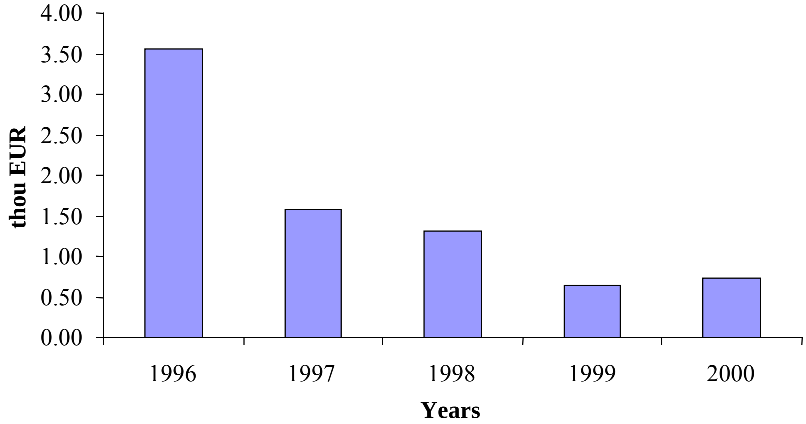


Figure 5 indicates the evolution of labour productivity calculated as gross value added per person employed. The numbers reflect real values. Adjustments have been made based on purchasing power parities and exchange rates. The rate is particularly indicative by relating it to Figure 3. While the production obtained per employee remained constant, allowing little space for interpretations, the contribution of each employee to the value added was dropping dramatically. On the one hand, the oversized employment did not adjust to the production capacities and on the other hand, the high production costs had a negative effect on the value added. The product quality and the level of processing are factors of considerable impact on value added, thus the higher the quality and processing are, the higher is expected to be the value added. The result obtained reflects the circumstances of the steel industry in Romania:

specialisation in producing low-processed products and insufficient investments in technologies.

Figure 5: Romanian labour productivity (gross value added per person employed). (based on data from the Romanian National Institute of Statistics)



Romanian performance in productivity is weak both for the steel and the manufacturing industries. Manufacturing productivity on the whole, amounts to one fourth of Hungarian and 10% of the Austrian level (Havlik 2001). Among the Romanian manufacturing industries, productivity in steel industry exceeded the average level, being the third most productive branch (Havlik 2001).

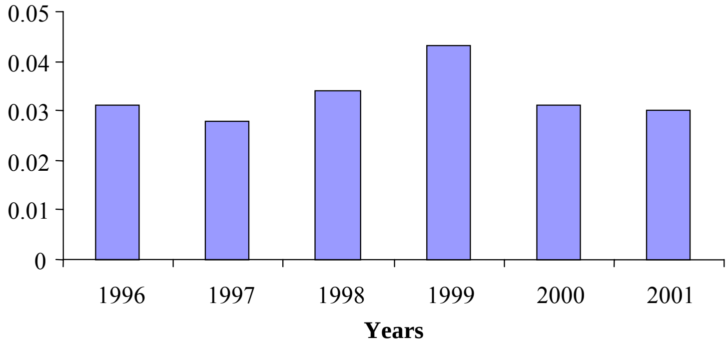
A sectorial analysis of unit labour costs (ULC) was made by Havlik (2001), based on the following formulas: ULC = wages/(output/employment) or

d ULC = d wages - d output + d employment

He found a cost gap between Romania and Austria of nearly 70%. Almost all the candidate countries have cost advantages in the steel industry, arising from the wage gaps.

Analysing the ULC components, we draw the following conclusions. The wage level in real terms did not fluctuate significantly over the period 1996-2000. The employment has contracted constantly, directly connected with the shrinkage of steel activities. Only 63.76% of employees in 1996 were still working in the same area in 2000. The same reason contributed to the deterioration of output (gross value added) with 34.27% between 1996 and 2000. Consequently, the output per employment rate is constant over time and the ULC fluctuations are relatively low (see Figure 6).

Figure 6: Evolution of ULC in Romania during the transition. (own calculation based on data from the Romanian National Institute of Statistics)



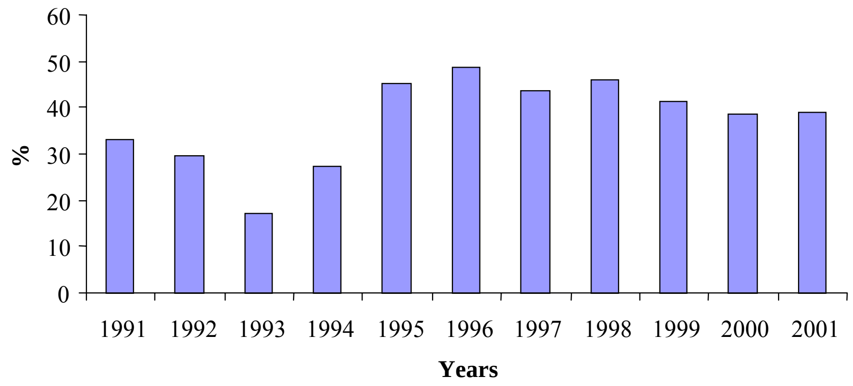
Considering the utilisation capacity, the European Commission associated the lowest performances in 2002 with the Romanian and Bulgarian steel industry: 67% and 64% respectively, as compared with 80% in the Czech Republic, 86% in Hungary, 100% in Latvia, 70% in Poland, 95% in Slovakia and 80% in the EU-15.

Competitiveness in terms of foreign trade

Evaluating competitiveness in terms of foreign trade is affected by biased measurements, due to influences from the production of local subsidiaries of foreign companies and from the production of domestic firms in other countries (see the study by Traill and da Silva 1996). Bearing in mind these limitations, statistical data on Romanian external trade are used for this analysis.

The reorientation of exports to the EU market, liberalisation and the removal of barriers are the main trends in Romanian foreign trade. The EU represents the target market for around 40% of the Romanian steel exports, while Southeast Asia (Singapore, Malaysia, China, Taiwan), South America and USA remain significant destinations. As Figure 7 shows, the EU plays an increasing role for the Romanian steel exports. Nevertheless, the Romanian market share in the EU imports is decidedly low compared to the regional figures. Imports from the East European area increased remarkably due to trade liberalisation and integration prospects and represented more than 45% in 2000. Russia, Poland and the Czech Republic are among the major steel suppliers for the European Union.

Figure 7: The shares of the EU market in Romanian steel exports. (own calculation based on data from Romanian National Institute of Statistics)

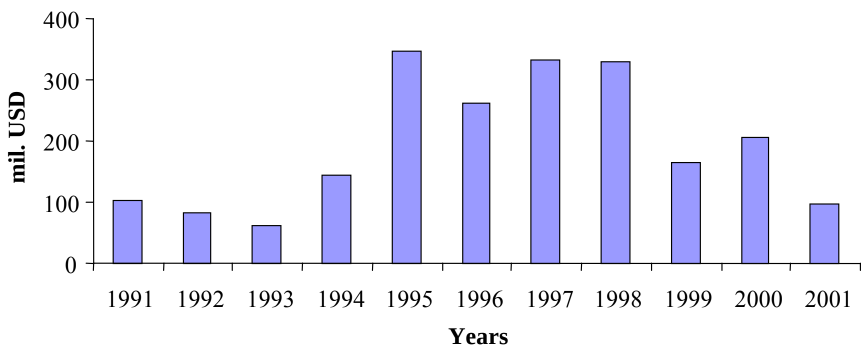


The structure of steel exports to the EU reflects a preponderance of raw materials and products, with pig iron and crude steel accounting for more than 60%. The proportion of unfinished products is higher if we consider the total exports.

With respect to the imports from the Community area, transactions have been enhanced significantly due to the major impact of trade liberalisation and legislative implementations. In contrast to the exports, highly-processed products dominated.

The trade balance reveals a positive export surplus in relation to the EU (see Figure 8). Nevertheless, declining surplus during the last few years indicates a deterioration of competitiveness in the steel trade.

Figure 8: Romanian trade balance of the steel industry in relation to the EU-15. (own calculation based on data from the Romanian National Institute of Statistics)

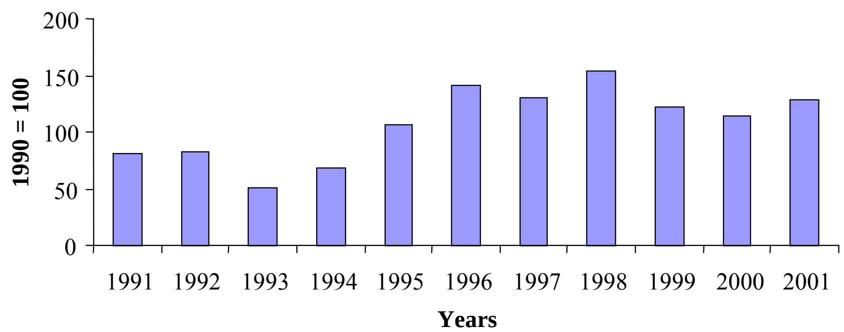


Detailed performance measures in foreign trade are analysed by Havlik (2001). One of the indicators used is the revealed comparative advantage (RCA), calculated based on relative industry's shares of imports and exports and relative shares of country's total manufacturing imports and exports. In case of Romania, Havlik found a positive RCA in the basic metals trade with the EU. However, the RCA has deteriorated markedly during the transition period, following a similar trend in the other accessing countries.

Competitiveness in terms of restructuring

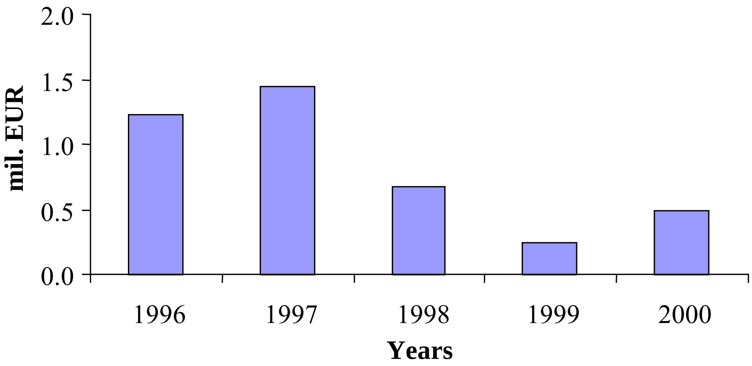
Investments play a key role in industrial restructuring. The competitiveness on the European market is heavily dependent on the effort of former communist countries to update their technological capacities and to modernise the equipment and industrial installations. Figure 9 presents the evolution of investments made in metallurgy, which include investments in buildings and constructions, technological equipment, inventory expenditure and fixed assets.

Figure 9: Investment indices in metallurgy (1990 = 100). (Source: Romanian National Institute of Statistics)



The average annual rate of investments, as calculated by Havlik (2001) indicates a 6% rate of growth in Romania, as compared with 11.8% in the Czech Republic and 9.6% in Poland. In addition to Havlik's ratio, we have calculated the return rate on assets as a report between investments and existing stock of equipment. The rate is an indicator of the technological renewal and it reached an average of 5.06% over the period 1991-2001, leading us to assume that a poor modernisation has taken place. In addition, Manoleli (2002) points out that only 15-21% of the required investments for environmental compliance were made in 2000.

Figure 10: Research expenditure in the Romanian metallurgy industry (real prices). (own calculation based on data from the Romanian National Institute of Statistics)



Research and development is a second key indicator of restructuring activities. The number of companies undertaking research and development expenditure is low, decreased from 1997 to 2001 and represented in 2000 only 2.72% of total enterprises in the sector. Among them the number of companies which introduced new or modernised products or applied new or modernised technologies accounted for 1.16% of the total number of manufacturing companies. A declining development in research investments is observed in Figure 10. In addition, the proportion of less than 1% of research expenditure in the metallurgical value added reflects a low level of research activity.

Challenges and opportunities for the Romanian steel industry

Based on the indicators of competitiveness examined in the previous section, in this chapter a brief synthesis is presented on the current state of the Romanian steel industry. The second part of the chapter is concerned with the opportunities that might make a contribution to the improvement of competitiveness.

The dimensions of competitiveness analysed above indicate a generally low preparedness for competing on the enlarged European market. Firstly, the labour productivity is less than half of the level in the CEECs and is six times below the EU average. High employment, in correlation with low utilisation capacity, is one of the causes identified for the current weak productivity. Although employment has diminished considerably during the transition, production followed the same trend and the industry remained generally oversized in employment. In addition, the value added brought by each employee has dropped dramatically, indicating an important deterioration in productivity performance. Insufficient investments in technological equipment as well as specialisation in low-processed products have contributed to the present situation.

Secondly, in terms of trade, despite its large production capacities, Romania remains a small supplier of steel on the European market. One reason for this is the very low trade with the EU countries before 1990, which caused difficulties in entering this market. On the other hand, the collapse of the internal market and the loss of traditional international customers in the early 1990s led to a massive contraction in steel production (Manoleli 2002) and large technological capacities remained unused. The statistical data indicates a reduction of internal consumption from 5.9 to 2.2 million metric tonnes over the period 1990-2000. Examined for structure of the trade relationships, a preponderance of basic steel and low-processed products may be observed in exports, while the highly-processed products prevail in imports. This is mainly related to the structure of production, oriented towards low-processed products, requiring large investments for modernisation of products. While there is a significant revealed comparative advantage for the CEECs in relation to the EU, part of it has been lost by the Romanian steel industry. In addition, the steel balance of trade deteriorated, due to unfavourable developments, especially in imports.

Thirdly, there is a decided need for investments in technologies and the restructuring is heavily dependent on modernisation and improvements in product quality, to ensure long-term survival and growth.

In accordance with the findings of this study, Havlik (2001) pointed out the low degree of readiness for European competition, explained by reduced volume of investments and foreign capital penetration, dominance of a few large plants and state financial support. Manoleli (2002) found a poor utilisation capacity, old infrastructure and insufficient equipment for pollution control. An evaluation made by the Institute of Industrial Economy (Romanian Chamber of Commerce 2002) identified a 10-25 year gap in technological development compared with developed countries and an overcapacity of production. The Commission staff working paper (2003) found significant delays in industrial restructuring and pointed out over-capacity and overstaff, difficulties in attracting strategic investors and social and regional consequences of reforms as the main issues to be addressed by the industrial sector.

Besides the above-mentioned issues, due mainly to the centralised economic structures, a few other aspects have contributed negatively to the present situation of the steel industry. Among these, the problem of material inputs could be mentioned. Iron ore, one of the main raw materials used in the technological process, is mainly acquired from external sources. Internal production of iron ore dropped during the last ten years concomitantly with quarry closure. In 2002, only 0.8% of the iron ore was supplied by internal providers, compared with 19% in 1993. The main consequence of large imports of raw materials is dependence on the external market and the industry's vulnerability to external disrupting factors.

Secondly, state aid, which has been widely used in Romania, is a problematic issue, considered to be an essential hindrance to free competition on the market and thus, becoming the subject of specific regulations inside EU area. The Romanian steel industry has survived with considerable financial and non-financial help from the state, with subsidies and debt annulment as the more used forms of support. The subsidies allocated to steel companies accounted for USD 1330 million over the period 1993-2002 (Romanian Government 2004).

At the micro-level, financial indicators indicate that compliance with the EU’s viability criteria has only partially been accomplished. The governmental decision regarding the strategy for the restructuring of the steel industry (Romanian Government 2004) found that indicators such as financial costs, price-cost differences for a number of companies are well bellow the EU requirements.

The aspects presented above are difficulties and challenges which remain to be overcome by the industry. We shall focus now on the favourable opportunities that are available and may be exploited with positive results by Romanian steel industry. Despite transitional problems, achievements and progress have been made and, associated with the development prospects in CEECs, can make their contribution to industrial recovery and competitiveness improvement.

Legal framework

On the legal side, the legislative harmonisation has concerned mainly two areas: environmental protection and competition.

From the environmental point of view, the European Union's IPPC Directive has been fully transposed into the Romanian internal legislation. The law was passed in 2002 and is based on integrated permits which use various criteria for environmental protection evaluation in order to authorise the functioning of industrial installations. In its negotiations with the European Union, Romania has been granted a transition period of 15 years, ending in 2008 for implementing the environmental standards. During this period, industrial installations are strictly controlled, ensuring that progress is made in environmental compliance.

Protocol 2 of the European Agreement in 1994, which entered into force in February 1995, set the legal framework concerning the competition and the bilateral relations between Romania and the European Union. The document provides the legal support for the elimination of quantitative restrictions and gradual removal of custom duties in order to achieve free competition and fair trading practices. As a result, starting from 2000, steel products originating in Romania have free access on the European market. The customs duties on imports from the Community were abolished in 1995 in the case of raw materials, scrap and semi-finished products and gradually until 2000 for flat- and hot-rolled products. In addition, Protocol 2 targeted state aid as one of the main barriers for a free competition. Due to compliance requirements, public aid has been allowed for the candidate countries for certain periods and specifically the restructuring purposes. In 2005, this derogation will ceased and remains a challenge for the industry to survive without state support.

The negotiations with the EU resulted in legal decisions (Romanian Government 2002 and Romanian Government 2004), expressing the state's concern to improve the performances and establishing a strategy for restructuring the steel industry. Two main directions have been identified for the future development of the industry: expansion on the European market and specialisation in highly-processed products.

As expected, implementing legislative regulations has had practical implications for Romanian foreign trade. Considerable growth in steel imports, especially for finished products is a significant concern for the industry. On the other side, the impact on exports to

EU and balance trade (Figures 7 and 8) is positive and countervails the increase in imports. Starting from 2000, the bilateral trade has been liberalised and no further implications are expected at the time of accession.

Privatization and foreign direct investments

Privatisation has been used as a technique for the restructuring of Romanian steel companies and consequently, approximately 95% of the steel industry capacity is privately owned. As generally admitted in the literature, the process of property transfer from public to private ownership has a positive impact on companies' restructuring. A broad study by Earle and Telegdy (2002) on privatisation effects in Romania found significant outcomes on productivity improvement, with strongest impacts correlated with outside blockholders. The features of privatisation in the case of the Romanian steel sector lead us to perceive encouraging perspectives for healthy recovery and survival on the European market.

Structurally, a small number of enterprises persists, with one company (Ispat Sidex) accounting for the largest part of the steel production (around 80%) and making a 4% contribution to gross domestic product (GDP). The production is mainly specialised in a specific range of products for each company, but some of them have a diversified production.

In terms of privatisation, we firstly identified the presence on the Romanian steel market of a worldwide leading investor. The acquisition of four major companies, including Sidex, by the same investor provides the opportunity to initiate strategic renewal and management innovation. The strategic objectives of the foreign investor include expansion on the East-European market, similar steel plants being purchased in candidate countries, thus consolidating its position in the region. The benefits arise from plant integration into the foreign corporation and from the access to the network of material resources, knowledge and market chains.

Secondly, as the steel social capital is mostly private, a major contribution of the owners to the financial recovery and technological modernisation is to be expected. Financial resources required by technological and environmental investments and the investors' know-how are essential for the success of the reforms.

Examining the contribution of privatisation and FDI to output, we consider the case of Ispat Sidex as being representative of the industry's development. The outcomes achieved so far due to privatisation consist of improvement of financial indicators and ceasing of financial losses. In fact, in 2003 the losses turned to a profit amounting to USD 100 million. Similarly, the production and sales consolidated both on domestic and external markets by 44% in 2002 compared to 2001.

Similar performance commitments are stipulated in the privatisation contracts of other steel companies. Overall, during the period 2002-2010, the sum of USD 550 million is expected to be invested in technological modernisation and USD 120 million in environmental improvements (Romanian Government 2004).

Environmental issues

Technological installations in the steel industry contribute significantly to pollution and updating them to environment-friendly equipment is a requirement in accessing countries' negotiations with the Community. The existing level of technologies denotes a low readiness for complying with environmental regulations. Despite the positive effects of investments for modernisation and productivity, the level of estimated costs for environmental compliance is a burden for the industry. Chivu (2002) estimated that a number of the 109 installations from the Romanian steel industry would be affected by the IPPC Directive. Nevertheless, the favourable prospects may countervail the impact of environmental issues on companies' competitiveness. The highest potential for environmental compliance depends on modernisation and industrial activities.

We consider below the case of air pollution, the most challenging environmental concern in the steel industry. Firstly, despite the polluting equipment, there is a positive evolution of pollution during the transition period, which is mainly due to the contraction in steel production, correlated with the closure of inefficient plants and installations. No sectorial information is available, but the total amount of greenhouse gas (GHG) emission decreased by 44% in 10 years. The future evolution of GHG emissions until 2010 was estimated by the second national communication to the United Nations. Three possible scenarios were considered: a reference scenario, without structural change in the economy and without implementation of new measures, a low and a high scenario, with a low and respectively high level of restructuring. Both the low and high scenarios indicate lower level of GHG emissions than in 1989, the year taken as a reference. In the case of the reference scenarios, the 1989 level is estimated to be achieved in 2010.

Secondly, investments made in technologies, although insufficient, have played their role to the reduction of pollution. Modernisations have been made at the blast furnaces, electrical ovens and installation for water collection and purification. Accordingly, the quantity of dust and metals emissions has been reduced. However, the amount of funds invested has been relatively low compared with the modernisation required. In ten years of transition, an amount of USD 570 million was invested in the modernisation of existing productive capacities (Manoleli 2002). The new private owners undertook investment efforts in the privatisation contracts. For Ispat Sidex, the investment commitments amounted to USD 351 million, with USD 251 million in the first five years and USD 76 million in environmental projects.

Thirdly, a strategy of technological reorientation has been adopted in order to reduce pollution. As previously mentioned, almost half of the crude steel is nowadays produced in electric furnaces as compared with 28.5% in 1993. The pollution in the case of electric furnaces is as much as 90% lower than pollution in traditional furnaces. Simultaneously, some of the old polluting installations and industrial platforms have been closed. The main facilities included coking plants in five enterprises, blast furnaces in four enterprises and Siemens-Martin based steel works in three plants.

Having in view the current situation of industrial pollution, we find positive perspectives on the emerging emission trading market, both at the level of the European Union and of the states included in the Kyoto Protocol (UNFCCC 1997). The Romanian Government ratified the Kyoto Protocol and the target set for the period 2008 - 2012 is to achieve 92% of the 1989 level. For the steel industry we consider below two polluting gases, which are targets for the Kyoto Protocol: carbon dioxide (CO_2) and methane (CH_4). Table 2 shows the level of emission in the reference year 1989 and their estimated evolution in 2010. The estimations are made for the overall country emissions due to unavailability of sectorial data and one should bear in mind these limitations of the analysis below.

Table 2: Emissions of CO2 and CH4 and the projections for 2010 (Gg/year).

Gas emission	1989	2010		
		Reference scenario	Low scenario	High scenario
CO_2	194826	228535.7	201447.5	167655.5
CH_4	2357	1760.2	1484.4	1356.2

Source: Romanian Ministry of Waters, Forests and Environmental Protection, 1998.

For CO_2 emissions, modernisation and active restructuring in the economy would mean a good position on the emission market. Emissions of CO_2 may decrease by 14%, well below the reduction commitment of 8% assumed by the Kyoto Protocol. For CH_4 emission, the outlook is even better. The reduction in gas emission varies between 25.32% (in the case of the reference scenario) and 42.46% (the high scenario).

We consider below NO_x (nitrogen oxides) and SO_2 (sulphur dioxide) gases (see table 3), the most polluting gases in the steel industry which are not currently part of the Kyoto Protocol, but it is to be expected that environmental standards will have to be reached at some point. Estimations for these gases were made by the Cofala (1999).

Table 3: Emissions of SO2 and NOx and the forecasts for 2010 (in kilotons).

Gas emission	1990	1994	2010		
			Reference scenario (based on current policies and trends)	Current legislation scenario (partial convergence)	EU emission standards scenario (complete convergence)
SO_2	1311	912	590	561	561
NO_x	546	319	453	524	329

(Source: Cofala 1999)

Comparing the figures with the reference year 1990, the reference scenario indicates a decrease of 55% in SO_2 emissions and 17% in NO_x emissions. Implementation of EU standards does not have implications for SO_2 emissions, but has a significant impact on NO_x reduction (by 37.21%).

The emission trading market came into force in January 2005 and offers flexible mechanisms for compliance with environmental regulations. On the emerging market, the rights to emit greenhouse gases are traded and represent an alternative to the restructuring process. The polluting companies have the option to find the most cost-effective scheme with the lowest possible cost for complying with the Kyoto Protocol or EU targets. The scheme is based on cost evaluation for implementing the environmental standards and the market prices per tonne of emission. The emission trading market is open at the beginning for CO_2 emissions but is expected to extend to other emissions, especially after 2008.

On this market, Romania and the countries of Eastern Europe are identified as net providers of emissions allowances. This position can be exploited by Romanian industry in order to enhance its competitiveness on the European market.

Assuming that meagre financial resources inhibit the restructuring process, the alternative for the Romanian steel companies is to take advantage of their emission allowances. Significant financial resources could be attracted by selling the allocated quotas to Western companies, evaluated as net buyers on the emission trading market. The funds could be used in a second stage for supporting the restructuring processes. Secondly, the restructuring can be sustained using the mechanism of a joint implementation project provided by the Kyoto Protocol. The mechanism offers the opportunity for a developed country to initiate a project in a developing country aiming at reducing polluting emissions in return for emission reduction units. The benefits resulting from this scheme are considerably more significant for the future development and competitiveness of the companies.

From the investment point of view, a large amount of emission reductions can be obtained with relatively small investments in modernisation and updating. For comparison, the existing capacities in plants in developed countries require a higher level of costs in research and modernisation.

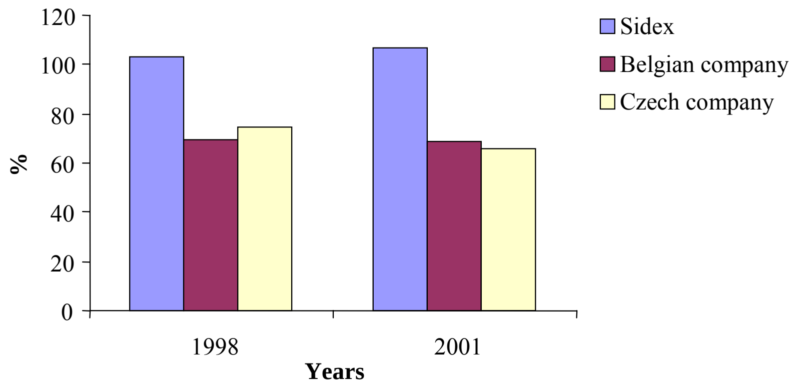
In addition to the emission trading market, there are currently favourable features in the economic environment which contribute positively to environmental restructuring. Among these, mention should be made of the increased FDI inflow, the financial resources attracted through various instruments from the European Union as well as the general fast growth of the economy.

Competitive advantages

We consider below an analysis of competitiveness in terms of cost structure. The case of Ispat Sidex is selected as representative of the Romanian steel industry. Two other companies from the same branch are chosen for purposes of comparison, one representing the steel industry in Eastern Europe (Czech Republic) and the other the industry in EU Member States (Belgium).

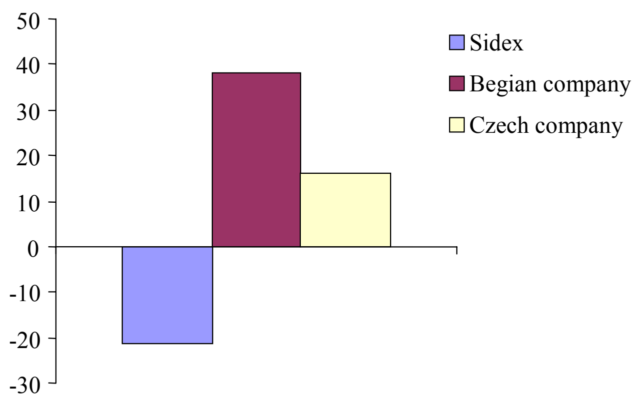
The costs as a competitive advantage are examined first by the rate of operating costs per turnover. Figure 11 indicates the differences in value for the companies analysed. The proportion of operating costs in turnover reached a high level in the case of Sidex, fluctuating between 88 and 107% during an eight-year period. The rates in the Czech company are similar to those in the Belgian company and the costs account for a considerably lower percentage in turnover than at Sidex.

Figure 11: Operating costs per turnover. (Source: Amadeus database)



Considering the proportion of value added in turnover, the best performance is achieved in the case of the Belgian company, with much lower rates in Eastern Europe (see Figure 12). The value was negative in the case of Sidex and became positive in 2002.

Figure 12: Value added per turnover (year 2000). (Source: Amadeus database)



The rates analysed above indicate that the Eastern European companies have been mainly oriented to producing low-processed products with a low level of productivity. Investigating the structure of costs, we find similarities for the Eastern European companies. The proportion of material costs is high (over 80%) compared with the Belgian company (around 70%), reflecting an important feature of the East European steel industry as a big energy and material consumer. The labour productivity calculated as the number of tonnes per employee discloses significant differences, with 600-700 tonnes/employee in case of the Western

European company and 100-250 tonnes per employee in Eastern European companies. Although important limitations in calculating the above rate arise from the different production specialisation of the companies, the very high employment related to the production can be seen.

The average annual cost per employee is lower at Ispat, representing 11.83% of the cost at the Belgian company. Analysing the structure of costs in Western and Eastern European companies, Reinaud (2004) found a clear discrepancy in the level of costs per tonne. In the case of the basic oxygen method, the costs amounted to USD 268/tonne of steel in a Western European plant compared with USD 199/tonne of steel, leading to a profitability of 14.5% and 29% respectively.

In conclusion, the Eastern European companies have a cost-competitive advantage on the external market, arising from the costs of materials and wages but this is not sufficient for the company's growth. Productivity is still low, due to excessive employment and overcapacities, and partly cancels out the benefits of the cost advantages.

In addition, in the case of Romanian company, the competitiveness of exports on the European market is still sustained by state subsidies, consisting of exemptions from profit and value added taxation and from customs duties for imports of raw materials and equipment.

Currently, although the structure of production is diversified, there is a preponderance of low-processed products. The governmental strategy (Romanian Government 2002) aims at gaining competitive advantages on the external market through a reorientation of production to highly-quality and highly-processed products. Adopting this strategy is a result of the necessity to comply with the EU requirements, as well as to follow the external market trend. For the following period an increase in production for steel pipes is expected compared with other flat products, as a consequence of external demand from energetic industries. The governmental strategy has in view a specialisation of production in the steel industry in order to avoid internal competition and to specialise in a narrow branch where the enterprise can acquire better know-how and a position on the market.

If we consider the previously mentioned evolutions, we expect conservation in labour cost advantage for the next period of time. On the one hand, economic growth and access to European structures will generate increases in wage levels. On the other hand, social restructuring will restrict major increases in labour costs. Until 2005 the new owner has a contractual commitment to maintain the number of employees. During this period, a reduction of 4000 employees is expected, due to retirement (Romanian Government 2002). After 2005, the owner can apply his own social strategy and we anticipate more reductions in employment. As a consequence, the increased value of labour expenses will compensate the reduction in employment and no large variations are expected in labour unit costs.

Concerning the material costs, a reduction in costs is expected due to technical modernisation. Restructuring in the technological process and reorientation from oxygen blown converters to electrical furnaces will improve energy efficiency and decrease iron ore consumption. In the case of the iron ore used in oxygen blown converters, the production is almost entirely dependent on imports. Unlike iron ore, scrap as a raw material used in the production in electrical furnaces relies on internal sources. Romanian production of scrap covers the internal demand and part of it goes for export. Consequently, the company will become less vulnerable to the external market and international prices.

On the other side, the tendency for the prices will be to converge on the EU level, as an effect of integration, widening the gap between production costs and the price level.

Modernisation of technical equipment will improve product quality. Adopting a quality-based strategy, the company can move towards a higher segment of prices and to obtain a quality premium. The transformation from a low-cost to a highly-qualitative provider remains a challenge to be faced by the company and the steel industry.

Concluding, the prospects for the following period indicate a preservation of current cost advantages on the European market and the opportunity to enter new segments on the European market.

Conclusions

This research analysed the competitiveness of the Romanian iron and steel industry within the context of the expected accession to the European community in 2007. The indicators used in this study revealed the negative impact that the previously centralised economic structures and various transitional problems have had on the industry's competitiveness. A low level of readiness for compliance with European standards was found. The competition and environmental issues are associated particularly with the main threats to the industry's competitiveness on the European market.

Despite these findings, the study identified favourable opportunities that counteract the adverse effects and make a positive contribution to industrial restructuring and successful integration into European structures. Among these, the most significant rely on privatisation, the emission trading market and cost competitive advantages.

The present study is restricted to the particular circumstances of one industry and one country and future research should consider the results within a broader context. Investigating the role played by each of the opportunities identified or to what extent the results are applicable to other industries and candidate countries are the main routes suggested for future exploration.

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THE BREWING MARKETS IN CENTRAL AND EASTERN EUROPE DURING THE PERIOD 1990–2003[1]

Jorma Larimo, Marin Marinov and Svetla Marinova

Abstract

The goal of this paper is to analyze the strategies used by international brewing companies serving the Central and Eastern European (CEE) market and the development of the various national beer markets in the region since the start of the transition. In more detail, the paper reviews the main trends related to the brewing industry in CEE countries. Furthermore, the investment strategies of foreign companies in the CEE brewing sector are analyzed. Recent stagnation in the brewing markets of Western Europe and North America has led to the increased interest of breweries in the market opportunities offered by the emerging world markets, including the rapidly developing markets of the former Soviet Bloc states. The transition to market-led economies in CEE has posed new requirements for growth and profitability, and offered opportunities for the development of the brewing industry in the region. The beer production and consumption in CEE has established traditions. The Czech Republic has been one of the leading beer markets in the world with the highest per capita beer consumption and world-renowned beer brands. Slovenia, Bulgaria and Hungary have had established national and international brewing traditions. During the transition period Russia, Poland and the Ukraine have significantly increased their role as high-growth beer markets. Since 1991 some 25 Western companies have invested in the CEE brewing markets. In early 2000 foreign breweries controlled more than a half of the main CEE beer markets. Key drivers for investment in the region have been market-seeking motives. The main market entry modes have been acquisition of former state-owned breweries and in some cases joint ventures or greenfield investments.

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Introduction

The brewing industry has recently experienced increasing saturation in mature markets, changes in production processes, greater variations in consumer behavior, vertical integration and development of distribution chains, increased internationalization, use of strategic alliances and other collaborative arrangements, and industry consolidation. Originally the brewing industry, with the exception of that in North America, has been very fragmented with a dominant role of local producers on a regional basis. This feature started to change in the 1980s. Changes have been most remarkably observed in the late 1990s and early 2000. The industry reached maturity in Europe where larger companies started to intensify their foreign operations. Due to the increased maturity of the beer markets in Western Europe, the main form of growth has been domestic and foreign acquisitions. Brewing companies have expanded into the world's newly emerging markets, especially into the buoyant and growing markets of CEE and China.

The goal of this paper is to analyze the internationalization strategies used by international brewing companies serving the CEE market since the start of the transition. In more detail the paper reviews the main trends in the brewing industry in CEE and the investment strategies adopted by foreign companies in the region.

There has been limited research focusing on the development and internationalization strategies used in the brewing industry. There are several case studies based on the strategies of some of the leading brewing companies, e.g., Heineken and Interbrew, and industry reports written by consultancy companies. Comprehensive studies are rare and extant ones are already outdated (Wilson and Gourvish 1998; Steele 1991). Research focusing on the development and strategies used in the brewing industry in CEE is limited. For instance, strategies used by Interbrew in the 1990s are studied by Boudewijn (1997), Marinov *et al.* (1997), and Marinov and Marinova (1998, 1999, 2001, 2002). The general trends in the development of the Baltic and Russian beer markets until 2000 are researched by Arnold *et al.* (2000). Marinov and Marinova (1999) have also analyzed the development of the strategies of foreign brewing investors in CEE having focus on the role of experiential learning.

This paper addresses the theoretical explanations and findings of empirical research on FDI in the brewing industry in CEE. The empirical material concerning investments in the brewing industry is based both on secondary sources (annual reports and other materials provided by the investing companies, journal articles and press releases) and on visits and interviews with the management of brewing companies.

The first part of the paper focuses on global trends in the brewing industry during the period 1990-2003. The second part discusses the development of the brewing industry in CEE. The motives for FDI in the CEE brewing industry and investor market strategies are presented in the third part, which is followed by a discussion of the ownership forms adopted by foreign investors and the key problems faced by breweries in CEE. The paper concludes with a discussion on the further developments of the brewing industry in CEE and offers suggestions for future research.

Global industry trends

Beer is the largest volume alcoholic drink in the world. In the major world markets, such as Germany and the UK, it accounts for around 80 per cent of all alcoholic drinks, and in the US for more than 60 per cent. Traditionally brewing markets have been characterized by a high degree of localized appeal (Gouvish 1998). Hence, the industry used to be dominated by local breweries satisfying the demand for good quality beer. To date the German market is characterized by a high degree of fragmentation. Global production has experienced steady growth that has been mostly due to rising consumption in emerging markets. The industry produced 1,166 ml hectoliters (hl) of beer in 1990; 1,253 in 1995; 1,383 in 2000; and 1,444 in 2002. This growth has reached 23 percent by 2002.

Since the second part of the 1990s there has been a constant decline in consumption trends in the Western European and North American beer markets and increasing consumption trends in several emerging markets, especially in China, Russia and Mexico (Kaplan 2003). While in 2000 the US ranked first in beer production (see Table 1), in 2003 China became the largest producer of beer in the world. The constant increase of beer consumption in Russia and the large opportunities for growth in per capita consumption in China and Russia have strengthened the brewing industry in these countries. These trends create good opportunities for market penetration by established brewing companies in dynamic markets with high growth potential (Rodwan 2002).

The decreasing consumption of beer in the traditional markets worldwide (see Table 1) has been caused by several reasons. Among them one should mention the falling number of people aged 15–35 (the age group with highest consumption of beer); changing work patterns (less physical hard work); an increased focus on health; strengthened drink-driving rules and increased competitive pressure caused by consolidation and augmented availability of beer substitutes such as soft drinks, wine and ready-to-drink premixes.

Table 1: Production, Export, Import and Consumption of Beer in Selected Markets (Source: Coelho & Rastoin 2003)

Country	Production in million hl/annum				Export, m hl/a 2000	Import, m hl/a 2000	Total consumption, m hl/a 2000	Per capita consumption, l/a 2000
	1990	1993	1996	2000				
China			163,2	220,0	0,8	0,8	223,1	17,2
USA			236,0	232,5	2,7	23,3	235,9	86,1
Germany	104,3	115,4	114,2	110,4	11,1	3,2	105,4	128,0
Brazil			80,2	82,0	0,5	0,1	86,2	51,2
Japan			68,7	80,0	0,5	0,9	71,5	56,2
Mexico			47,2	60,3	7,9	0,5	50,4	48,9
United Kingdom	61,8	54,9	58,4	55,3	3,7	5,5	57,0	95,9
Russia			20,6	54,9	0,3	0,4	48,9	33,6
Spain	27,3	24,3	24,7	26,4	0,6	2,7	28,5	72,0
The Netherlands		20,4	23,5	25,1	12,9	0,9	13,1	82,8

Table 2 presents the leading breweries in the world. In the 1990s Anheuser-Busch was the indisputable market leader. However, in the last few years there have been a number of acquisitions, mergers, strategic alliances and joint ventures among major players in the industry. For example, a large merger was the one between the Brazilian Brahma and Companhia Cervejeira Antarctica in 1999, which led to the creation of Ambev, the main beverage company in South America. A significant acquisition took place in 2000 with Interbrew acquiring Whitbread Brewing and Brauerei Beck&Co. Some other consolidating activities include the merger of Carlsberg and Orkla ASA to form Carlsberg Breweries A/S; the acquisitions of Kronenbourg in 2000 and Hartwall in 2002 by Scottish&Newcastle; the acquisition of Miller Brewing by South African Breweries in 2002 and the acquisition of BBAG by Heineken in 2003. To strengthen their market position and increase competitiveness the leading breweries have consolidated operations worldwide.

Attempts for the internationalization of the brewing industry started long ago (Karrenbrock 1990). For example, Bass initiated exports of beer to Russia in 1784. Until 1990 the role of foreign investment operations in the brewing industry was limited however. The leading companies seem to have followed somewhat different types of internationalization strategies.

Table 2: Leading Breweries in the World (Source: Coelho & Rastoin 2003)

Company	Production m hl/a			Number of restructuring operations				Ranking (2000)	Leading Brands (2000)
	1993	1996	2000	1991-1995	1996-2000	Total	Tot. alcohol		
Anheuser-Bush	102,0	110,7	124,1	28	24	52	31	Americas No 1	Budweiser
Heineken	53,7	54,4	74,8	19	22	41	37	Europe No 1	Heineken
Interbrew	16,5	34,0	64,1	15	32	47	36	Europe No 2	Stella Artois
Brahma/AmBev	28,0	38,3	62,4	20	33	53	33	Americas No 2	Skol
SAB	22,9	38,8	61,3	7	32	39	35	Africa No 1	Castle Lager
Carlsberg	34,0	32,3	60,9	18	39	57	37	Europe No 3	Carlsberg
Miller	50,3	52,8	50,6	17	26	43	24	Americas No 3	Miller LITE
Kirin	35,0	32,3	38,5	29	43	72	16	Asia No 1	Kirin Lager
S&N-Kronenbourg			36,8	15	22	37	*6*	Europe No 4	Kronenbourg
Modelo			36,6	4	8	12	6	Americas No 4	Corona
Coors	23,0			21	11	32	9	Americas No 5	Coors
Foster's	26,0	27,3		18	39	57	32	Australia No 1	Foster's

Until the beginning of the 21st century the leading American brewing companies, namely Anheuser-Busch, Miller Brewing and Coors, based their operations predominantly in the US and had an exclusive focus on beer. Their foreign expansion involved licensing agreements covering production, distribution, and commercialization of beer. The leading Asian breweries, such as the Japanese Kirin, have mainly used somewhat different strategy. They have diversified into other food-related businesses, for example, in functional foods and soft drinks. They relied on internationalization mainly in Asian countries. The strategy of the leading European breweries was with major focus on the brewing sector (e.g. Scottish&Newcastle) and they expanded internationally through foreign acquisitions (Coelho and Rastoin 2003). The foreign expansion of European breweries targeted Western Europe, the region of CEE, Asia and other parts of the world. This approach to internationalization has recently been adopted by Asian and US breweries, as well as SABMiller (Schumacher 2002). Central and Eastern Europe has played a significant role in the growth strategies of European breweries, increasing their market reach in terms of consumer base, volume and dynamics. This process has been largely helped by the economic and political changes in CEE in the transition period. Hence, the paper focuses on the development of the brewing markets in the region, the motives for investment and strategies used by foreign brewing companies in these markets.

Production, sales and foreign trade in the CEE brewing sector

The Czech Republic has long established traditions in the brewing industry. In the early 1990s the per capita consumption of beer was the highest in the world, in the range of 160 liters per capita. In Hungary the per capita consumption exceeded 100 liters. In Bulgaria and Romania the consumption per capita was lower than in Hungary and former Czechoslovakia but growing steadily. In Poland, the Baltic States, Russia and the Ukraine the per capita consumption figures were considerably lower, e.g., 20-25 liters per capita in Russia and 10-15 liters per capita in the Ukraine. In terms of volume of beer produced Russia was the largest producer, followed by the then Czechoslovakia. While it was the market size that accounted for Russia's large production output, in the Czech Republic it was consumption per capita driven.

Table 3: Beer Production, Imports, Exports and Consumption in CEE in 1991 (In thousands of liters)

Country	Beer Production	Beer Imports	Beer Exports	Total Consumption
Bulgaria	4,879	6	208	4,677
Ex-Czechoslovakia	22,276	8	1,852	20,432
Hungary	9,570	1,600	2	11,168
Poland	13,633	177	6	13,804
Romania	9,757	258	-	10,016
Russia	32,692	155	16	32,832

Source: UK Breweries Society 1992.

In the beginning of the transition period Bulgaria, ex-Czechoslovakia and Hungary were the only countries from CEE that were members of the European Brewing Union. They had well-established traditions in the brewing industry and their breweries had modern technology and production know-how. While Bulgaria and ex-Czechoslovakia were export oriented, especially Hungary, but also Romania, Poland, and Russia were predominant with beer imports (see Table 3). To date the Czech Republic is still a significant beer exporter but Bulgarian beer exports have been almost wiped out following the acquisitions of its major breweries by foreign companies. In 1998 the beer imports to Russia drastically diminished because of the substantial increase in import taxes. Despite a rapid growth in the domestic demand, some Russian companies such as Baltika and Vena have intensified their export efforts and it may be expected that this trend will continue in the future.

Table 4: Beer Consumption in Some Central and Eastern European Countries

Country	Per Capita Consumption, liters/annum in 1996	Per Capita Consumption, liters/annum in 2001	Total Consumption, million liters/annum in 2001	Percentage Increase in Consumption 1993-2001
Russia	16.0	43.6	6,483.3	+ 263.3
Poland	39.0	67.8	2,691.7	+ 105.5
Czech Republic	157.3	160.8	1,640.2	+ 6.5
Romania	37.4	56.9	1,280.3	+ 38.8
Ukraine	NA	23.3	1,162.5	+ 9.6
Hungary	73.0	77.1	778.7	+ 2.8
Serbia-Montenegro	NA	53.7	569.2	NA
Slovakia	92.0	90.2	487.8	- 0.9
Bulgaria	53.3	51.7	423.9	+ 36.1
Croatia	NA	85.7	385.7	+ 12.8
Belarus	NA	23.5	239.7	NA
Lithuania	34.0	62.2	230.1	NA
Slovenia	NA	68.3	140.7	+ 3.8
Moldova	NA	25.1	107.9	NA
Latvia	24.0	43.3	103.9	NA
Estonia	33.0	64.1	89.7	NA
Macedonia	NA	33.0	66.2	+ 2.7

Sources: Brau Beviale, Datamonitor, Drinks Database.

During the 1990s and early-2000 the beer markets of CEE have all followed a different development path responding to changes in national and regional consumption patterns. While some markets have been mostly stable (e.g., Czech market), others have followed a downward trend (e.g., Hungarian market), a third group of markets has been with varied patterns of ups and downs responding to changes in the overall economic conditions that have determined consumer disposable income (e.g., Baltic countries, Bulgaria, Romania, Russia). At the same time some CEE beer markets have exhibited a relatively steady growth since the start of transition (e.g., Poland, Croatia, Slovenia). In the last several years the beer markets of Central and Eastern Europe have in general started to look promising. This concerns the situation especially in Russia and Poland, but also in other CEE countries. The changes in beer consumption in Central and Eastern Europe in the period 1993-2001 are presented in Table 4. Currently Russia ranks eighth in the world lead tables in terms of volume of beer produced, while Poland ranks fifth in Europe. The two markets have lately indicated growth rates that are higher than the average for the CEE region.

Motives and market strategies in the brewing industry in CEE

One of the most commonly used frameworks for analyzing the internationalization of companies is Dunning's OLI-paradigm (see e.g. Dunning 1988; 1993). Dunning argues that when companies undertake FDI three conditions have to be fulfilled. Firstly, the firm must possess ownership specific advantages in relation to local companies (e.g., property rights and/or intangible assets and/or there should be advantages of common governance). Secondly, the foreign country must possess location specific advantages (access to raw materials or other resources, lower price of those resources than in the home country, existence of investment incentives, higher productivity, etc.) so that the FDI would be realized there instead of in the home country of the investing firm. Finally, it must be more advantageous for the company to internalize the use of the ownership specific advantages than to sell them or the right to them, i.e. not to use exports or licensing as the form of foreign operation. Given that the three conditions are fulfilled, the decision to undertake FDIs has to be consistent with the long-term management strategy of the company. FDIs can also be classified as being defensive versus aggressive investments and the motives for them can be market seeking, resource seeking (physical/human resources), efficiency seeking (economies of specialization/scope), and strategic asset seeking (technology/capabilities) (Dunning 1993). The results in several studies seem to indicate that aggressive investments dominate in relation to the defensive type and that market-seeking motives are more common than other motives, although some FDIs in Western Europe and North-America are driven by a combination of motives (Dunning 1993; Marinova *et al*. 2004).

Recent studies (see for example, Tatoglu and Glaister 2000) have focused attention on the particular motives of Western companies in making investments in emerging markets. A number of studies on CEE (e.g., Dunning and Rojec 1994; OECD 1994; Paliwoda 1995; Svetlicic and Rojec 1994; EBRD Report 1994; Marinov and Marinova 2001; Marinova *et al.* 2004) confirm that although there can be four main groups of motives for FDI in CEE, market-seeking motives are the most important ones, followed by resource seeking motives. For example, Gatling (1993) reveals a clear pattern of investors' motives across all CEE countries, i.e. to establish a meaningful market share in the host market; tap into the regional market; tap into the EU market; and low-cost sourcing from that market. A study of OECD countries (1994) shows the foreign investors' motives, as ranked by 162 companies investing in CEE, as follows: access to large domestic markets; gaining market share; low cost production; and source of raw materials. Hence, market-seeking motives seem to have had a major impact on the investors' interest in CEE.

Research on FDI in the brewing industry in CEE indicates that there have been well-founded reasons for the choice of FDI as a main mode of market entry rather than exports or licensing. There has been limited demand for foreign beer brands due to the local nature of the industry and the consumer preference for local brands. Price sensitivity and consumer preferences have made exporting and licensing a viable option for CEE market expansion for companies having strong global beer brands. Consequently, smaller companies have considered joint venture and/or greenfield investment to tap into the CEE markets. These modes of market entry have been largely helped by the low production costs in CEE compared to the rest of Europe. For example, the production costs and taxation in Finland and Sweden are much higher than in CEE countries thus leaving limited possibilities for beer exports. Restrictive import taxes in some CEE countries, e.g., Lithuania, Russia, and the Ukraine, have also predetermined the choice of modes of market entry in their beer markets.

The motives for FDI in the CEE brewing industry seem to be very similar to those in several other consumer goods industries, such as confectionary. Due to industry specificity market seeking motives have been the main drivers for investment. Other important motives have been strategic asset seeking, mainly access to brands owned by local breweries. Efficiency seeking motives were inspired by low production costs in the region. Investment decisions of smaller breweries acquiring beer companies in CEE have followed the moves of large breweries such as Heineken, Interbrew, SABMiller, and Carlsberg. In the case of Nordic brewing investors in CEE, especially the Finnish ones, there have been some specifics in the investment motives. The initial Nordic investments were motivated mainly by defensive reasons. For example, Finnish breweries wanted to benefit from the first mover advantage through investment in the Baltic States and in St. Petersburg area to counteract investment moves of large brewers. These investments also created entry barriers for low cost exports from the Baltic and Russian production bases to Finland thus protecting the domestic market from cheaper imports. Market seeking motives were of secondary importance for Finnish brewing investments in the first part of the 1990s. However, in the later years of transition they became the primary driver for FDIs made by Finnish and Nordic companies such as those of Baltic Beverages Holding (BBH).

The first brewing companies that invested in CEE in 1991 and 1992 were BBH and Harboe in Estonia; Interbrew, Heineken and SAB in Hungary, and Sinebrychoff in Russia. They were followed by a number of other brewers such as SUN Breweries, Carlsberg, and Bass. When investing in CEE Heineken and Interbrew were among the largest brewers in the world. Their expansion in the newly opened CEE markets was supported by international experience and financial strength. The relatively new brewer, BBH, was established in 1991 as a joint venture between the Swedish-Norwegian Pripps Ringnes and Finnish Hartwall breweries (both owning 50 percent of BBH). BBH was set up with the objective to analyze the opportunities and make investments in CEE countries. The two other pioneers in the CEE market, Finnish Sinebrychoff and Danish Harboe were small breweries operating almost exclusively in their home markets. By 1995 there were brewing investments in eleven CEE countries. It is interesting to observe that none from the following world's largest breweries in 2000, Anheuser-Bush (USA), Brahma/Ambev (Brazil), Kirin (Japan), and Modelo (Mexico) had any investment in CEE. The then independent brewer Miller (USA) did not invest in CEE before its acquisition by SAB in 2002. The British-French brewing company Scottish&Newcastle - Kronenbourg entered the CEE markets through the acquisition of the Finnish Hartwall brewery in 2002.

The choice of the target country for foreign investment is usually based on a combination of factors such as market size, future growth potential, cultural and economic distance, and level of political uncertainty. Considering the size of markets as related to per capita consumption, the beer markets of the Czech Republic and Hungary were most attractive in the early 1990s. Western investors evaluated the economic and political environment in those countries as less risky than in the rest of the CEE countries. In the case of the Baltic States the market size was small, but the mental distance was low as they were culturally and geographically close to the Nordic countries. Thus, Nordic investing companies such as BBH entered Estonia and Latvia to test the foreign brewing operations in CEE countries before moving into Russia where the risks were far greater due to economic and political uncertainty and larger mental distance. Additionally, the market size and growth potentials in Russia have been substantially more promising than in the Baltic States. Carlsberg adopted a somewhat different investment strategy in terms of investment location choosing Poland and Croatia as first target countries inside CEE instead of the Baltic region. Poland was chosen because of the large market size, high growth potential and geographical proximity. Croatia represented a test market for the South-Eastern Europe. Previous positive experience from a long lasting licensing agreement with a Croatian company encouraged Carlsberg to engage in acquiring a local brewer in 1994.

The majority of pioneering investors in the CEE brewing sector were brewing companies that had a long-term growth vision for the region. However, among the early entrants there were companies like Nomura Investment Bank with short-term investment goals. Several years after their investment in the Czech brewing industry they sold their shares in the Czech breweries. Most of the investments in the brewing sector in CEE have been long-term investments, with only few being regarded as short-term ones. There have also been soft drinks producers that have diversified their operations investing into the brewing industry in CEE, e.g., Bravo International.

In terms of number of investments, about a half of all brewing companies entering the CEE markets limited their commitment to one or two investment deals. However, there are a few that spread their commitment across a number of companies and countries in the region, e.g., by 2003 BBH made more than 20 investments. Other companies that made numerous investments are Interbrew, SABMiller and Heineken. The greatest amount of partly or totally foreign owned breweries can be found in Russia – over twenty five. Poland has also many foreign owned brewing operations. In the CEE region Interbrew has the greatest coverage in terms of number of countries. As one of the largest regional investors BBH has, at least so far, avoided entering Central and Southern European markets and has concentrated investments on the Baltic States, Russia, the Ukraine, and Kazakhstan.

Forms of investment and ownership strategies in CEE markets

The strategic decisions when investing relate to the form of investment and ownership structure of the firm where the investment is made. Concerning the ownership structure the major alternatives are a wholly owned subsidiary (WOS) or a joint venture (JV). In the latter case there are three possibilities: a minority ownership with a foreign share below 50 percent, a 50-50 percent ownership structure, and a majority ownership above 51 percent but not with total ownership of the acquired company. According to the transaction cost theory the choice between full and partial ownership of a foreign company depends on the costs and benefits of sharing its equity compared to those of retaining full ownership (Beamish and Banks 1987; Hennart 1988). The main advantage of a WOS is that the investing firm does not have to share the decision-making and financial results. This means that the investing firm must have all the needed financial and management resources. A JV alternative means shared decision-making and shared profits. Thus, there may be more problems to reach an agreement on the strategy of the JV and to integrate the venture into the global network of the foreign partner. Additionally, if the foreign partner is transferring tacit technical and/or marketing know-how, there is the danger of creating a competitor. However, the investing firm does not have to provide all the needed financial and management resources on its own. In addition, the local partner may have the needed connections with local suppliers, government, and/or buyers, distribution network, and possibly strong brands and advanced technology. In Western Europe and North-America WOSs seem to have been the preferred alternative, whereas elsewhere JVs are more common solutions (Bell 1996; Hennart and Larimo 1998).

In general, WOSs have been the main ownership structure chosen in FDIs realized in Western European countries, while in non-OECD countries, including CEE, acquisitions of former state-owned enterprises (SOEs) and later on JVs have been the main alternatives chosen. In late 1980s and early 1990s this was influenced to a great extent by the local legislation as well as political and market uncertainty. Concerning the privatization process, the governments in most countries did not hand in 100 percent of the ownership of the SOEs to the foreign investors right from the beginning. Governments tended to preserve a share of the companies. Shares were also given to the management and company employees in almost all privatization cases. The government strategy was not to transfer full control over the productive assets all at once fearing that they would lose control over the development of the respective companies and the brewing industry, which could cause social dissatisfaction (Marinov *et al.* 1997). During the mid-1990s the legislation started to allow more freedom for foreign companies to choose between JVs and WOSs. As the market and political uncertainty decreased in several CEE countries, the relative share of WOSs increased (Larimo 2001). Foreign investors were allowed to purchase the shares held by employees or controlled by the CEE country governments, local investors and financial institutions in those companies. Hence, foreign investors have gradually increased their shareholding in the CEE breweries. Furthermore, majority ownership at entry has been more common than minority or 50-50 ownership as the CEE governments needed cash, while foreign investors aimed at acquiring a controlling stake. A good example is BBH, which has increased the original ownership in all brewing investments in CEE over the years (from the original 51-60 percent to 80-95 percent).

In mature industries, such as brewing in Western Europe, WOSs have been the preferred ownership form in order to avoid possible problems of joint decision making related to restructuring and integration of operations. In some CEE countries the brewing industry is mature, characterized by low growth rate. In other CEE countries, e.g., Russia and the Ukraine, there has been steady growth from the mid-1990s. Thus, the industry lifecycle is at different stages of development in the various CEE countries. The ownership strategies of the foreign investors in the brewing industry in CEE are presented in Table 5.

Data indicates that JVs have clearly been the prevailing alternative in Russia and the Ukraine. This has been the case especially in the first part of the 1990s and this trend continued in the later years of the transition process. Lack of knowledge and experience in the specific contexts coupled with the high risk and uncertainty account for such an investment decision.

Table 5: Ownership and Form of Investment Undertaken by Foreign Investors in CEE Brewing Industry

COMPANY	No of FDIs	STRATEGY AT ENTRY				FORM OF INVESTMENT			
		1990-1996		1997-2003		1990-1996		1997-2003	
		JV	WOS	JV	WOS	Greenfield	Acquisition	Greenfield	Acquisition
BBH	25	x	-	-	-	-	X	x	x
Interbrew	15	x	-	x	-	-	X	-	-
Heineken	13	x	-	x	-	-	X	-	x
BrauUnion	12	x	-	x	-	-	X	-	x
SABMiller	12	x	-	x	-	-	X	-	x
SUN Breweries	10	x	-	x	-	-	X	x	x
Carlsberg	6	x	-	x	-	-	X	x	x
Efes	4	-	-	-	-	-	-	x	-
Olvi	4	x	-	x	-	-	X	-	x
Nomura Investment Bank	3	x	-	-	-	-	X	-	-
Brewinvest on behalf of Heineken	3	x	-	x	-	-	X	-	x
Brau und Brunnen	2-4	x	-	-	-	-	X	-	-
Brewpole	1-3	x	-	-	-	-	X	-	-
Bitburger	1-3	-	-	-	-	-	-	-	-
Danish Brewery Group	2	-	x	-	-	-	X	-	-
Sinebrychoff	1	x	-	-	-	-	X	-	-
Bass	1	x	-	-	-	-	X	-	-
Icelandic Business Group	1	-	-	-	x	-	-	x	-
Grolsch	1	x	-	-	-	-	X	-	-
Lahden Polttimo	1	-	-	x	-	-	-	x	-
Groupe Soufflet	1	-	-	x	-	-	-	x	-
Cyprus-based business group	1	-	-	x	-	-	-	x	-
New Century Holdings	1	-	-	x	-	-	-	x	-
Harboes Bryggeri	1	x	-	-	-	-	X	-	-

According to transaction cost theory the choice between acquisition and greenfield forms of investment depends on the costs and benefits of each form as is also the case with the ownership strategy. Acquisitions and greenfield investments differ in three main ways, which imply costs and advantages contingent on the characteristics of the target industry, of the investing firm, and of the host/target country. Firstly, according to Caves (1982) an acquisition entails lower information and management costs and lower risk than a greenfield investment. Acquisition means buying a going concern, a bundle of assets that may include knowledge of the foreign market and trade names. Acquisitions, however, require the payment of the capitalized value of rents. Hence, according to Caves they entail lower return but less risk than greenfield investments. The high failure rates of acquisitions do not necessarily give support for the lower risks in acquisitions. Another difference between the two forms of investment is in their time dimension (Caves 1982). Building a subsidiary from scratch takes more time than buying a going concern. Thus, there are revenues already from the beginning, whereas the building process of a new plant may take longer and therefore, it may be one or more years before there are revenues from greenfield investments. Everything else constant, the opportunity costs of the greenfield form of investment will be higher the faster the growth of the target market/industry is. A third major difference between greenfield entry and acquisition is that the former expands total supply, while the latter need not.

In Western Europe and North America the acquisition form of investment has been the main form of entry mainly since the mid-1980s (OECD 2001; United Nations 2002) due to the maturity of various industries, the need for economies of scale, access to market shares, distribution and/or supply networks, and availability of diverse potential acquisition candidates (Larimo 2003).

In other countries the role of greenfield investments has been greater. While some studies on the forms of investment in CEE indicate that during the 1990s the predominant form was acquisitions (Artisien-Maksimenko 2000), other researchers suggest acquisition and greenfield investments were of equal importance (Meyer 1998; Pye 1998; Larimo 2001). The significance of this argument can be further explored if the volume of investments going into CEE through acquisitions and greenfield investment forms is analyzed in more depth. The main arguments for the choice of the greenfield form have been the growth of several fields of industries in these countries and the lack of suitable target firms for acquisitions. A peculiar investment form to CEE countries has been the so called “brownfield” investment where foreign investors acquired local firms but replaced the existing physical capital stock almost totally, retaining intangible assets such as brand names and the workforce (Estrin, Hughes and Todd 1996).

As the results from Table 5 indicate acquisitions have been the prevailing form of investment in the brewing industry in CEE. In fact, no FDI made in the form of greenfield investment could be identified in the brewing industry in the period 1991-1996 and there are very few greenfield investments made later. The greenfield investment form seems to have been relatively much more common among malt house FDIs than among brewing investments. Based on annual reports and company internal materials the main motives behind the choice of the acquisition form have been the same as in Western European countries, namely, buying market share and local brand(s). Established breweries took the chance of buying productive assets in CEE that were relatively cheap and easy to upgrade but offered them market access, local brands and know-how.

Problems and performance in the CEE markets

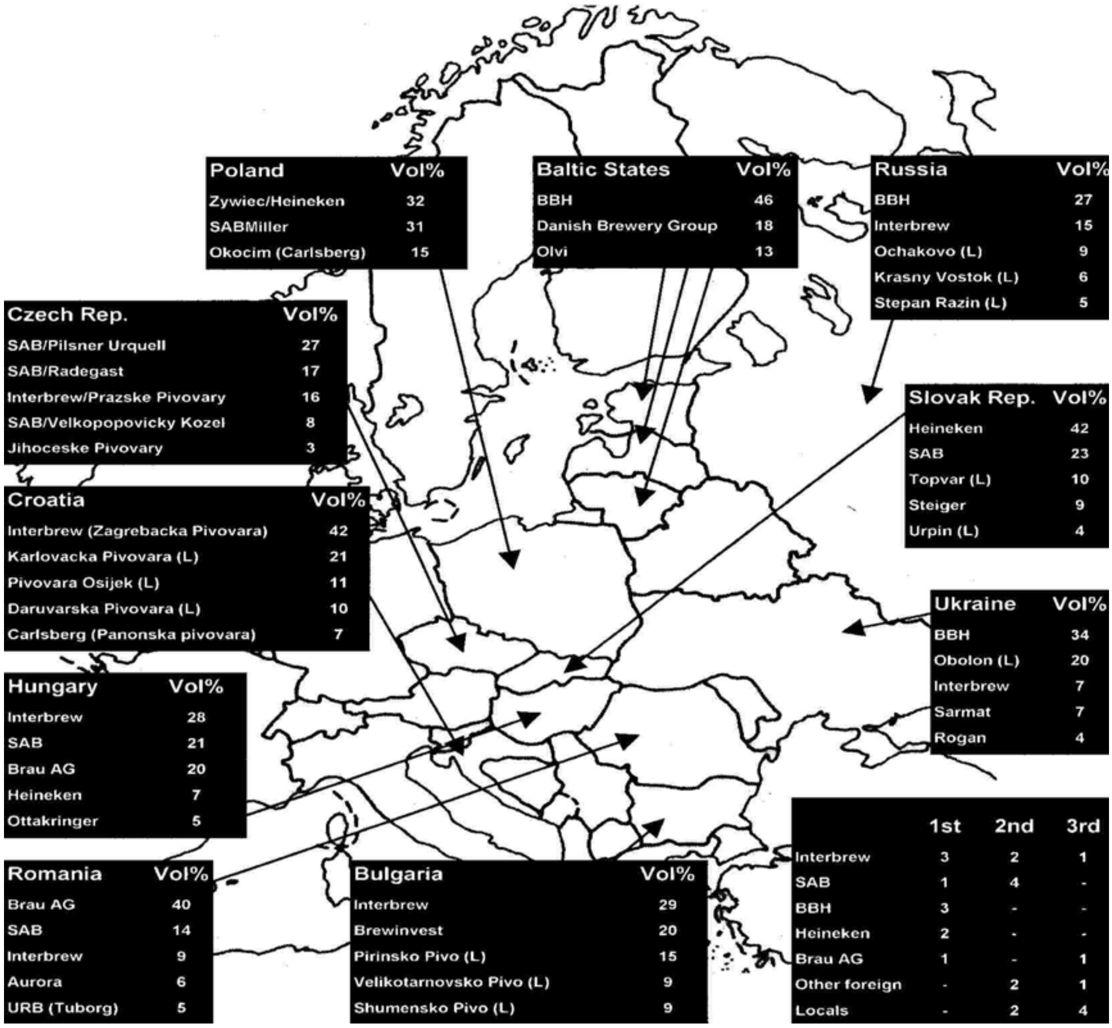
In the early 1990s the problems in the CEE brewing industry mostly stemmed from the political, economic and legal restrictions faced by FDIs. For example, the access of foreign investors to the privatization of SOEs in the Czech Republic was delayed by the implementation of voucher privatization. In the case of Poland the possibilities for a single investor were limited as the government wanted to attract more investors with high financial capabilities. In Russia, the Ukraine, Belarus and other CIS countries there has been more uncertainty related to the local economic, political and legislative development. In addition, the governments and the management of CEE breweries have demanded from the potential investors to carry out major restructuring of operations, bring in new production technology, improve product quality and expand export presence. Many of these objectives did not match the motives of the interested foreign investors.

In Russia and the Ukraine special problems have existed due to lack of proper distribution networks and deficits of good quality raw materials. The shortage of quality malt and hops has forced some of the biggest breweries to build their own malt houses. However, they are still encountering problems with supplying the necessary quality and amount of inputs. Some years ago it was estimated that although there were over 80 malt houses in Russia and their supply was in theory enough to fulfill the needs of the brewing industry, only 25 of the malt houses produced marketable malt and only 43 percent of the demand for malt could be satisfied with local raw materials (British Embassy 2001). Therefore, owning a malt house provided and still provides a brewer with a distinct advantage in a strongly competitive marketplace. The problem with the availability of high quality malt has even caused a problem for the growth of the whole industry in Russia.

The performance of FDIs can be measured using subjective and objective measures. If longevity is applied as a criterion, there have not been closures of breweries, although some breweries changed their owners. Among the companies that seem to have failed in the CEE brewing markets one should mention Bass. The company incurred continuous financial losses in the Czech Republic and had to sell their shares in the acquired breweries. Other examples are Nomura Investment Bank and the original founders of Bravo International and Grolsch who have also sold their shares in the CEE breweries. A more common case has been the sale of the original CEE investor to another brewer leading to ownership change for the CEE breweries. For example, Carlsberg bought the Finnish brewery Sinebrychoff thus acquiring Vena brewery in Russia. Another example is the acquisition of Brau AG by Heineken, which meant that the Dutch company gained a much stronger position in several CEE markets. The performance of the brewing companies in CEE in terms of market share is presented in Figure 1.

The data from Figure 1 indicates that BBH and Interbrew were both market leaders in three CEE national beer markets. Heineken was market leader in two markets. Brau AG and SAB were market leaders in one CEE country beer market. SAB ranked as market challenger in four of the CEE beer markets.

Figure 1: Market Share of the Leading Breweries in Various CEE Markets in 2001 *(Sources*: GfK market shares in 2001; authors' calculations).



The dominant role of foreign breweries in the CEE brewing markets is reflected clearly in the fact that the market leader and market challenger were foreign companies in the majority of CEE national markets. The joint market share of totally or partly controlled foreign companies was at least 50 percent in all markets. In Hungary and Romania the foreign ownership of the local breweries was even higher. The market leader companies have very strong positions and clear market leadership in countries like the Czech Republic, Slovakia, Croatia, Romania, the Baltic States and Russia. In the Baltic States and Russia BBH has been the indisputable market leader in the last five years. While in the mid-1990s BBH and SUN Brewing had almost equal market share in Russia, in the late 1990s SUN Interbrew lost market share. This has provided BBH with the opportunity to acquire competitor market coverage and to increase their market share from 19 percent in 1997 to 32 percent in 2002. SUN Interbrew have focused their growth on the Ukrainian market where they have become the market leader.

Apart from market share, brand sales can be indicative of company performance. For example, Baltika brewery in St. Petersburg can be regarded as one of the best performing breweries in CEE as the brand name Baltika has established itself among the best selling beer brands in Europe (see Table 6). The brewery was founded in 1991 and BHH acquired 52.4 percent of the company in 1993 increasing its shares over time. In a relatively short period of time the Baltika brand has become market leader in volume sales in Russia with a market share of 13 percent in 2002. In the same year it ranked second in Europe.

Table 6: Biggest European Beer Brands in 2002

Company	Sales (ml hectoliters)
1. Heineken	12.1
2. Baltika	9,14
3. Amstel	8,63
4. Kronenbourg	7,99
5. Stella Artois	7,73
6. Carling	7,36
7. Carlsberg	7,03
8. Efes-Pilsner	6,4
9. Foster's	5,74
10. Ochakovo	5,27

Source: Baltika Annual report 2003)

The dominant positions of foreign breweries in the CEE markets have made national governments set restrictions for new deals by foreign brewers. Thus, when Carlsberg bought 60 percent of Orkla and simultaneously received 50 percent shares in BBH, the latter had to sell the previously acquired Kalnapilis brewery in Lithuania. Similarly, in Ukraine SUN Interbrew had to divest from its investment in the Crimea brewery to be able to acquire the Rogan brewery.

BBH has been among the key players in the brewery sector in CEE. Their investment strategy and management experience in markets with rather low geographical and also cultural distance accounts for the success in CEE. BBH has been among the first foreign breweries to invest in CEE undertaking a balanced risk. Aspiring for majority ownership the company has focused on local entrepreneurial drive and used a balance of freedom and control of operations applying strong financial incentives. BBH has acquired strong national and regional brands thus building national brand portfolios, developing distribution networks, and focusing on backward integration. For example, Baltika brewery produces about 60 percent of the malt it needs. BBH has usually focused first on brewing industry and have gradually diversified to other sectors (malt house and soft drinks). The company has relied heavily on local traditions in preserving the names of local beers and gradually introducing local brand extensions. BBH has achieved a nationwide coverage in Russia. Nowadays the company has some 15 distribution centers in different parts of the country.

Another major brewer in CEE has been SABMiller. It has expanded in CEE through its European subsidiary SABMiller Europe. The company has acquired brewing facilities in the Czech Republic, Hungary, Poland, Romania, Slovakia, and Russia. In 2003 turnover from all its CEE breweries was US$1,280 million. After the initial acquisition in Hungary, unlike Interbrew and Heineken, the then independent SAB brewery did not rush into the region and postponed their further expansion until 1996. SAB's acquisitions in the Czech Republic took place in 1999 with the simultaneous purchase of the national market leader, Pilsner Urquell brewery, as well as Radegast and Velké Popovice, which are two significant regional breweries. The deals provided SAB with the opportunity to enter and establish a dominant position in the important Czech beer market with a production capacity of 7.9 million hectoliters. SAB adopted a strategy of developing higher margin incremental sales of the acquired brands through its existing distribution channels, and an entry point into a developed beer market through the expansion of the Pilsner Urguell brand in the premium export segment of major international beer markets.

There are common features and differences in the strategies applied by the investing brewing companies in CEE. For example, the strategic approaches of BBH and Interbrew have been somewhat different. BBH adopted a preemptive, defensive strategy trying to protect the high value, high priced Nordic beer markets. In the initial stages of its CEE expansion it acquired companies in the Baltic States to prevent any export into Finland and Sweden. It should be mentioned that BBH has undergone ownership changes while developing their CEE penetration. The investment priorities in CEE have largely reflected the strategic priorities of their owners. By comparison the expansion of Interbrew was dominated by market seeking motives. The differences in the initial motives did not prevent the two companies to engage in a rapid aggressive internationalization in CEE. Their target country strategy differed: BBH focused on the Baltic States and Russia, followed by further expansion into the Ukraine and Kazakhstan. Their priority was to tap into and develop the big Russian market thus benefiting from its huge potential. Interbrew made its first investment in Hungary, gradually expanding into other CEE markets. They entered Russia and the Ukraine via an alliance with the Indian SUN Brewing that had already established operations in Russia and the Ukraine. Both companies have used mainly partial acquisitions in their market entry. The evolving legal and economic opportunities have been explored in a similar fashion as the two companies have gradually increased their shares in the acquired companies. Currently some of the CEE companies owned by Interbrew operate as WOSs. Both companies have tried to transfer the main aspects of the parent's corporate culture to the CEE entities. Meanwhile, they have developed local management expertise that forms the core of their CEE management teams.

Conclusion

Due to the maturity, stagnation, and even decline in beer consumption in Western Europe and North America, a number of companies started in the early 1990s to invest in emerging markets on a significant scale, including CEE in their market portfolio. In the early 1990s Czech Republic was the leading country in the world in terms of per capita consumption and one of the leading countries in per capita production. In some CEE countries e.g., Poland, the Baltic States, Russia and the Ukraine, vodka was the most preferred alcoholic drink and the per capita beer consumption was substantially lower than in the mature Western and CEE beer markets. In the period 1990-2003 beer production and consumption have been mostly stable in the Czech Republic and Slovakia and declined in Hungary. In the Baltic States, Russia, Bulgaria and Romania there was a declining trend in both production and consumption of beer in the early 1990s. After 1995 there has been a steady growth in production and consumption of beer in Russia. Currently the country ranks among the leading producers of beer in the world. There is a strong growth trend in the consumption of beer in CEE markets in the following years (see Table 7). If the estimates are realized, the growth will be mostly due to beer production and consumption increases in Russia, the Ukraine and Poland, large markets with huge potential.

Using the OLI-framework for the analysis of FDI behavior of brewing companies in CEE it can be concluded that the greatest ownership (O) specific advantages of Western companies have been in the strong brands, know-how related to marketing and distribution, and in the economies of scale. Brewery technology in the acquired companies was good by global standards with some exception, e.g., the brewing technology in Russia. There have been significant growth trends in production and consumption in a number of CEE countries that encouraged the location (L) of most of the investment decisions in the region. The smaller investing breweries did not have strong beer brands, hence exporting and licensing was not a realistic alternative for them. The high import taxes have substantially discouraged exporting to CEE. Additionally, the local CEE brands have been particularly strong in perception and consumer preferences. Thus, foreign direct investment remained the only viable alternative for the company wanting to exploit CEE beer markets and wishing to get a stronger foothold in the respective target market (I). Of the four different motives inspiring investments (market, resource, knowledge or strategic asset -seeking), FDIs in the brewing industry in CEE have been strongly dominated by market-seeking investments.

Table 7: Forecast for Growth in Beer Consumption 2003-2007

Region	Percentage Growth in Beer Consumption 2003-2007
Central and Eastern Europe	35
Asia Pacific	28
Africa and Middle East	14
Latin America	10
Australia	5
Western Europe	3
North America	2
Average for the World	15

Source: Euromonitor)

Foreign investments in CEE breweries were initiated in 1991. During the period 1991-2003 more than 25 foreign companies were identified as having made in total some 120 investments in the CEE beer markets in both beer and malt production. Among the first investors were the large brewers Interbrew, Heineken and SAB, but also some small companies like Brau Union, Harboe and Sinebrychoff. In 1991-1992 investments were made in Hungary, Estonia, Latvia, and Russia and during the following years in the Czech Republic, Poland, Romania, Croatia, Slovenia, Bulgaria, and Lithuania. By 2003 there was at least one foreign investor in all of the CEE beer markets.

Most of the investments in CEE brewing companies made in the period 1991-1996 were JVs. Generally, later on the foreign owners have increased their ownership participation in some cases to WOSs. Concerning the form of investment, the maturity of beer markets in some CEE countries has made greenfield investments inappropriate. In some high growth markets such as Russia difficulties with obtaining permissions for greenfield investments were significant. It can be suggested that the need for ownership of local brand(s) and the lack of regional market knowledge by the investor have made acquisitions preferable. There have been a small number of greenfield investments, mainly in cases of malt house creation. It may be expected that this trend will continue also in the future because the demand for new breweries will decline but the need for extension of existing ones, especially in the high growth markets, will increase.

There has been a great deal of variability concerning the problems foreign investors encountered in the CEE countries. These were partly associated with declining per capita consumption and arranging of nation wide distribution and logistical systems. Furthermore, there have been problems associated with the availability and quality of raw materials, especially malt and hops, causing an increase in imports of such inputs and backward integration through the establishment of own malt houses by the committed foreign breweries.

Due to their managerial experience and financial strength most foreign breweries have performed well in CEE. In 2001 Interbrew was market leader in four and BBH in three of the CEE markets. Focusing on Russia BBH has achieved significant success there becoming a market leader in the country. Over a period of ten years the main BBH brand, Baltika, has become the second largest brand in Europe in terms of sales. Noteworthy is that over half of all reviewed CEE markets are controlled nowadays by totally or partly foreign owned brewers.

In order to have a better view of the development of the markets and strategies used by foreign investors, one interesting avenue for future research could focus on the marketing strategies of the investing brewing companies in CEE. This would also give a better understanding of the key reasons for the success and failure of brewing companies in CEE markets. Furthermore the restructuring in the brewing industry at global level has continued and this has and will cause constantly changes also in CEE markets. Thus a follow up study of the development would be of interest. Finally, a comparison of the development in CEE with the development in other emerging markets e.g. in Asia would be interesting.

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South-African Breweries

Sun Brewing

BETWEEN A ROCK AND A HARD PLACE: THE ENERGY SECTOR IN CENTRAL AND EASTERN EUROPE

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Abstract

Upon its enlargement in 2004, the EU gained several new members from Central and Eastern Europe (CEE). EU enlargement presents a number of challenges for companies from CEE as they attempt to internationalize. Not surprisingly, the playing field is not level; some countries have become insiders of the EU while others remain outsiders. To cope with their new environment, both groups have developed strategies (driven by different motivations for internationalization), which are the focus of this paper.

For insiders, the common economic space of the EU will lead to more competition from Western companies. The challenge is to keep their competitive edge. To realize this goal the companies have to expand in other new member countries as well as outside the enlarged EU to increase their resource base and to incorporate strategic assets. An expansion to post-Socialist markets in CEE would provide advantages for them: besides local experience and existing business networks, they would be able to participate in undervalued privatizations.

For outsiders like the Russian oil and gas companies, the challenge is to establish a foothold in the enlarged EU to benefit from the European internal market. This would increase the competition for insiders because Russian companies are also vying for assets in CEE.

Keywords: EU enlargement, internationalization, oil and gas sector, Hungary, Russia.

Introduction

One important phenomenon of the last century following the break-up of the Soviet Union has been the internationalization of companies from Central and Eastern Europe (CEE). Internationalization means the development of cross-border activities between and within companies by expanding sales markets and investing in international activities over an extended period of time. These activities are traditionally measured by exports and outward foreign direct investment (FDI)[1].

The analysis of internationalization on the firm level started in the 1950s, focusing mainly on western companies (cf. an overview Dunning 1979; Buckley 1995). Since the beginning of the 1970s, however, the focus in internationalization research has shifted to developing countries. Numerous studies on multinational companies from the so-called Third World have been conducted (cf. e.g. Kumar/ McLeod 1981; Lall et al. 1983; Wells 1983; Kuada/ Sørensen 2000).

While the operations of Western companies in Central and Eastern European transition economies and their inward FDI have received broad attention in research (cf. e.g. Michalet 1997; Estrin et al. 1997; Artisien-Maksimenko 2000), the internationalization of companies from the transition economies themselves has hardly been examined at all. Despite a surge of interest in the mid-1980s, research on the internationalization of companies from CEE has remained at a low level (for the era of central command economies, see Hamilton 1986; McMillan 1987).

However, firms in these countries have shown increasing investment activity abroad in the last decade. Consequently, some research has been undertaken on the outward FDI of CEE countries (cf. e.g. Bulatov 2001; Kalotay 2003; Jaklič - Svetličič 2003; Pelto et al. 2003) as well as on the internationalization of companies from CEE (cf. e.g. Elenkov 1999; Liuhto 2000; Liuhto 2001a; Liuhto 2001b; Heinrich 2001a; Heinrich 2001b; Peregudov 2001; Heinrich 2003; Vahtra/ Liuhto 2004).

Furthermore, besides the lack of detailed research into the internationalization processes – either on the country or firm level – the challenges caused by the enlargement of the European Union (EU) have not been analyzed in greater detail.

In May 2004, the EU undertook its biggest enlargement ever in terms of scope and diversity. Ten countries – mostly from Central Europe – became new members: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Two other Central European countries – Bulgaria and Romania – hope to join in 2007; both have made significant progress in the past years in their efforts to meet the accession criteria.

The enlargement resulted in a wider Europe; however, it also produced 'outsider states'.

No matter how frequently EU officials reiterate their intention not to re-divide Europe, irrespective of how many ‘partnership’ agreements are signed with non-members, the inevitable consequence of admitting some countries as full members to the organization and excluding others is to produce ‘insiders’ and ‘outsiders’ (Light et al. 2000; White et al. 2002).

Therefore, the enlargement of the EU presents different obstacles for the internationalization of companies from countries which are insiders of the EU and those which remain outsiders. In the example of the oil and gas sector, this paper will place the challenges caused by the enlargement and the companies’ strategies to cope with them under scrutiny. These strategies are driven by different motivations for internationalization.

This study attempts to make two contributions to the literature. The first is to furnish research on the internationalization of companies from CEE in general and to encourage future research on that topic. The second contribution is an analysis of the motives of this internationalization, which is driven by different strategies to cope with the EU enlargement. The author selected the basic indicators of internationalization – sales and outward FDI – and, additionally, strategic partnerships as a means of market entry to analyze the motives for internationalization.

The paper is organized as follows. After a general overview of internationalization theory and a methodological outline, the situation of internationalizing companies in CEE is described. The specific challenges for companies from the energy sector caused by the EU enlargement are analysed: for instance, companies in the new EU member states (insiders) are pressured by emerging competition from Western companies as well as from the East, because Russian energy companies (outsiders) are trying to gain access to the EU markets by establishing a foothold in the new member states. Four illustrative case studies about the internationalization process of the selected companies as well as their motivation for internationalization follow. A conclusion summarizing and generalizing the results of the case studies builds the end.

Theoretical grounding

The motives for internationalization

The internationalization of a firm is reflected in its process of international market expansion and investment over time, which can be measured in its international sales and outward FDI. Internationalization refers to the way a company strategically exploits locational advantages

[1] According to IMF and OECD recommendations, direct investment is the category of international investment that reflects the objective of a resident entity in one economy (direct investor) of establishing a lasting interest in an enterprise resident in another economy.

and economies of scale to leverage a competitive edge world-wide. The concept of internationalization describes the establishment of a network of cross-border activities between and within companies in which any or all of the company's departments may be involved. Three main approaches to research on internationalization have emerged in the literature: FDI theory (including transaction cost analysis), stage models, and network perspectives. However, only FDI theory makes distinctive assumptions about the motivation of FDI, and therefore, this paper focuses on this theoretical approach.

The general body of FDI research has emerged from various theoretical contributions. A common feature of FDI theory is that foreign direct investment is the response by a firm to a particular type of market failure. The basic idea is that incomplete contracts and missing markets give rise to the possibility of opportunistic behaviour in serving a foreign market from a distance (Williamson 1975) and for this reason a firm prefers to replace external contracts with direct ownership and internal hierarchies. The original FDI theory (Hymer 1976) starts from the principle that multinational enterprises operate at an inherent disadvantage with respect to national firms because of the additional costs of doing business abroad. These costs derive from communications and management problems, negative consumer attitudes toward ”foreign” firms; language, culture and other operational barriers, and the costs of being outside the normal business and government networks. Thus, a commitment in a foreign market has to possess compensating advantages such as superior technology or products, or firm-level economies of scale.

Dunning (1980, 1988) suggests that for a firm to undertake FDI, ownership-specific advantages must be obtained. The eclectic paradigm claims that foreign direct investment arises when three conditions are satisfied (the so-called OLI paradigm: ownership, location, internalization). First, the firm must possess specific ownership advantages (tangible or intangible) not available to other firms, such as a superior technology, patents on particular products, a brand name, a trademark or other indication of product quality. Second, the foreign market should offer some locational advantages – specific in their origin to particular locations and which can only be utilized on-site, like natural resources, most kinds of labour, proximity to markets, but also the legal and commercial environment in which the assets are used (market structures, legislation etc.) – that make it more profitable to serve the foreign market by local production rather than by exporting or importing (e.g. high tariff barriers to exports or anti-dumping regulations). Third, there should be an internalization advantage in that the firm believes that its ownership advantages are best exploited internally. This advantage derives from the difficulties that arise in writing enforceable and controllable contracts with potential foreign partners (market failures) that generate an income that approximates the true worth of the advantage being marketed.

There is a complex relationship between ownership and location specific advantages. While the home country normally gives rise to ownership advantages, location specific advantages are derived from FDI in a host county. ”The possession of ownership advantages determines which firms will supply a particular foreign market, whereas the pattern of location endowments explains whether the firm will supply that market by exports (trade) or by local production (non-trade)" (Dunning 1980: 11).

In summary, the main motives for internationalization are market seeking, resource seeking, efficiency seeking and strategic asset seeking (Buckley 1988; Dunning 1993, 1998; Hanson et al. 2001)

1. Market seeking: The FDI theory suggests that involvement in foreign markets is strongly linked to the absolute size of the host market and the potential for market growth. Such market-seeking FDI is usually seen as a response to the costs of serving a foreign market at a distance. Generally speaking, the larger the foreign market the greater is the tendency of the supplying firm both to prefer foreign production and to wish to own and control that production in the form of FDI.
2. Resource seeking: Physical resource seeking applies to transnational corporations seeking access to raw materials abroad, to obtain security of supply.
3. Efficiency seeking: Foreign operations to reduce input costs are strongly associated with the manufacturing industry, e.g. lower labour costs in the foreign country.
4. Strategic asset seeking: 'Strategic asset or capability seeking' (Dunning 1993) describes attempts to secure the input of key elements in the production process such as technology; professional, managerial, and financial skills; knowledge of various types, and marketing expertise. One common way to acquire these assets is to form a joint venture with a partner with whom, and from whom, these capabilities can be learned. The growth of strategic asset seeking FDI is best demonstrated by the increasing role of mergers and acquisitions as modalities of FDI.

Methodology

The choice of method in this paper is primarily a qualitative process-tracing case study. First of all, analyzing the internationalization of a company requires case study research because internationalization is an individual process which differs from company to company. Additionally, research about CEE markets and companies is – at this stage – very problematic to conduct using ready-tailored quantitative data, simply due to the lack of data or their limited reliability (Törnroos 1999). Case studies can be seen as data collection and, therefore, as a first step on the way to quantitative analysis.

In contrast to quantitative studies relying on statistical sampling, in which researchers randomly select the sample from the population, the cases in this study were chosen for theoretical reasons to replicate or extend the emergent theory. The case studies involve either single or multiple cases and numerous levels of analysis – including, for instance, analysis at the country, industry and firm levels (Eisenhardt 1989; Yin 2003).

The enlargement of the EU poses different challenges for the internationalization of companies from countries which are insiders of the EU and those which remain outsiders. To analyze the motives of this internationalization, the basic indicators of internationalization –

sales and outward FDI – and, additionally, strategic partnerships as a means of market entry are utilized in this study.

The selection of the case studies was based on the decision to choose the most similar cases, i.e. the most internationalized companies. The companies were chosen from the two leading CEE countries in terms of outward FDI, Russia (outsider) and Hungary (insider), as well as from one of the most internationalized industries in the world, the oil and gas sector. Due to the fact that internationalization is a rather new phenomenon in post-Socialist countries, the number of companies from the oil and gas sector in CEE which are internationalized beyond the export or import of energy sources is limited. In Russia, only three oil and gas companies have FDI outside the CIS countries, namely Gazprom, Lukoil and Yukos. In Hungary, MOL has a near monopoly in the oil and gas sector.

Therefore, with the Hungarian firm MOL and Russian companies Gazprom, Lukoil and Yukos, this study focuses on some of the most internationalized companies from CEE.

Internationalization of companies from CEE

Despite some internationalization experience gained in the Socialist period – mostly through export activities (see e.g. Heinrich 2001b for Gazprom) –, outward FDI and the emergence of internationalizing companies from CEE are recent phenomena. Companies have realized that imitating the export-led growth model alone cannot keep and enhance competitiveness in the global economy. However, the investment activities of internationalizing companies from CEE are characterized by regional concentration – mainly in countries in which economic activities already existed (Jaklič - Svetličič 2003: 68, 71).

Therefore, the most prominent internationalizing companies from CEE are mostly older and larger corporations established in the Socialist period with substantial previous export experience and a certain international trade record. Their advantages are, for instance, stock of resources, strong brand names, steady business ties abroad and substantial knowledge of some foreign markets (Jaklič - Svetličič 2003: 74; Antalóczy - Éltetö 2002).

EU insider

Outward FDI from Hungary has been increasing since 1997. Until that year, the value of investment abroad had been insignificant. Since then, Hungary has become one of the chief outward investors from the CEE region, second only to Russia in 2003 (UNCTAD 2004: 375). Hungarian outward FDI is highly concentrated on a small number of corporations: barely 2% of the Hungarian companies investing abroad were responsible for around 52% of the total capital placement in early 2001 (Antalóczy - Éltetö 2002).

In 2000, more than 57% of the Hungarian outward FDI was directed to neighbouring countries in the CEE region. The bulk of the outward FDI derives from the manufacturing sector within which oil refining occupies an important place, due to the investments by MOL.

The share of Hungary's outward FDI flowing from the oil refining sector increased from 34.0% in 1999 to 53.2% in 2000 and accounted for 63% in 2003. In 2000, 80.4% of the oil refining sector's outward FDI flowed to non-EU countries in CEE, only 8.2% to EU countries while 9.9% was invested in the USA (Antalóczy - Éltetö 2002: 9-10; UNCTAD 2004a: 74-75). This trend will continue: the majority of Hungarian FDI will flow to CEE due to the fact that the Western member countries of the EU are dominated by financially powerful Western companies.

Market seeking has been the most important underlying motive of outward FDI in acceding countries due to their small domestic market size. "Firms are primarily looking for business opportunities and possibilities to exploit their ownership advantages [...] and less to institutional environments", like country risks or trade barriers (Jaklič - Svetličič 2003: 71). Foreign markets were attractive especially if competition was strong and home markets saturated (Antalóczy - Éltetö 2002). Particularly in Hungary, the competition's threat through inward FDI works as a trigger of outward FDI (Jaklič - Svetličič 2003: 74-75).

The situation of the energy sector in Central Europe is affected simultaneously by two influences: increasing competition from Western companies and energy dependence on Russia. The opening up of the Central European energy markets and their integration into the West European pipeline and delivery network has had some negative effects on energy companies in CEE. The East European oil and gas market is threatened by the risk of domination by foreign companies. Global industry leaders like British Petroleum (BP) or Royal Dutch/ Shell as well as regional leaders like the Austrian OMV entered the market aggressively and were able to undertake significant financial investments.

The CEE energy markets have already been strongly penetrated by foreign companies. Former state-owned national oil and gas companies have been attacked by local consolidation on the one hand and acquisition by global majors on the other. Until today, only some have been able to keep their local downstream dominance, e.g. the Polish PKN Orlen and Hungarian MOL. To strengthen their local market leadership both are actively seeking internationalization of their businesses, forming regional leaders in CEE (Kroger et al. 2003: 36).

On the other hand, the EU as a whole but especially the new member states in CEE are heavily dependent on Russia as a supplier of energy sources. The EU and Russia have been historical partners in the energy sector since the 1970s. Due to the fact that EU countries possess only minimal oil and natural gas reserves, but consumed 17.2% of the world's oil and 16.3% of the world's natural gas production in 2000, the EU is one of the world's major oil and gas importers (European Union 2004: 66, table 2.8.2). In 2002, Russia covered 22.3% of the EU's oil imports, second only to Norway with 23.0%. Russia's share of the EU's gas imports is even higher; in 2001, Russia accounted for 38.7% of the EU's natural gas imports, which makes it the biggest supplier (EU 2004: 29, table 2.2.6). The energy situation in the new Central European member countries is similar to or even worse than that of old EU members.

Table 1: Import dependency of the European Union, 2001 (in %)

	Oil	**Natural gas**	**All fuels**
Austria	**88.9**	72.1	64.7
Belgium	100.8	99.7	80.1
Denmark	-66.8	-66.0	-27.2
Finland	107.1	100.0	55.9
France	98.3	93.1	50.0
Germany	98.5	77.0	61.4
Greece	98.5	99.2	68.9
Ireland	102.9	81.6	90.0
Italy	94.0	77.1	82.1
Luxembourg	98.8	100.0	97.9
Portugal	102.7	99.9	87.2
Spain	98.3	96.5	74.3
Sweden	100.0	100.0	35.9
The Netherlands	94.8	-56.7	34.1
UK	-43.5	-9.6	-8.9
EU 15	**77.0**	**43.3**	**50.1**
Cyprus	100.6	—	99.2
Czech Republic	97.9	99.8	23.3
Estonia	101.9	100.0	31.7
Hungary	77.3	75.4	65.2
Latvia	95.0	101.9	62.6
Lithuania	94.8	100.0	59.5
Malta	100.5	—	100.5
Poland	98.5	66.3	11.0
Slovakia	91.7	98.8	64.5
Slovenia	101.4	99.3	52.1
All acceding countries	**95.0**	**84.3**	**29.9**

Definition: Import Dependency = Net Imports / (Bunkers + Gross Inland Consumption). Negative numbers indicate that the country is a net exporter. Values over 100% are possible due to changes in stocks.

Source: European Union 2004: 28, 58, table 2.2.5, table 2.6.4.

However, EU objectives are the opening up of energy markets to competition and securing energy supplies through the diversification of sources by geographical regions, goals which may adversely affect Russian energy exports to the EU in the medium and long runs. This position has been explicitly formulated by the European Commission (cf. European Commission 2001). Even though there are officially no restrictions on amounts, it is recommended that not more than 30% of EU's energy needs come from any one source.

Due to historical circumstances after the Second World War, the new EU member states from Central Europe were members of the CMEA (Council of Mutual Economic Assistance)[2], dominated by the Soviet Union, which delivered all the energy not produced by the member countries themselves. After the breakdown of the Soviet Union, dependence on now mostly Russian energy resources still remains even if the countries are trying to diversify their suppliers.

Table 2: Dependency on Russian energy imports in Central Europe, 2000 (in %)

	Crude oil	**Natural gas**
Bulgaria	5	94
Czech Republic	65	82
Hungary	100	81
Poland	100	99
Romania	55	100
Slovakia	100	100
Slovenia	0	62

Source: Liuhto 2002: 15.

While Bulgaria, the Czech Republic and Slovenia were able to reduce their dependency on Russian crude oil imports in 2000 (compared to 1996), Hungary, Poland, Romania and Slovakia have had to increase their imports, in some cases dramatically. Additionally, only Bulgaria, the Czech Republic and Hungary were able to reduce their natural gas imports from Russia.

However, integration into the West European pipeline and delivery network have made it easier for CEE countries to diversify their energy suppliers. Until 1996, the refineries in Hungary, Poland, and the Czech and Slovak Republics received all their crude oil from Russia through the Druzba pipeline. But new pipeline projects are gradually eroding Russian dominance (Petroleum Economist, No. 4, 1996: 51). Gas companies in the Czech Republic, Hungary and Poland have actively negotiated to diversify their suppliers and bring non-

[2] The Soviet Union formed the CMEA in January 1949 to counter the Marshall Plan. It was envisioned that the CMEA would provide all necessary imports and exports for all member states so that they would never need to rely on imports from other countries. Fuel exports to CMEA economies were highly subsidized (Korchemkin 1996, p. 121).

Russian deliveries to the region. In 1995, Hungary's MOL signed a contract with Germany's Ruhrgas for the delivery of 0.5bn cm annually starting in 1996, which was expanded to 0.91bn cm per year in 1998. Additionally, MOL signed a delivery contract with Gaz de France for 0.4bn cm per year in 1996. However, both contracts were viewed more as 'security measures' than as real diversification of suppliers. Nevertheless, Hungary has indicated its wish to incorporate a significant quantity of non-Russian natural gas into its import portfolios (Stern 1999: 168, 170).

EU outsider

For companies from CEE, Kalotay (2003: 18) asserts that they are escaping a difficult and partly unstable business environment rather than using specific ownership advantages; this mindset can be called ownership disadvantage. However, Russian companies from the extracting industries also have a specific ownership advantage – their resource base. In 2001, as table 3 indicates, nearly two thirds of Russia's 15 biggest exporting companies belonged to the oil and gas industry and the rest to the metals industry. Together these 15 firms accounted for about half of all Russian exports by value.[3]

[3] Data from 2001 are the most recent available.

Table 3: The 15 largest Russian exporters, 2001

Company	Industry	Exports (in billion USD)	
		2001	2000
Gazprom	Oil and gas industry	16.4	13.9
Lukoil	Oil and gas industry	6.6	6.2
Yukos	Oil and gas industry	5.7	5.2
Tyumen Oil Co. (TNK)	Oil and gas industry	5.6	3.5
Surgutneftegas	Oil and gas industry	2.4	1.7
Russian Aluminium	Non-ferrous metallurgy	2.2	2.2
Tatneft	Oil and gas industry	2.1	2.6
Slavneft	Oil and gas industry	1.8	1.3
Norilsk Nickel	Non-ferrous metallurgy	1.8	2.2
Sibneft	Oil and gas industry	1.7	1.7
Rosneft	Oil and gas industry	1.3	1.3
Alrosa	Non-ferrous metallurgy	1.2	0.8
Bashneft	Oil and gas industry	0.8	0.9
Magnitogorsk Iron and Steel Works	Ferrous metallurgy	0.8	0.8
Novolipetsky Metallurgical Combine	Ferrous metallurgy	0.7	0.9

Source: Expert (2003), http://www.expert.ru/expert/ratings/export/02-23-30/t1.htm.

Similarly, the structure of Russian outward FDI is characterized by the dominance of companies from the raw material sector, primarily oil and gas companies. According to UNCTAD (2004: 74), more than half of the 15 leading outward investing companies (in terms of new projects set up abroad) were from the natural resources sector in 2002-2003 (including Gazprom, Lukoil and Yukos).

The Russian Federation, with an outward FDI stock of USD51.8bn in 2003, comprises the largest share of outward FDI from CEE countries. Nevertheless, Russia's outward FDI stock amounted to just a mere 0.6% of the world's FDI stock. However, the outward FDI stock represents only a fraction of the total Russian capital abroad; capital flight is not included (UNCTAD 2004: 72, 385; Vahtra/ Liuhto 2004: 9).

According to UNCTAD (2003: 31), information on the structural patterns, such as the geographical destination of outward FDI from CEE, is scattered and has to be interpreted with care. However, geographical distributions of foreign affiliates features the domination of Western developed countries. Outward FDI flows in the second half of the 1990s indicate that Russian investment activities are highly regionally concentrated; the main destination for Russian FDI was the EU with a share of 30.5%. The second major destination was CEE, including the countries of the Commonwealth of Independent States (CIS), with a share of

25.3%, followed by North America with 23.0%. These three regions alone amount for nearly 80% of Russian outward FDI (calculation based on Kalotay 2003: 11-13).

However, internationalizing Russian companies, which as a rule do not have the financial power or international experience (companies from the oil and gas sector excepted) of their Western competitors, try to operate in similar market environments or work within existing business networks (Bulatov 2001: 188). While EU acceding countries from CEE have generally invested increasingly in other CEE economies with which they have traditionally close business links, Russia can be seen as an exception to this trend (UNCTAD 2003: 31), at least according to the officially recorded FDI flows of Russian origin.

Between 1995 and 2001, Russian FDI flows into EU acceding countries in CEE amounted to a mere USD411.8mn (Goskomstat 2003: 240; own calculations). It has to be noted that Goskomstat reported a significantly lower figure for Russian FDI in Poland than the UNCTAD did. From 1995 to 1999 alone, the amount of Russian FDI recorded by UNCTAD reached USD1,112.2mn (Kalotay 2003: 11-13). It seems obvious that Goskomstat did not record Gazprom's investments in Poland (Vahtra/ Liuhto 2004: 16).

Taking that into account and adding Russian FDI flows to Bulgaria, which amounted to USD45.4mn between 1995 and 1999, while Romania acquired USD3.2mn (Kalotay 2003: 11-13), a total of USD1,501.4mn can be calculated. However, while the total Russian outward FDI flows between 1995 and 2001 amounted to USD13.901mn, the share of CEE countries is still a mere 10.8%.

In the period from 2001 to 2003, the Russian FDI stock in CEE increased slightly to a total of USD1,945mn. The by far largest Russian FDI stock was still located in Poland with USD1.3bn, followed by Lithuania (USD288mn), Bulgaria (USD202mn) and Latvia (USD171mn) (calculations based on Vahtra - Liuhto 2004: 13, 16; Pelto et al. 2003: 8; Liuhto - Jumpponen 2003: 32). In relation to Russia's total outward FDI stock of USD51,809mn in 2003, the share of CEE countries is a mere 3.8%.

The figures mentioned above do not include the investments of companies registered in Cyprus, which are supposed to harbour Russian capital. These capital flows of unspecified origin are hard to calculate and will not be addressed in this paper (cf. e.g. Pelto et al. 2003). One motive for these hidden investments by Russian companies might be resistance in the countries of destination in CEE to Russian FDI.

In general, the dominant motive for Russian companies to enter a foreign market is to open up possibilities for business. The companies strive for prominence at foreign markets and they try to achieve this without intermediaries because it is more profitable and reliable to do so without a ”middle man”. Negative aspects of Russia's investment climate, such as high taxation as well as political and legal instability, which might ordinarily work as push factors, were not the dominant motives for outward FDI of the older companies analyzed by Bulatov (2001: 186, 193).

In the energy industry in particular, Russian companies started to diversify their production base and access foreign markets by acquiring companies and establishing foreign affiliates (UNCTAD 2004: 74).

Market access of Russian goods and services to new member countries will be regulated by the Partnership and Co-operation Agreement (PCA).[4] This commission came into force in December 1997 and is supposed to build the overall framework for political dialogue on various levels, as well as for economic and social co-operation and the approximation of their legislation to EU standards. Regarding the PCA, the average customs tariff for Russian imports (with the exception of agricultural products) will be lowered to the EU level, which is much lower than those which were in force in acceding countries before the enlargement. Further fulfilment of the PCA between Russia and the EU would promote integration according to European standards; integration from inside by applying the EU’s acquis communautaire nationally (Kivikari 2003: 59, 61; Astrov - Havlik 2004: 10, 12).

However, Russia will not necessarily benefit from the unification of rules and regulations, especially in the field of environmental regulations in the short run. Some Russian experts and officials in the relevant ministries fear a further deterioration of trade with the CEE countries after their accession to the EU (Astrov - Havlik 2004: 12). The anti-dumping measures regularly imposed upon Russian exports have long been a source of friction.

Russia’s trade relations with countries in CEE will be adversely affected, for instance, as they gradually re-orient their trade towards the EU. Additionally, there will be increased competition on CEE markets with companies from the West and Western investment flows might be diverted from Russia to the new EU members.

Additionally, since the European summit in Helsinki in 1999, it has been obvious that the Balkans are a key region of interest for the EU. The EU has not formulated an offer of accession for Russia, partly due to the Union’s limited capacities but also to a lack of political will, which could draw a new dividing line as a negative side effect of EU enlargement. On the other hand, Russia has not yet declared an interest in EU membership.

Only in the areas of transportation and energy could a pan-European integration be advanced. Following the basic idea of functional integration, co-operation in some key areas could have spill-over effects on other fields of co-operation. Even without any prospect of EU membership, functional integration could be strengthened into a free trade area (see Samson 2002).[5]

This specific aspect of the EU-Russia relationship started with the Energy Charter[6] in 1994 and led to the EU-Russia energy dialogue which started at the EU-Russian summit in Paris,

[4] See http://www.europa.eu.int/comm/external_relations/ceeca/pca/index.htm.

[5] The concept of a Common European Economic Space (CEES) was developed after the Russia-EU summit of 17 May 2001 and is a pragmatic approach to solving the problem of increasing trade and investments between Russia and the EU.

[6] After the break-up of the Soviet Union, an initiative was set in motion to facilitate trade and co-operation between the energy sectors of Western Europe, the Former Soviet Union (FSU) and Eastern European nations. The plan espoused in 1990, to develop open and competitive markets in energy products and materials, was underpinned by the realization of an interdependency that persisted between the Eastern and Western European energy sectors. Whilst initially an exclusively European initiative, other nations such as the USA and Japan

on 30 October 2000, and is based on the recognition of long-term and mutual interdependence of the EU and Russia in the energy sector.

At the beginning of 2004, Russia possessed substantial oil and natural gas reserves, which amount to 6.0% and 26.7% of the world's proven reserves, respectively. The country produces more hydrocarbons than it consumes, which allows Russia to be the world's biggest exporter of natural gas and the second biggest oil exporter (BP 2004: 6, 22).

Since 1991, Russian oil and natural gas exporters have increasingly shifted their focus from the countries of the FSU and Central Europe to Western Europe. As countries in the FSU racked up huge energy debts, Russian exporters targeted customers in Western Europe. Additionally, the Russian oil and gas industry, with the exception of oil refining, receives nearly all its profits from exports due to low domestic prices. Therefore, nearly half of Russia's oil production and a third of the country's gas production are being exported. Gazprom, for instance, has become heavily dependent on gas exports to Europe; the earnings are used both to achieve profitability and to guarantee loans (Stern 1999: 149).

With the energy agreement signed by the EU and Russia in October 2000, Russia is eager to increase its supply share to the EU against competitors from Norway, North Africa and the Persian Gulf. Although Russian oil and gas exports to the EU are not hindered by any relevant conflict, two other issues are threatening Russia's energy partnership: EU demands for Russian energy sector reform and the fear of Russian domination by new EU members.

The EU wants Russia to open its gas pipeline network to third (and among them foreign) parties and to increase prices for domestic gas consumers (i.e. to reduce indirect subsidies). Russia considers these demands an interference in internal Russian affairs and to deliberately discriminate against Russian companies participating in EU energy markets. However, the EU raised the same demands in negotiations over Russia's WTO entry, one of Russia's foreign economic policy priorities. As a result of the Russia-EU agreement on Russia's WTO entry, signed in May 2004, Russia agreed to open the gas pipeline network to third parties and to raise domestic gas prices considerably (for assessments of the agreement, see e.g. UFG, Russia Morning Comment, 24 May 2004: 3-5; The Economist, 29 May 2004: 30-31). By 2010, Russia's domestic gas prices are set to nearly double to USD49-57. However, that is still some 50% below the projected export price which the EU had originally demanded (Aris 2004b).

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entered the fray to ensure their own potential access to Eastern European energy markets. The binding multilateral Energy Charter Treaty was finally signed in Lisbon on 17 December 1994. It sets out a sectoral legal framework for energy; it deals inter alia with issues pertaining to trade, transit, investment, competition and environmental concerns (Clark 1998). The trade regulations refer basically to World Trade Organization (WTO) principles of non-discrimination and transparency policy. Transit constitutes the most innovative legal instrument, as there is no previous multilateral agreement on the issue (for an analysis of energy trade between Russia and the EU see Belyi 2003).

Case Studies

In the following case studies the emphasis lies on the international activities of the selected companies in Western and Central Europe. The activities of the companies in other parts of the world are given only brief mention.

MOL

MOL, Hungary's largest company, is a downstream oil and gas firm specialized in refining and distribution, with regional rather than global aspirations. MOL dominates both the Hungarian wholesale market with a market share of around 80% and the gasoline market with a 41% market share (MOL 2004: 24). MOL's reserves and production of crude oil and natural gas have contracted significantly since privatization. Despite the substantial decline in its reserves and production, MOL's sales volume have remained fairly stable due to an increase in imports (see table 4), mainly from Russia. Even if MOL's dependence on imports is high, the company also exports parts of its own production and is active in the transit of natural gas to other countries (Liuhto 2001a: 447-448). In 2003, the company had a network of 416 filling stations in seven countries (MOL 2004: 2, 11).

Table 4: Share of imports on MOL's total crude oil processing and gas sales

Oil (in mn tons)									
	1995	1996	1997	1998	1999	2000	2001	2002	2003*
Total crude oil processing	6.9	6.5	6.7	6.8	7.0	6.8	6.8	6.0	10.5
Imported oil	5.2	5.1	5.3	5.6	5.8	5.7	5.8	5.0	9.4
Import ration oil	73.4	78.5	79.1	82.4	82.9	83.8	85.3	83.3	89.5
Gas (in bn cm)									
	1995	1996	1997	1998	1999	2000	2001	2002	2003*
Total gas sales	11.5	12.8	12.2	12.2	12.4	12.2	13.4	13.4	14.6
Imported gas	6.8	8.9	8.1	8.7	9.0	9.0	9.6	10.7	12.2
Import ration gas	59.1	69.5	66.4	71.3	72.6	73.8	71.6	79.9	83.6

* = MOL Group with Slavnaft from 1 April.
Sources: MOL 1999: 84-85; MOL 2004: 72-73.

"In order to vitalize its export and import activities, MOL has begun operations abroad" (Liuhto 2001a: 448). MOL purchased its first international oil field in 1991, when it acquired the Kebili and Sabia Block in central Tunisia. MOL also held an interest in an Egyptian oil field in the Nile Delta as well as in projects in Greece, Albania, Syria, Yemen, Qatar and Pakistan (Liuhto 2001a: 448-449; MOL 2001: 23-24).

As a response to the increased consolidation in the industry, MOL has changed its strategic direction since 1999. It has decided to withdraw from its geographically diversified international exploration portfolio, taking into account the long lead-time and higher risk involved. Instead, the company plans to use its competitive advantages and focus its activities on Russia and CEE, using its historical, technical and cultural knowledge of the region. MOL has further decided to concentrate on refining and marketing and to become a regional leader (MOL 2000: 7, 20).[7]

It has focused its reserve acquisitions primarily in Russia due to more attractive acquisition costs and a better return on investment than internationally (Liuhto 2001a: 448). Accordingly, in 2000, MOL sold its interests in the Tunisian and Egyptian oil fields. The company's exploration project in Qatar has been closed, while its two Albanian projects have been relinquished.

However, in Greece, Syria, Pakistan and Yemen MOL concluded that it is financially advantageous to complete its committed work programmes (MOL 2001: 8, 24). Nevertheless, MOL sold a 30% share in both of its blocks in Yemen to its partners in its Pakistani exploration project to reduce the financial risk in 2001. In the following year the company withdrew from its project in Greece (MOL 2002: 8; MOL 2003a: 33).

In early 2002, MOL and Russia's Yukos set up a joint venture to develop the Western Malobalyksky deposit in Western Siberia. The company had already signed an agreement on the joint development of the deposit in November 1999 (Vedomosti, 30 January 2002). The project was supposed to serve MOL's strategic interests and to prepare the company for its future role as joint operator in Russia (MOL 2001: 23). However, the future of the joint venture depends heavily on the fate of Yukos (see below).

In continuing its resource seeking activities, MOL has acquired a 22.5% share in the Fedorovsky Block, located in North Western Kazakhstan next to the Russian border. The three party consortium includes MOL and American First International Oil Company (FIOC) each with 22.5% of the shares and Avery Worldwide Limited – acting as operator – with the remaining stake of 55% (MOL, Press release, 1 July 2004).

In the downstream sector, MOL acquired a 36.2% stake in Slovnaft at the end of 2000. This Slovak oil company is involved in crude oil refining and the distribution and sale of refined oil products and exports them mainly to the Czech Republic, Austria, Hungary,

[7] Kroger et al. (2003: 39) state that a leading geographical position accompanied with strategic advantages or regional specialization arising from the regional closeness of the downstream businesses to its local customers is clearly advantageous. This is supposed to be a winning strategy against the increasing consolidation pressure of global majors. However, the national downstream markets in the new EU member states are quite diverse with a strong position of the national champion. Western majors – such as BP and Royal Dutch/ Shell – have made these downstream markets much more competitive, but they have not acquired a dominant position in Central Europe. Regional competitors have developed even stronger positions in the neighbouring downstream markets (cf. e.g. MOL 2003b). For instance, Austrian OMV acquired BP's retail outlets in Hungary in 1999, an expansion strategy initiated in the previous years (OMV, company information). Thus, it is more an indirect global pressure which influenced the regional companies to increase their acquisitions in neighbouring markets and, therefore, increasing the competition pressure for other regional companies. PKN Orlen, MOL and OMV are good examples of downstream-driven companies.

Germany and Poland. It has filling stations in Slovakia, the Czech Republic and Ukraine (Liuhto 2001a: 450; Kapoor 2000: 18). By January 2004, MOL had increased its share in Slovnaft to 98.4% and after a successful integration both companies have been operating as one integrated business entity (MOL 2004: 16).

In 1999, MOL was in merger talks with the Croatian oil firm INA. But that deal did not materialize. Finally, on 17 July 2003, MOL bought 25% of INA. It is the company’s second cross-border acquisition after buying Slovakia’s Slovnaft in 2000. The acquisition of INA gave MOL direct access to crude oil supplies from the Adriatic sea and also built a strategic alliance for further expansion in Central Europe (MOL 2004: 4, 9, 17).

In July 2004, MOL acquired a majority interest in Roth Heizöle GmbH, the largest family-owned company in the Austrian mineral oil sector operating in the Graz and Linz region. The company markets around 400,000t of petroleum products yearly and operates around 70 filling stations. Roth Heizöle GmbH also possesses three major storage depots and the required logistics for the transport of petroleum products. Since MOL has been the key supplier of the company for a long time and wished to stabilize its position on the Austrian wholesale market, the acquisition of Roth Heizöle resulted in further penetration of the end-user market (MOL, Press release, 27 July 2004).

In November 2004, MOL signed an agreement with Shell for the acquisition of 100% of the shares of Shell Romania. The deal includes a network of 59 retail service stations spread across Romania and the lubricants, aviation and commercial businesses. Through this transaction the total number of MOL-operated filling stations in Romania now exceeds 130 (MOL, Press release, 23 November 2004).

Since 1999, MOL has also negotiated a co-operation with PKN Orlen, the largest crude oil refiner and manufacturer of petrochemical products in Poland (Liuhto 2001a: 450-451). In November 2003, MOL and PKN Orlen signed a memorandum of understanding, whereby the parties agreed to examine the potential for partnership. For MOL this could enable entry into Poland, the largest market in the region, with significant growth potential. An agreement between MOL and PKN Orlen would be the most significant regional consolidation step in Central Europe so far (MOL, Press release, 13 February 2004). However, the future of the expected merger between the two companies was uncertain. For political reasons Poland was reluctant to give up control of this strategic asset (IntelliNews, Hungary This Week, 19 April 2004). Finally, with the listing of MOL on the Warsaw Stock Exchange, PKN Orlen announced in December 2004 that it is no longer interested in a merger (Puls Biznesu, 22 December 2004).

Additionally, MOL offered the Romanian oil company Petrom a plan for a strategic partnership instead of bidding in the privatization tender. Petrom has a 45% share of the Romanian gas market as well as a 50% share of the gasoline market. It owns some 600 filling stations in the country and two refineries with a combined annual capacity of 8.0mn tons. The company drills roughly 6.0mn tons of crude oil and 6.5bn cubic metres of gas per year (IntelliNews, Hungary This Week, 19 April 2004). However, in the end its competitor OMV won the privatization tender, increasing its share to 51% in July 2004 (company information). This was a setback for MOL, which considers Romania an important strategic market.

Earlier, in August 2003, MOL lost the tender for a 79.5% stake in the number two gasoline retail network in Serbia, Beopetrol, to Lukoil. The acquisition of Beopetrol gives Lukoil a competitive advantage against its competitors in Serbia, such as MOL, OMV and INA (Russia Morning Comment, 26 August 2003: 4).

Summary of MOL's internationalization

Motives of internationalization	• market seeking • resource seeking • strategic asset seeking
Forms of internationalization	• joint ventures • acquisitions • co-operations • marketing subsidiaries
Countries of activity	Austria, Croatia, Pakistan, Poland, Russia, Slovakia, Syria, Yemen
Comments	While MOL's internationalization was mainly driven by resource seeking motives until 1999, the company changed its business strategy focusing more on downstream acquisitions in CEE countries. MOL shifted its focus more to strategic asset seeking.

Gazprom

Russia's Gazprom holds nearly the monopoly on production, transport and export of natural gas. The main activities of Gazprom outside Russia include the expansion of export capacities, investment in the foreign and foremost European natural gas industry as well as the building of strategic partnerships with foreign companies.

Gazprom has developed plans to expand natural gas exports in all possible directions even if the export share has remained fairly stable at around one third of its production. In Western and Central Europe especially, Gazprom is trying to diversify the structure of its consumer base and to increase participation in deliveries to end-users. Moreover, the company has made overtures to gain direct access to large industrial and gas-fired power generation markets in Western and Central Europe. Gazprom has endeavoured to sign long-time delivery contracts and to maintain its export monopoly to Europe. However, independent gas producers should be conceded export quotas (Heinrich 2001a; on the development of the natural gas sector in CEE, see Shkuta 1999).

Table 5: Share of exports on Gazprom's total natural gas production (in bn cm)

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Production	559.5	564.7	533.8	553.7	545.6	523.2	511.9	521.9	540.2	545.1
Exports	191.9	196.3	188.9	173.0	174.0	173.7	166.5	168.9	175.5	192.7
Export ratio	34.3	34.8	35.4	31.2	31.8	33.2	32.5	32.4	32.5	35.4

Sources: Company information; UFG, Russia Morning Comment, 26 January 2005: 4; own calculations.

Gazprom has profited from the EU gas market liberalization initiatives by gaining access to the downstream business in Western Europe. To participate in the profitable downstream market, Gazprom has established joint venture marketing companies in nearly all the countries to which Russian natural gas is exported (see table 6). Gazprom has also invested in non-core business equity outside the Russian Federation, like gas equipment manufacturing, petrochemicals and banking.

Table 6: Gazprom's joint ventures in Western and Central Europe

Country	***1.1.2.1 Joint venture***	Share	Activities
Austria	GHW	50	Gas trading
Bulgaria	Topenergo	100	Gas trading and transport
	Overgas	50	Gas trading
Estonia	Eesti Gaas	37	Gas trading and transport
Finland	Gasum Oy	25	Gas transportation and marketing
	North Transgas Oy	50	Pipeline construction beneath the Baltic Sea
France	FRAgaz	50	Gas trading
Germany	Ditgaz	49	Gas trading
	Verbundnetz Gas	5.3	Gas transportation and marketing
	Wingas	35	Gas transportation and storage
	Wintershall Erdgas Handelshaus (WIEH)	50	Only trader of Gazprom's exports until 2012
	Zarubezhgaz	100	Gas trading
Greece	Prometheus Gaz	50	Marketing and construction
Hungary	Panrusgas	50	Gas trading and transport
	Borsodchem	25	Petrochemicals
	DKG-EAST Co. Inc.	38.1	Oil and gas equipment manufacturing
	General Banking and Trust Co. Ltd.	25.5	Banking
Italy	Promgaz	50	Gas trading and marketing
	Volta	49	Gas trading and transport
Latvia	Latvijas Gaze	34	Gas trading and transport
Lithuania	Stella-Vitae	30	Gas trading
	Lietuvos Dujos	34	Gas trading and transport
	Kaunas power plant	100	Gas fired heat and power plant
Poland	Gas Trading	35	Gas trading
	Evropol Gaz	48	Gas transport
Romania	WIROM	25	Gas trading (controlled through WIEH)
Slovakia	Slovrusgaz	50	Gas trading and transport
	SPP	16.3	Gas transport
Slovenia	Tagdem	7,6	Gas trading
The Netherlands	Pieter-Gaz	51	Gas trading
Turkey	Bosphorus Gaz	40	Gas trading
UK/ Belgium	Interconnector	10	Pipeline which connected Bacton (UK) with Zeebrugge (Belgium)
Yugoslavia	JugoRosGaz	50	Gas trading and transport
	Progress Gas	50	Gas trading

Sources: Heinrich 2003: 61; UFG, Russia Morning Comment, 1 April 2003: 5; NewsBase, FSU Oil & Gas Monitor, No. 13, 31 March 2004, No. 14, 7 April 2004, No. 16, 21 April 2004, No. 46, 17 November 2004 and No. 50, 15 December 2004; Interfax, 29 October 2004.

The problems and political protests Gazprom was confronted with upon the acquisition of the Hungarian Borsodchem in 2000 (see below) highlight the unpleasant reality Russian energy companies face as they expand towards Central Europe: they are unwelcome.

On the other hand, Gazprom is engaging in strategic partnerships with leading Western natural gas companies in order to gain access to new markets and new sources of finance. It is a means of bringing in foreign companies that have their own access to loans at more affordable rates. In Germany, Gazprom is co-operating with Ruhrgas and BASF/ Wintershall, in Italy with Eni. The company is also co-operating with the international Royal Dutch/ Shell Group (the following based – if not otherwise stated – on Heinrich 2003: 58-60).

While the co-operation with Shell focuses on markets in Asia, the Far East and South East Asia, the partnership with Eni includes the 'Blue Stream' pipeline project in the Black Sea. The co-operation with Ruhrgas and BASF/ Wintershall, however, is more focused on Western and Central European gas markets.

The co-operation with Ruhrgas – which has a market share of around 60% in Germany – helps Gazprom to increase its access to the West European gas market and to prepare for the partial liberalization of the EU gas market.

In 1989, Gazprom began to look for new business opportunities in the West European downstream sector. However, Ruhrgas seemed unwilling to grant its Russian partner access to that profitable part of the gas market. As a result, Gazprom signed a co-operation agreement with Wintershall – a subsidiary of BASF and one of Ruhrgas's main competitors in the German natural gas market. The co-operation with Wintershall offers Gazprom lasting access to the West European gas supply system in the downstream sector. In March 1999, Gazprom formed a strategic alliance with BASF for exploiting oil and gas in Russia.

Summary of Gazprom's internationalization

Motives of internationalization	• market seeking • strategic asset seeking
Forms of internationalization	• joint ventures • acquisitions • strategic partnerships • marketing subsidiaries
Activities in new EU member countries	Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia
Comments	Gazprom was able to establish a foothold in nearly all the new EU member states in CEE even though it faces more suspicion and resistance there than in Western Europe.

Lukoil

Since its establishment as an independent company in 1993, Lukoil has pursued the aim of becoming one of the five largest oil companies in the world, and it has accordingly developed a long-term expansion strategy. Primary goals were the increase of international oil production, the modernization and increase of refinery capacities as well as an increased access to international consumer markets. Even the Russian financial crisis of 1998 did not really slow Lukoil's expansion. However, the company spent considerable sums to come closer to its goals.

Lukoil can be considered the leading Russian oil company in international operations. In 2003, around 3% of the company's crude oil reserves were located outside Russia. The production of international projects amounted to around 4% of Lukoil's total crude oil production. Furthermore, 30% of the company's refining capacities are located abroad. However, in 2003, refineries abroad processed only 8.0mt of crude oil, which is 18% of Lukoil's total refining (Lukoil 2004: 30, 32, own calculations). Internationally, Lukoil is involved in downstream and upstream activities in CEE and the Near East, as well as in the USA (Väätänen - Liuhto 2001: 98-99). Since 1998, the company has exported nearly 40% of its production, which increased to nearly 50% in 2003.

Table 7: Share of exports on Lukoil's total national crude oil production (in mn tons)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Production	57.3	58.1	61.7	63.0	73.8	75.6	76.1	76.9	78.6	84.1
Exports	18.4	16.5	19.2	24.7	30.5	30.3	32.8	34.2	37.7	33*
Export ratio	32.1	28.4	31.1	39.2	41.3	40.1	43.1	44.5	48.0	39.2

Note: * exports via Transneft pipelines only (beyond CIS)
Sources: Company information; NewsBase, FSU Oil & Gas Monitor, No. 1, 12 January 2005; NewsBase, FSU Oil & Gas Monitor, No. 2, 19 January 2005; own calculations.

So far, Lukoil has not been able to get a foothold in the EU or the acceding countries via FDI. Attempts to acquire stakes in refining facilities in Lithuania, the Czech Republic, Poland and Greece have failed.

In 1999, Lukoil tried to acquire a stake in Mazeikiu Nafta, the Lithuanian refinery, but failed; 33% of the shares were sold to the US company Williams International. Lukoil was also eager to obtain a 70% stake in the Czech Republic Paramo. This deal collapsed as well (Liuhto 2001b: 33-34).

Lukoil and the British company Rotch Energy submitted a common bid in the privatization auction of a 75% stake in the Polish Gdansk refinery in 2002, one of the country's largest refineries with a 20% share of Polish refining and about 7% of the retail market. Poland is the largest petrochemicals market in CEE (Chemical Market Reporter, 9 September 2002; Petroleum Argus, FSU Energy, Vol. 7, No. 29, 26. July 2002: 9). But the deal has fallen hostage to politics and behind-the-scenes lobbying. However, Polish officials are scrutinizing the offer as they balance industrial and financial needs with geopolitics. Lukoil and other Russian energy concerns face a legacy of distrust in CEE, where they have been accused of deploying hardball business tactics (NewsBase, FSU Oil & Gas Monitor, No. 36, 11 September 2002).

Lukoil – together with the Greek Latsis Group – took part in the privatization of 23% of the state-owned Hellenic Petroleum, which controls half of Greece's total refining capacity (NewsBase, FSU Oil & Gas Monitor, No. 45, 13 November 2001). In 2002, Lukoil and the Latsis Group were the only bidders in the privatization tender (Petroleum Argus, FSU Energy, Vol. 7, No. 15, 19 April 2002: 11). However, in early 2003, Lukoil confirmed that its Hellenic Petroleum deal had fallen through. The Greek government cancelled the sale after failing to agree on terms with Lukoil (UFG, Russia Morning Comment, 5 February 2003: 4).

Nevertheless, Lukoil was more successful in the EU candidate countries Romania and Bulgaria. In February 1998, the company acquired a majority stake in the Romanian refinery Petrotel, followed by the acquisition of a 58% stake in the Bulgarian Neftochim refinery in 1999. Both acquisitions are part of a strategy to open up markets around the Black Sea and to refine the crude oil from the Caspian Sea (Company information; Petroleum Argus, FSU Energy, Vol. 7, No. 14, 12 April 2002: 9).

Lukoil continued its acquisitions in Romania and Bulgaria. In January 2004, the company took over MV Properties petrol stations (NewsBase, FSU Oil & Gas Monitor, No. 4, 28 January 2004). Lukoil also increased its stake in Bulgaria's Neftochim refinery to 93.16% in January 2005. In light of the new acquisition and should Lukoil's planned upgrade programmes be implemented, analysts believe that the refinery will achieve EURO-3 standards in 2007 and EURO-4 standards in 2009 (NewsBase, FSU Oil & Gas Monitor, No. 2, 19 January 2005).

Despite forging two strategic partnerships (with the Italian Agip in 1994 and with the US oil company Atlantic Richfield in 1996), Lukoil did not gain access to markets in the EU or acceding countries as both partnerships focused on activities in the Caspian Sea region.

Summary of Lukoil's internationalization

Motives of internationalization	• market seeking • strategic asset seeking
Forms of internationalization	• acquisitions • strategic partnerships • joint ventures • marketing subsidiaries
Activities in new EU member countries	None
Comments	Lukoil was not able to establish a foothold in the new EU member states in CEE. Therefore, it established a strong presence in EU candidate countries (Romania, Bulgaria), supplying the EU market with oil products.

Yukos

As opposed to Lukoil, the company has no upstream facilities outside Russia. Yukos started its internationalization via FDI only in 2000 with a pipeline project in Croatia. Before that, Yukos was active only in exporting, with Hungary as one of its biggest customers. The company was able to increase its export ratio to over half its production from 2001 to 2003.

Table 8: Share of exports on Yukos' total crude oil production (in mn tons)

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Production	36.1	35.3	35.6	44.6	44.5	49.6	58.1	69.5	80.8	85.7
Exports*	7.8	7.6	9.1	13.3	17.9	22.4	30.1	35.5	43.0	34**
Export ratio	21.6	21.5	25.6	29.8	40.2	45.2	51.8	51.1	53.2	39.7

Notes: * 1995-1997 exports excluding former Soviet Union
** exports via Transneft pipelines only (beyond CIS)
Sources: Company information; Neft' i Biznes (1997) No. 2, p. 10; Shmarov 2001: 58; NewsBase, FSU Oil & Gas Monitor, No. 1, 12 January 2005; NewsBase, FSU Oil & Gas Monitor, No. 2, 19 January 2005; own calculations.

Besides a pipeline project in Croatia, Yukos acquired a 26.85% stake in the Lithuanian refinery Mazeikiu Nafta from the US company Williams International in April 2001. Only two months later, the company increased its stake in Mazeikiu Nafta to 53.7% and installed its own management (NAUFOR – Skrin News, 14 December 2001; IntelliNews, Russia this Week, 24 June 2002).

In September 2001, Yukos acquired 12.1% of the financially shaken Anglo-Norwegian engineering company Kvaerner. In the following month Yukos increased its stake to 22%. Additionally, Yukos took over the Kvaerner subsidiaries Kvaerner Hydrocarbons and Kvaerner Process Technology, which were sold in mid-2003 (NewsBase, FSU Oil & Gas Monitor, No. 43, 30 October 2001; UFG, Russia Morning Comment, 4 June 2003: 5).

In December 2001, Yukos finished its shopping spree with the purchase of 49% of Slovakia's pipeline company Transpetrol. This acquisition strengthens the company's position in supplying crude oil to Slovakia, the Czech Republic and Germany (CentreInvest, Russian Market Weekly, 17 December 2001).

Further attempts to stake a claim in the EU through FDI have failed so far, such as the acquisition of BP's 55% stake in the German Bayernoil refinery and its network of 650 filling stations (UFG, Russia Morning Comment, 7 May 2002: 5).

Yukos has repeatedly voiced its desire to invest in the European downstream as part of a policy of further integration based on its rapidly growing oil production. Poland, Hungary, Germany and Austria were cited as the most prospective areas (UFG, Russia Morning Comment, 24 April 2002: 4). Accordingly, Yukos has signed an agreement with Austrian company OMV to build a new oil pipeline from Bratislava (Slovakia) to OMV's oil refinery in Schwechat (Austria), which will transport up to 5mt of oil a year. The oil pipeline will help Yukos to increase its exports onto the European market (Rosbalt, 14 August 2003).

To enlarge their international activities and to develop joint investment projects, Yukos and the US Marathon Oil announced a strategic partnership in 2001 (Petroleum Argus, FSU Energy, Vol. 6, No. 40, 12 October 2001: 2). Marathon has exploration projects in Ireland and the UK (North Sea) which might help Yukos to enter these markets.

Since October 2003, the Yukos affair has brought its ambitious goals to a standstill. While in the beginning only members of the management were personally accused of tax evasion and fraud, in the aftermath the accusations were extended to the company as a whole. The legal actions conducted by the tax administration seems to a lot of observers to be politically motivated, with the aim of breaking up Yukos as a company (Aris 2003, 2004a). In December 2004, its main production unit was finally put up for forced auction and sold to cover Yukos' tax debt, at least in parts. This step endangers the existence of Yukos as a company; its bankruptcy or liquidation is likely.

Therefore, Slovakia wants to redeem the 49% stake in the Transpetrol pipeline, sold in 2002 to Yukos. However, Russian government officials do not think it expedient to sell the stake back to the Slovaks and believe that other Russian companies may be interested in the pipeline (NewsBase, FSU Oil & Gas Monitor, No. 45, 10 November 2004).

The Lithuanian government has also decided to put the Mazeikiu Nafta oil refinery back under its control and may also consider redeeming Yukos' entire stake (NewsBase, FSU Oil & Gas Monitor, No. 2, 19 January 2005).

After early 2005, Yukos was even forced to stop its oil exports by the Transneft trunk pipeline system. The troubled Yukos has been forced to declare force majeure on oil exports to Petroval, its main European oil trader. Where Yukos' shipments have declined, export schedules of major Russian oil companies are rising (NewsBase, FSU Oil & Gas Monitor, No. 3, 26 January 2005).

Summary of Yukos' internationalization

Motives of internationalization	• market seeking • strategic asset seeking
Forms of internationalization	• joint ventures • acquisitions • co-operation
Activities in new EU member countries	Hungary, Lithuania, Slovakia
Comments	

Conclusion

Regarding the OLI paradigm (see table 9 for a summary), insiders such as the Hungarian oil and gas company MOL have had the market access, i.e. the access to the common European market, as ownership advantage since the EU enlargement. However, even at the forefront of the accession, insiders such as MOL undoubtedly face more competition from Western companies.

The challenge for MOL is to keep up its competitiveness; to realize this goal MOL has to expand in other acceding countries as well as outside the enlarged EU (e.g. the Balkans or Russia) to increase its resource base and to incorporate strategic assets. MOL has been a driving force in the regional consolidation of Central Europe's oil industry to internalize locational advantages by broadening its resource base, incorporating strategic assets (and simultaneously putting competitors out of the domestic market), and strengthening its market position abroad as well as entering new markets.

Since 1999, MOL's internationalization strategy has focused more – but not exclusively – on post-Socialist markets in CEE, after it had divested assets in North Africa, Southern Europe and Qatar. This strategy provides certain advantages for the company: besides local experience and existing business networks, MOL has been able to participate in the undervalued privatization in CEE (Antalóczy - Éltetö 2002).

The acquisition of Slovnaft – removing a major rival on the domestic wholesale market and on regional target markets – has consolidated MOL's domestic market position, has strengthened its position in Romania, Slovakia and the Czech Republic as well as created a platform for expansion into under-developed southern Poland. In qualitative terms, with the acquisition MOL controls some of the most complex and modern refining assets in the region, which gives MOL the opportunity to become involved in all aspects of oil business (Kapoor 2000: 20; Kaminov 2002: 3).

The strategic partnership with the Croatian INA has strengthened MOL's position in the domestic market as well as in Croatia and Slovakia and gives it the opportunity to expand further into Central Europe (MOL 2004: 17). Additionally, through INA MOL has access to oil terminals at the Adriatic Sea which could lead to a further diversification of crude oil supply.

Liuhto (2001a: 439) concludes: ”It seems evident that MOL must become a strong regional player in order to survive the competition. In fact, the company's own internationalization can be the only remedy to fight against foreign corporations entering MOL's home market, regardless of whether these foreign rivals arrive from the East or the West”.

Table 9: Motives for Internationalization

	Ownership	Location	Internalization
MOL	access to markets	possession of resources, access to markets, strengthening the vertically integration	to ensure stability of surplus at the right price, vertically integration
Gazprom	resources	Access to markets, access to pipelines	to ensure distribution of resources, participation in the downstream market
Yukos	resources	Access to markets, access to refining capacities	to ensure distribution of resources, participation in the downstream market
Lukoil	resources	Access to markets, access to refining capacities	to ensure distribution of resources, participation in the downstream market

With the new member countries from Central Europe, the enlargement of the EU incorporates energy markets traditionally dependent on Russian energy supplies. In response, the Russian firms under review have tried to establish a strong presence in the new EU member states by using local experience and business networks in the post-Socialist markets and to take part in the undervalued privatization in CEE.

For outsiders like the Russian oil and gas companies, the challenge is to establish a foothold in the enlarged EU to benefit from the European internal market. In the late 1990s, with the ownership advantage of a strong resource base and EU enlargement drawing closer, Russian companies increasingly tried to gain access to the EU downstream market, and especially oil companies, to refining capacities close to large consumer markets. The sale of oil products and the delivery of natural gas directly to the end consumer offer considerably higher profits than the sale of raw products at the border.

Because the EU energy market is dominated by Western companies, Russian firms have accordingly tried to anchor themselves in acceding countries by using local experience and business networks in the post-Socialist markets and to take part in the undervalued privatization in CEE (Liuhto 2001b: 39). Only Gazprom has been able to invest in gas transport and trading companies in the EU and, additionally, in seven of the ten acceding countries (in CEE, Gazprom has only in the Czech Republic not been able to get a foothold yet). Russia’s major oil companies Lukoil and Yukos have participated in all major privatization auctions for refineries, though with limited success, and have built up a network of service stations.

Political resistance to Russian investors in the new EU member countries has often led to year-long delays and political scandals. In Lithuania a prime minister resigned in 1999 over a quarrel between US and Russian companies for a stake in the national oil company, Mazeikiu Nafta. It took until 2001 before a deal with Yukos was finally reached (Pleines 2002). Gazprom used an Ireland-based sham firm for a hostile take-over of Hungary’s Borsodchem chemical manufacturer in 2000, a move that was opposed by the Hungarian government and caused considerable political protests (Chemical Market Reporter, 6 November 2000). Poland's government altered the privatization strategy for the Gdansk refinery after assessing the political risk a successful Lukoil bid would entail (even together with its British partner). As a result the Russian company had no chance of winning.

When Russian companies met with heavy discrimination, they teamed up with Western companies or used sham firms to disguise their Russian origin. In this context Pelto et al. (2003) argue that Russian flight capital is behind many Cypriot investments in new member countries. An exception to this rule are the Baltic states. Here Russian oil companies used pressure, mainly interruptions of energy supplies, as an instrument in attempts to take over national companies (as Lukoil tried in the case Mazeikiu Nafta). This picture is in line with the more aggressive tactics of Russian oil and gas companies employ on countries in the territory of the former Soviet Union (Pleines 2004).

This political resistance to and discrimination against Russian companies and their investment activities in the new EU member countries in CEE leave them in the margins of the EU enlargement and explain the failure of Lukoil investment activities as opposed to MOL's success.

In conclusion, both insiders and outsiders of the EU enlargement have had to and must continue to cope with this new situation, which means first and foremost more competition. Insiders have tried to grow and become regional leaders to avoid take-overs by Western or Russian companies. Outsiders have tried to benefit from the EU's single market by getting a foothold in it. For both, the markets in CEE are known and not yet completely dominated by Western companies. While the companies in new EU member countries, such as MOL, have the market access, Russian energy companies have, with their resource base, the necessary assets – one might think – for a partnership successful enough to withstand international competition. On the other hand, Russian companies have also become competitors for regional companies like MOL through acquisitions, e.g. by the privatization tender of Croatia's INA. Additionally, historically motivated distrust and geopolitical thinking makes co-operation and compromise difficult in the ever-shifting battle for success on the expanded EU turf.

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Chapter 5

REGIONAL DEVELOPMENTS

LATVIA AND THE NORTHERN DIMENSION: TRADE AND INVESTMENT 1925-1939 AND 1992-2004

Viesturs Pauls Karnups

Abstract

This article examines the historical roots of Latvian foreign trade and investment with the countries of the Northern Dimension (ND) during the interwar period, compares this with the current situation, analyses the relationship between trade and investments in Latvia for both the interwar period and the period after the restoration of independence and makes some cautious forecasts regarding future trends and directions.

It would appear that for the interwar period foreign investment inflows worked as both a complement and a substitute for imports, while in the current period foreign investment inflows and imports have worked as mainly as complements, except in the case of the Nordic countries where foreign investment appears to have been a substitute for imports.

The analysis of the two time periods would seem to confirm previous findings that the reorientation of Latvian trade after the regaining of independence is largely through her ND neighbours and in a historical sense, a reintegration into previously existing markets.

In the future Latvia can expect slow, but steady increases in both trade with and investment from the ND countries, especially in relation to the Nordic countries.

Keywords: Latvia, Northern Dimension, Foreign Trade, Investment

Introduction

With the accession of Finland and Sweden in 1995, the European Union acquired a northern dimension, which was further emphasised by the accession of the Baltic States – Estonia, Latvia and Lithuania, as well as Poland on 1 May 2004. On 15 September 1997, the Prime Minister of Finland, Paavo Lipponen (1997) presented the Northern Dimension (ND) initiative at a conference on the Barents Sea region. Finland put forward a ND proposal at the European Council meeting in Luxemburg in December 1997. An Action Plan for the implementation of a ND for the policies of the European Union was presented by the European Commission in April 2000 and adopted in June 2000 at the Feira Summit (see Muravska, 2002: 524-529). The ND now forms part of the EU conceptual framework. The main idea behind the ND is to ensure that EU activities and available instruments continue to take into account issues involving northern Europe. It is intended to be a comprehensive concept for the EU's policy in an area that is to large extent equivalent with the Baltic Sea region.

The ND however, includes not only those countries, which physically have a Baltic Sea coastline, but also countries normally included in the Nordic group of countries – Norway and Iceland. The ND covers the following geographical area: from Iceland to the west across to North West Russia, from the Norwegian, Barents and Kara Seas in the North to the Southern coast of the Baltic Sea. Non-EU states that fall within its scope are the Russian Federation, Norway and Iceland.

Among the sectoral objectives of the ND is the field of *cross-border co-operation, trade and investment*. This paper examines the historical roots of Latvian foreign trade with and investment by the countries of the ND during the interwar period compares this with the current situation and makes some cautious forecasts regarding future trends and directions. In the analysis, however, Iceland has been omitted for the sake of comparability with the interwar period – Iceland was for the most part considered part of Denmark at that time. Of course, the concept of a Northern Dimension in the modern sense did not exist in the interwar period, however, for the purposes of this paper the term will be also be applied retroactively rather than using a more general term such as immediate neighbouring states or Baltic Sea states.

Trade within the context of this paper refers to merchandise exports and imports, while investments refers to foreign investment stock, i.e. investments made by non-residents as direct and portfolio investment in the company capital of the Latvian undertakings. The trade statistics analysis for the interwar period has been limited to the time period 1925-1939 to coincide with available data on interwar investments.

The relationship between foreign investment and foreign trade is complex. Giuseppe Nicoletti et al. (2003) point out that [world] trends and patterns in foreign investment and trade offer *prima facie* evidence that the two phenomena are closely linked: both increased sharply over the past decade; both seem to be at least partly affected by factors related to distance, location and size of the economy; and in some cases trade openness seems to go hand in hand with high foreign investment and foreign affiliate activity.

In the theory of international trade and factor mobility,[1] trade in goods and trade in factors are often studied as if they are substitutes or alternatively complements (see Fontagne (1999) for an extensive overview of theoretical and empirical findings). That is, the amount of investments between two countries should be related to the amount of trade between them. Based on these theories, the amount of foreign investment flowing into Latvia could possibly be explained by growing international trade in the region. That is, foreign investment inflows and imports may work as complements. Alternatively, the relationship between trade and investment in Latvia may be that imports may have worked as a substitute for foreign investment inflows into Latvia or visa versa.

This article also analyses the relationship between trade and investments in Latvia for both the interwar period and the period after the restoration of independence. It would appear that for the interwar period foreign investment inflows worked as both a complement and a substitute for imports, while in the current period foreign investment inflows and imports have worked as mainly as complements, except in the case of the Nordic countries where foreign investment appears to have been a substitute for imports.

Thus, the structure of the article is as follows: the first part is an analysis of trade and investment in the interwar period, the second part analyses trade and investment in the current period from the restoration of independence to 2004, and the third part sets forth the conclusions derived from the analyses.

Historical aspects – 1925-1939

Latvian Foreign Trade with the Northern Dimension 1925-1939

Latvia's foreign trade in the 1920s was based in large measure on a system of commercial and trade treaties. Up to 1929, Latvia had concluded commercial treaties with all important European states, including Norway (14.08.1924), Finland (23.08.1924), Denmark (03.11.1924), Iceland (03.11.1924), Sweden (22.12.1924), Germany (28.06.1926), Russia (USSR) (02.06.1927), and Poland (12.02.1929). Latvia concluded a provisional commercial agreement with Estonia in 1928 and a commercial agreement between Latvia and Lithuania was concluded in 1930.[2] They provided the regulatory framework within which were stated

[1] Foreign investment is usually treated as the equivalent to the international movement of capital where the owner has some strategic interest in the firm where he invests.
[2] Prior to this Latvian-Lithuanian trade was governed by a special law granting most-favoured-nation treatment for Lithuanian imports.

the obligations undertaken by Latvia in its foreign trade relations with the ND countries, at least until 1930.

Table 1: Latvian exports to Northern Dimension countries 1925-1939

Selected years	Germany		Nordic countries[1]		Baltic States[2]		Poland		Russia (USSR)	
	(1000 lats)	% of total exports	(1000 lats)	% of total exports	(1000 lats)	% of total exports	(1000 lats)	% of total exports	(1000 lats)	% of total exports
1925	40636	22,6	7543	4,3	10591	5,9	3903	2,2	7519	4,2
1926	45837	24.3	7189	3.9	9016	4.8	3367	1.8	10240	5,4
1929	72442	26.5	9738	3.5	10546	3.9	3771	1.4	40079	14,6
1932	25287	26,2	2510	2,7	5462	5,7	1174	1,2	14222	14,7
1934	25185	29,5	4235	5	3520	4,2	347	0,4	1913	2,2
1936	42665	30,8	8487	6,2	3669	2,7	686	0,5	4140	3
1937	92374	35,1	10500	4,1	4080	1,6	800	0,3	6645	2,6
1938	76001	33,5	8258	3,6	3709	1,6	609	0,3	7634	3,4
1939	82949	36,5	15956	7,5	2537	1,2	261	0,1	11588	5,1
Av. % of total exports for 1925-1939		28,7		4.3		3.8		1.2		7.0

Notes: [1] Finland, Denmark, Sweden, Norway; [2] Estonia, Lithuania

Source: *Latvijas Statistiskā gada grāmata. 1925-1939* [Latvian Statistical Yearbooks 1925-1939] – Rīga: Valsts Statistiskā Pārvalde, *Strukturbericht über das Ostland. Teil I: Ostland in Zahlen*. – Rīga: Reichskommissar für das Ostland, 1942: 57; and *Historisk Statistikk 1968*. – Oslo: Statistisk Sentralbyrå, 1969:325.

With the onset of the Great Depression in Latvia in 1930 Latvia, following the lead of the rest of Europe, did all it could to reduce imports and halt the outflow of foreign currency, including the establishment of a currency commission and import credit restrictions, suspension of the gold standard with respect to lat (but retaining the gold parity), the establishment of a contingent (quota) system for imports, increases in import duties and the promotion of import-substitution. The most successful import-substitution was in the area of cereals and animal fodder imports, which by 1933 had almost disappeared as an import item.

In 1932, Latvia signed a so-called bilateral "clearing" agreement with Germany. The basic idea behind bilateral clearing agreements was to even out or "balance" trade between two countries, while at the same time conserving scarce foreign currency and gold reserves. In 1935, Latvia also signed clearing agreements with Sweden, Lithuania, Estonia and Russia (USSR). Finland, Denmark, Norway and Poland remained 'hard currency' countries and as a result, trade in fact was reduced with these countries.

Latvian exports to the ND countries in the period 1925-1939 (Table 1) were dominated by Germany with an average share of total exports for the period of 28.7%, while the average for the Nordic countries together was only 4.3% of total exports, the Baltic States (Estonia and Lithuania) – 3.8%, Poland – 1.2%, and for Russia (USSR) – 7%, making an average share for the ND countries as a whole of 45% of total exports. In comparison, in 1938 41.9% of all Latvian exports went to Great Britain alone. As can be seen from Table 1 above, the trade agreements and bilateral clearing agreements signed during this period had only a small effect on Latvian exports to the ND countries except for exports to Russia (USSR) during the life of the 1927-1932 trade agreement.[3]

[3] Latvia concluded a particularly advantageous trade agreement with Russia (USSR) in 1927, according to the terms of which Russia (USSR) would import from Latvia some Ls 40 million of mainly manufactured goods annually. This provided a short-lived stimulus to Latvia's industrial sector and delayed the onset of the effects of the Great Depression by one year. At the end of the Agreement in 1932, it was not renewed and Latvia's trade with Russia (USSR) returned to previous low levels.

Table 2: Latvian imports to Northern Dimension countries 1925-1929

Selected years	Germany		Nordic countries[1]		Baltic States[2]		Poland		Russia (USSR)	
	(1000 lats)	% of total imports	(1000 lats)	% of total imports	(1000 lats)	% of total imports	(1000 lats)	% of total imports	(1000 lats)	% of total imports
1925	116319	41.5	28487	10.2	18482	6.5	10262	3.7	10638	3.8
1926	103886	40	28659	11	15883	6.1	16381	6.3	11703	4.5
1929	149177	41.2	19856	5.6	17077	4.7	33158	9.2	17022	4.7
1932	30140	35.6	3769	4.4	2696	3.2	5063	6	8506	10.1
1934	23206	24.5	3958	4.2	5429	5.3	3802	4	2767	2.9
1936	46785	38.4	7057	5.8	2870	2.4	1928	1.6	3558	2.9
1937	62595	27.1	16688	7.2	3179	1.3	4559	2	8679	3.8
1938	88659	39	11599	5	4574	2	3282	1.4	8382	3.7
1939	100318	44.7	13081	6.2	3348	1.5	1693	0.8	14213	6.3
Av. % of total imports for 1925 -1939		36.6		6.7		4.0		4.8		5.2

Notes: [1] Finland, Denmark, Sweden, Norway; [2] Estonia, Lithuania

Source: *Latvijas Statistiskā gada grāmata. 1925-1939* [Latvian Statistical Yearbooks 1925-1939] – Rīga: Valsts Statistiskā Pārvalde; *Strukturbericht über das Ostland. Teil I: Ostland in Zahlen*. – Rīga: Reichskommissar für das Ostland, 1942: 58; and *Historisk Statistikk 1968*. – Oslo: Statistisk Sentralbyrå, 1969: 325.

Latvian imports from the ND countries in the period 1925-1939 (Table 2) were again dominated by Germany with an average share of total imports for the period of 36.6%, while the average for the Nordic countries together was only 6.7% of total imports, the Baltic States – 4%, Poland – 4.8%, and for the USSR – 5.2%, making an average share for the ND countries as whole of 57.3% of total imports. In comparison, in 1938 only 19.3% of all Latvian imports came from Great Britain. Again, as can be seen from Table 2 above, the trade agreements and bilateral clearing agreements signed during this period had only a small effect on Latvian imports from the ND countries.

Taking both tables together it is striking that apart from Germany, Latvia was only relatively marginally engaged in trade with her ND neighbours. Only an average of 16.3% of Latvia's export trade went to all the other ND countries, and only 20.7% of Latvia's imports came from them. Imports and exports in fact declined in the 1930s in relation to the Baltic States, Poland and Russia (USSR). In general, Britain and Germany dominated Latvia's foreign trade throughout the interwar period.[4] Other important export partners were Belgium and the Netherlands, and the USA. Latvia's exports to her near neighbours of the ND (except for Germany) were small and relative to Britain and Germany negligible – total exports in 1937 to Estonia, Lithuania, Denmark, Sweden, Norway, Finland, Poland and Russia (USSR) were only 8.6% of all exports (Latvijas ārējā tirdzniecība un tranzits 1937, 1938: X-XI). In 1937, some 48% of all imports came from Britain and Germany, while imports from the countries of the ND (except for Germany) made up 14.3% of all imports (Latvijas ārējā tirdzniecība un tranzits 1937, 1938: X-XI). Thus, Latvia's imports from her near neighbours were significantly higher and relative to Britain and Germany of greater importance than exports. Other important countries for imports were Belgium and the Netherlands.

In 1937 Latvia exported mainly raw materials, and agricultural and forestry products to industrialised or industrialising countries such as Germany, Sweden, Denmark, Norway, Finland and Russia while to other agricultural countries or countries which competed with Latvia in exporting similar products (such as Poland and the Baltic States) Latvia exported mainly manufactured goods. However, the manufacturing sector in Latvia was small (in 1926 19.7% of total exports, increased in 1929 (thanks to the trade treaty with Russia (USSR)) to 30% of total exports, but fell again to 18.2% of total exports in 1938 (Zālīte, 1999: 84)). Nevertheless, the ND countries were important to many individual sectors of the Latvian economy (see Karnups, 2004: 245-246).

Investment in Latvia by the Northern Dimension Countries

Even before the end of the Latvian War of Independence against Soviet Russia, foreign companies from the ND countries had established branches in Latvia. In 1919, some Scandinavian trading houses established branches in Rīga, Liepāja and Ventspils and a lively trade was maintained through the establishment of steamship lines between Scandinavia and Latvia [*Economists*, 1920, No.1:13]. Scandinavian capital investment in Latvia in the period 1920-1933 was relatively small and practically confined to Danish and Swedish entrepreneurs. While Swedish capital investments grew up to 1932 (especially after the syndicate agreement with the Swedish Match Company in 1928) and then practically remained at the 1932 level, Danish capital investment remained practically unchanged up to 1929, but there was a dramatic "flight" of Danish capital with the onset of the Great Depression. Similarly, from a very low base, Norwegian capital took "flight" in 1932 and had disappeared altogether by 1936. In the period 1920 to 1933 Swedish and Danish capital was mainly invested in the chemical industry (linoleum, vegetable oil, matches), as well as major investment by Swedish capital in the wood-working industry (match sticks). There were also

[4] This was of course due to the operation of the "triangle of trade", where Latvia sold more to Britain than it purchased from it and used the surplus to purchase manufactured goods from Germany. – Hiden and Salmon, 1991: 86.

minor investments by Swedish and Danish capital in the metal industry (nails and sheet-metal) and banking. Norwegian capital was mainly in the wood-working industry.

The scope of investment in Latvia by the countries of the Northern Dimension during the interwar period can be seen in the following table.

Table 3: Foreign Investment Stock of Northern Dimension Countries in the Company Capital of Latvian Undertakings (as at 1 January). 1925-1939

Selected years	Germany		Nordic countries[1]		Baltic States[2]		Poland		Russia (USSR)	
	(1000 lats)	% of total investments	(1000 lats)	% of total investments	(1000 lats)	% of total investments	(1000 lats)	% of total investments	(1000 lats)	% of total investments
1925	5828	10.4	7629	13.6	3752	6.7	471	0.8	1054	1.9
1926	9509	12.8	9144	12.3	4922	6.6	1163	1.6	2166	2.9
1929	18124	19.2	12443	13.2	6333	6.7	1527	1.6	2869	3
1932	27110	27.7	14525	14.9	7860	8.0	1685	1.7	4153	4.3
1934	23045	25.7	14190	15.8	7958	8.9	1555	1.7	3553	4
1936	19324	26.9	14587	20.3	5540	7.7	1024	1.4	427	0.6
1937	13895	21.7	14055	21.9	5176	8.1	909	1.4	394	0.6
1938	12194	19.9	13072	21.3	2717	4.4	696	1.1	381	0.6
1939	13395	22.3	11110	18.5	2515	4.2	1075	1.8	305	0.5
Av. % of total investments for 1925-1939		21.1		15.4		7.0		1.5		2.6

Notes: [1] Finland, Denmark, Sweden, Norway; [2] Estonia, Lithuania

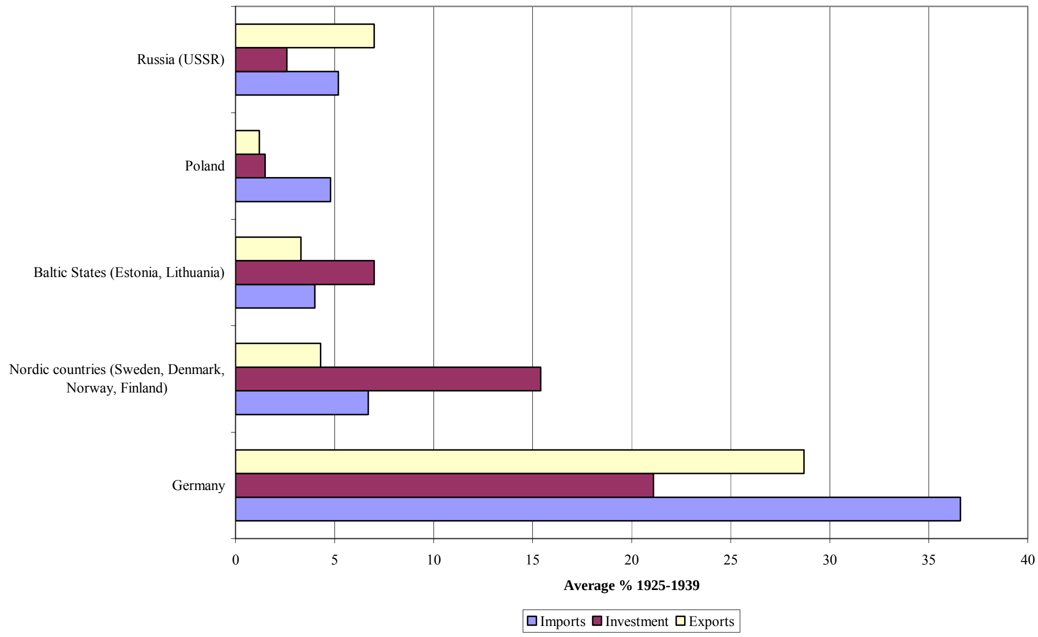
Source: *Latvijas Statistiskā gada grāmata. 1929,1939* [Latvian Statistical Yearbooks 1929,1939] – Rīga: Valsts Statistiskā Pārvalde; Statistikas tabulas [Statistical Tables] – Rīga: Latvijas PSR Tautsaimniecības Statistikas pārvalde, 1940.

As can be seen in Table 3, foreign investments in Latvian undertakings from ND countries continued to increase throughout most of the interwar years, despite the effects of the Great Depression. As did many other European countries, Latvia also instituted exchange controls in the wake of the 1931 British devaluation of the pound in an attempt to prevent capital flight. Whilst suspending the operation of the gold standard, Latvia maintained nominal gold parity for the lat. Investment by ND countries increased over the period until the 1934 coup d'etat, after which the nationalistic Ulmanis regime began to systematically reduce the amount of the foreign investment stock. Foreign investment stock in the company capital of Latvian undertakings overall was reduced from 50.4% in 1934 to 25.4% in 1939 of which the reduction in industry was from 52.4% in 1934 to 31.9% in 1939, in commerce from 35.9% to 28.2% and in finance and banking from 62.4% to 9.7% (Finanču un kredita statistika, 1939:

172). Nevertheless, with the exception of Russia (USSR) (where the stock was dramatically reduced in 1936 with the liquidation of the *Kooperatīvā transitbanka* [Co-operative Transit Bank], a bank which was wholly owned by Russia (USSR), including the Moscow Narodnyi Bank), the reduction for ND country investments was gradual and in the case of the Nordic countries increased slightly in this period, due mainly to Swedish investments in the building of the Ķegums hydro-electricity station on the Daugava River.

German capital was mainly invested in the textile industry, chemical industry, paper industry, commerce and banking, and the Nordic countries invested mainly in the timber industry, chemical industry, metal industry and energy industry. Baltic State investment was concentrated in the textile industry and paper industry, while for Poland it was the chemical industry and commerce. As mentioned earlier, Russian (USSR) investment was almost wholly concentrated in the banking sector.

Figure 1: Trade and Investment in Latvia according to Origin, Northern Dimension Share of total Latvian Imports/Exports and Investments Received 1925-1939



From Fig. 1, it can be seen that ratio of Latvian trade to the foreign investment stock of ND countries in the interwar period varies greatly, with investments from the Baltic States and the Nordic countries far exceeding either imports from or exports to these states. In the case of Poland, investments marginally exceed imports, while for Russia (USSR) and Germany investments are a poor third to both imports and exports. In most cases (except for Russia (USSR)), it would appear that investments in Latvia were accompanied by an increase in imports from the home countries, rather than an increase in exports to the home countries. This would suggest that the investments stimulated an increase in demand for imports from the investing country based on the economic growth stimulus of investments to the economy in general. The case of the Baltic States and the Nordic countries would suggest that investments to a degree substituted for imports, while in the case Germany it would appear that investments complemented imports.

After the occupation of Latvia and the other Baltic States by Russia (USSR) in 1940, the Nordic countries (particularly Sweden, Denmark and Norway) applied to Russia (USSR) for compensation for their nationalised investments. For different reasons neither the Baltic States or Germany, nor Poland were in a position to ask for compensation from Russia (USSR).

In relation to Swedish investment, in May 1941 the Swedish and Soviet governments signed a treaty in relation to mutual economic claims regarding the Baltic States including Latvia. The final official calculation of Swedish economic assets in Latvia as presented to the USSR by the Swedish Foreign Office was 38,1 million SEK. Of the companies named by the Swedish Foreign Office, Swedish Match was involved in the chemical industry (matches) and wood industry (matchsticks), Svenska Entreprenad AB (Ķegums HES), Wingårdh in the chemical industry (super phosphate), Skånska Cement in the construction industry (cement), Wicander in the chemical industry (linoleum) and AGA in the chemical industry (gas and gas equipment).

The Danes also presented a claim for compensation of former Danish assets in the Baltic States, some 16.5 million DKK in relation to nationalisations and 2.5 million DKK in commercial claims. The official calculation of Danish economic assets in Latvia as presented to the USSR was 3.5 million DKK. In addition, there was a claim from Vacuum Oil Co. Ltd., for branches in Rīga and Tallinn (0.7 million DKK). The company Aarhus Oliemølle Ltd partly owned an oil factory in Liepāja, a Mr. Haagensen had a business and property in Latvia and a Mr. Klingenberg had a factory in Rīga.

Compensation claims from Sweden in respect of nationalised assets in the Baltic States were basically settled by Russia (USSR) in 1946, but commercial claims only in 1964. Sweden received only some 11 million SEK from Russia (USSR) for the nationalised assets and 60 000 SEK for commercial claims (Kangeris, 1998: 208-209.) Denmark received 2.6 million DKK from Russia (USSR) in 1964 as settlement of all claims, and even Norway received in 1959 ½ million NOK from Russia (USSR) in compensation for lost assets in the Baltic States (Kyn, 1998: 233-234).

Current aspects – 1992-2004

Latvian Foreign Trade with the Northern Dimension 1992-2004

After the restoration of independence in 1991, Latvia faced the same task as in 1920 – to re-integrate into the European economy and, in particular, restore trading links with the ND countries. In the broader context, since Latvia's regaining of independence in 1991 there have been a number of studies of Latvia's reintegration into the Baltic Sea Region and European trade as a whole utilising the analytical framework known as the "gravity model" to evaluate the current trade patterns of the Baltic States including Latvia (See, for example, Byers, D et. al. (2000); Cornett and Iversen (1998) and Lasser and Schrader (2002). The gravity model attempts to explain trade between two market economies in terms of the distance between them, their population and their income levels. In the context of this article the work by Eichengreen and Irwin (1996) and, in particular, Lasser and Schrader (2002) are of relevance. Eichengreen and Irwin make the point that history plays a role in shaping the direction of international trade, or put another way "past trade patterns influence current trade flows in a way that a passing historical event causes lasting cost reductions" (Eichengreen and Irwin, 1996: 5). Within the gravity model framework, Eichengreen and Irwin found that historical factors, which are associated with the sunk costs of market entry and exit, exercise an important influence on trade flows.

Thus, history matters. Moreover, in their recent (2002) paper, Lasser and Schrader have provided some historical data within a gravity model framework on Baltic regional trade patterns and have attempted integrate the ideas of Eichengreen and Irwin into the analysis (Lasser and Schrader, 2002: 5). They suggest that "history may play a special role for current Baltic trade relations", and that "the changes in regional trade patterns following [the regaining of] independence show parallels to the development of Baltic trade after World War I" (Lasser and Schrader, 2002: 12-13). Indeed, the results of their analysis indicated that the process of EU association was not reflected in the regression analysis, but that in fact "the process of European integration mainly runs [for the Baltic States] via their Northern Dimension neighbours" and thus, "in this respect EU integration means reintegration into regional markets to which a historical affinity exists" (Lasser and Schrader, 2002: 44-45). Certainly, for Latvia, trade with the ND countries has been of paramount importance in the post-restoration of independence period.

Table 4: Latvian exports to Northern Dimension countries 1992-2003

Year	Germany		Nordic countries [1]		Baltic States [2]		Poland		Russia	
	(1000 lats)	% of total exports	(1000 lats)	% of total exports	(1000 lats)	% of total exports	(1000 lats)	% of total exports	(1000 lats)	% of total exports
1992	45492	7.9	70333	12.2	28268	4.9	12923	2.2	148737	25.8
1993	44548	6.3	65362	9.3	41930	6.0	19960	2.8	200105	28.5
1994	58271	10.5	63650	11.5	45054	8.1	8988	1.6	155719	28.1
1995	93662	13.6	112004	16.3	59577	8.7	17191	2.5	174386	25.3
1996	109575	13.8	105388	13.3	88235	11.1	10962	1.4	181603	22.8
1997	133793	13.8	139073	14.3	113560	11.7	11789	1.2	203587	21.0
1998	166822	15.6	195657	18.3	127851	12.0	18836	1.8	129007	12.1
1999	169984	16.9	196570	19.5	123101	12.2	17887	1.8	66412	6.6
2000	194288	17.2	219514	19.4	145825	12.9	18204	1.6	47266	4.2
2001	209501	16.7	239090	19.0	174058	13.9	24102	1.9	73506	5.9
2002	218269	15.5	285081	20.2	202203	14.4	22034	1.6	82546	5.9
2003	245313	14.9	349616	15.8	243596	10.5	24565	1.5	88797	5.4
Av. % of total exports for 1992-2003	13.6		15.8		10.5		1.8		16.0	

Notes: [1] Finland, Denmark, Sweden, Norway; [2] Estonia, Lithuania

Source: *Latvijas statistikas gadagrāmata. 1993-2002*. Rīga: LR Centrālā statistikas pārvalde and Latvijas ārējā tirdzniecība. Ceturkšņa biļetens (2004) [Foreign Trade of Latvia. Quarterly Bulletin] #4, 2003, Rīga: Latvijas Republikas Centrālā statistikas pārvalde

In the period 1992-2003, Latvian exports to the ND countries (Table 4) have become more 'multi-polar', that is, unlike the interwar period when Germany alone dominated, today the other countries of the ND have also become important (especially the Baltic States, the Nordic countries and Russia). Germany had an average share of total exports for the period of only 13.6%, while the average for the Nordic countries together was 15.8% of total exports, the Baltic States (Estonia and Lithuania) – 10.5%, Poland – 1.8%, and for Russia – 16%, making an average share for the ND countries as whole of 57.7% of total exports, an increase of some 22% over the same figure for the interwar period.

Table 5: Latvian imports from Northern Dimension countries 1992-2003

Year	Germany		Nordic countries [1]		Baltic States [2]		Poland		Russia	
	(1000 lats)	% of total imports	(1000 lats)	% of total imports	(1000 lats)	% of total imports	(1000 lats)	% of total imports	(1000 lats)	% of total imports
1992	81176	14.9	39270	7.3	51695	9.5	6774	1.3	150825	27.8
1993	63679	9.8	73363	11.3	86477	13.4	6254	1	181941	28.1
1994	94011	13.5	123359	18	65655	9.4	11115	1.6	164178	23.6
1995	147825	15.4	212094	23.2	101753	10.7	18234	1.9	208335	21.7
1996	176880	13.8	286167	23.7	153444	12	32772	2.1	258416	20.2
1997	253201	16	353849	22.4	195479	12.4	50781	2.7	246946	15.6
1998	315547	16.8	414319	22	243345	12.9	66212	3.8	221290	11.8
1999	261297	15.2	378341	21.9	236570	13.7	75587	4.4	180971	10.5
2000	302601	15.7	388898	20.1	266975	13.8	91900	4.8	224459	11.6
2001	374863	17	429116	19.5	325497	14.8	110210	5	202152	9.2
2002	429459	17.2	475821	19.1	399672	16	125763	5	218750	8.8
2003	479788	16.1	548778	18.4	481448	16.1	152702	5.1	260718	8.7
Av. % of total imports for 1992-2003		15.1		18.9		12.9		3.2		16.5

Notes: [1] Finland, Denmark, Sweden, Norway; [2] Estonia, Lithuania

Source: Latvijas statistikas gadagrāmata [Latvian Statistical Yearbook] 1993-2002., Rīga: LR Centrālā statistikas pārvalde and Latvijas ārējā tirdzniecība. Ceturkšņa biļetens (2004) [Foreign Trade of Latvia. Quarterly Bulletin] #4, 2003, Rīga: Latvijas Republikas Centrālā statistikas pārvalde

Latvia's imports (Table 5) reflect much the same pattern as exports in that Germany is no longer dominant and there is a greater emphasis on all her ND neighbours. Germany had an average share of total exports for the period of only 15.1%, while the average for the Nordic countries together was 18.9% of total imports, the Baltic States (Estonia and Lithuania) – 12.9%, Poland – 3.2%, and for Russia – 16.5%, making an average share for the ND countries as whole of 66.6% of total imports, an increase of some 14% over the same figure for the interwar period.

Up to the end of 1991, practically all of Latvia's foreign trade (in fact inter-Republican trade) took place within the Soviet Union (Van Arkadie & Karlsson, 1992: 172).[5] At the beginning of 1992, all import controls had been lifted. Export quotas and licences were eliminated in June 1992 and replaced with an export tariff system. Money reform and liberalisation of internal prices also took place at this time.

Latvia's foreign trade policy during this period was based upon liberalisation of foreign trade on the basis of bilateral and multilateral trade agreements, taking into account the

[5] They estimate that 82% of the imports of the Baltic States and 91% of their exports in 1987 were trade flows between the Republics of the Soviet Union.

trading policies of the EU. The liberalisation of foreign trade has in fact meant the gradual reduction of tariff and non-tariff barriers. In 1999, Latvia became a full member of the WTO. Latvia has also entered into free trade agreements with 28 states, including all EU and EFTA member states. An integral part of Latvia's foreign trade policy in this period has included several agreements with the Baltic States – free trade agreements for both manufactured and agricultural goods, as well as an agreement to revoke non-tariff barriers.[6] For a detailed analysis of the structure of Latvian exports to and imports from the ND countries see Karnups (2004).

In fact Latvia's trade with her nearest neighbours (excluding Germany) has increased dramatically – in 2003 exports to Estonia, Lithuania, Denmark, Sweden, Norway, Finland, Poland and Russia were 42.8% of total exports (nearly 5 times the figure for 1937), while imports were 48.3% of total Latvian imports (some 3.4 times greater than the figure for 1937).

Investment in Latvia by the Northern Dimension Countries 1992-2003

The level of foreign investment into Latvia has increased significantly since the restoration of independence in 1991. The rapid privatisation of former state-owned undertakings during the 1990s was a significant factor in this behind the inflow of foreign investment.

[6] For a detailed analysis of inter-Baltic State trade see Spīča, I. (2000).

Table 6: Foreign Investment Stock of Northern Dimension Countries in the Company Capital of Latvian Undertakings (as at 31 December). 1992-2003

Year	Germany		Nordic countries[1]		Baltic States[2]		Poland		Russia	
	(1000 lats)	% of total investments	(1000 lats)	% of total investments	(1000 lats)	% of total investments	(1000 lats)	% of total investments	(1000 lats)	% of total investments
1992	595.8	2.6	3588.1	15.9	67.8	0.3	169.4	0.8	2102.2	9.3
1993	3663.4	7.3	7802.2	15.5	350.9	0.7	861.9	1.7	5391.6	10.7
1994	12002.1	6.9	54544.8	31.5	937.2	0.5	851.3	0.5	10288.6	5.9
1995	16369.9	6.0	86757.2	31.6	1512.4	0.6	562.6	0.2	51280.5	18.7
1996	17791.0	4.7	129743.7	34.3	6016.2	1.6	835.5	0.2	50757.8	13.4
1997	48422.3	8.8	144227.4	26.1	22453.6	4.1	307.0	0.1	52665.1	9.5
1998	56662.6	8.6	201795.5	30.5	27293.6	4.1	186.4	0.0	56954.8	8.6
1999	65475.2	8.8	238925.7	32.1	41300.4	5.5	260.3	0.0	56380.2	7.6
2000	105859.0	12.7	280277.2	33.7	53647.1	6.4	276.5	0.0	60593.5	7.3
2001	135195.2	12.7	379765.9	35.6	67277.1	6.3	530.6	0.0	66666.9	6.3
2002	129310.3	11.0	434909.6	37.1	78891.8	6.7	466.0	0.0	68733.0	5.9
2003	126725.5	9.9	451719.4	35.3	87549.4	6.8	553.3	0.0	79179.0	6.2
Av. % of total investments for 1992-2003		8..3		29 .9		3.6		0.3		9.1

Notes: [1] Finland, Denmark, Sweden, Norway; [2] Estonia, Lithuania

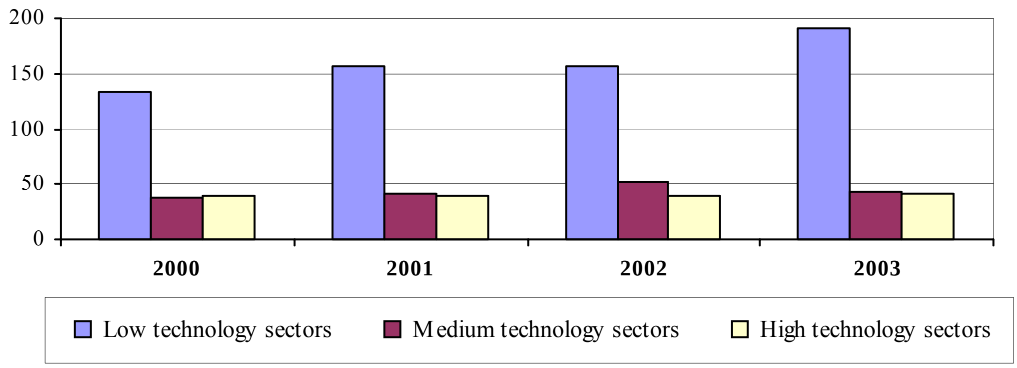
Source: Investīcijas Latvijā. Ceturkšņa biļetens. [Investment in Latvia. Quarterly Bulletin] #4/1997, #4(24)/2001 and #4(32)/2003

Privatisation started soon after the regaining of independence and is now essentially complete except for large transactions in infrastructure (especially the energy sector). Thus, the focus of foreign investment is rapidly shifting to greenfield investment.

As can be seen from Table 6, investments from the ND countries has in general steadily increased despite the various shocks such as the collapse of the Russian rouble in 1998 with its corresponding effect on trade. Latvia now enjoys one of the highest foreign investment per capita positions among the former Soviet republics, ranking among the top five. Two free seaports, a low corporate tax rate, and an able labour force make Latvia an attractive country for investors.

In 2003, German capital was mainly invested in the financial and banking sector, energy industry, textile industry and insurance. The main investors being such companies as Ruhrgas Ag, Norddeutsche Landesbank Girozentrale and Vereins- Und Westbank Ag. The greatest part of Danish capital was invested in the telecommunications sector, followed by real estate, insurance and minerals industry. The main investors are Tilts Communications A/s, Hydro Texaco A/s and Torpgard Holdings. Norway has mainly invested in real estate, petrol stations and retail trade. Main investors being Linstow Senterutvikling As, Statoil Asa and Linstow International As. Sweden has invested mainly in the commerce sector and the financial and banking sector. The main investors are Tele 2 Aktiebolag, Skandinaviska Enskilda Banken Ab and Teliasonera Aktiebolag. Finnish investment was mainly in petrol stations, retail trade, real estate and insurance. Main investors being Fortum Oil and Gas Oy, Kesko Oyj and Stora Enso Oyj. Estonia has mainly invested in the financial and banking sector, food industry and real estate. The main investors are Hansapank As, Stora Enso Timber As and Rakvere Lihakombinaat As. Lithuania has mainly invested in the wholesale and retail trade. The main investor being Paulauskas Vytautas. Finally, Russia has mainly invested in oil pipelines, energy industry and the financial and banking sectors. The main investors being Transneft, Gazprom and Moscow Municipal Bank-Bank of Moscow.

Figure 3: FDI Stock in Manufacturing (end of 2003, million LVL)

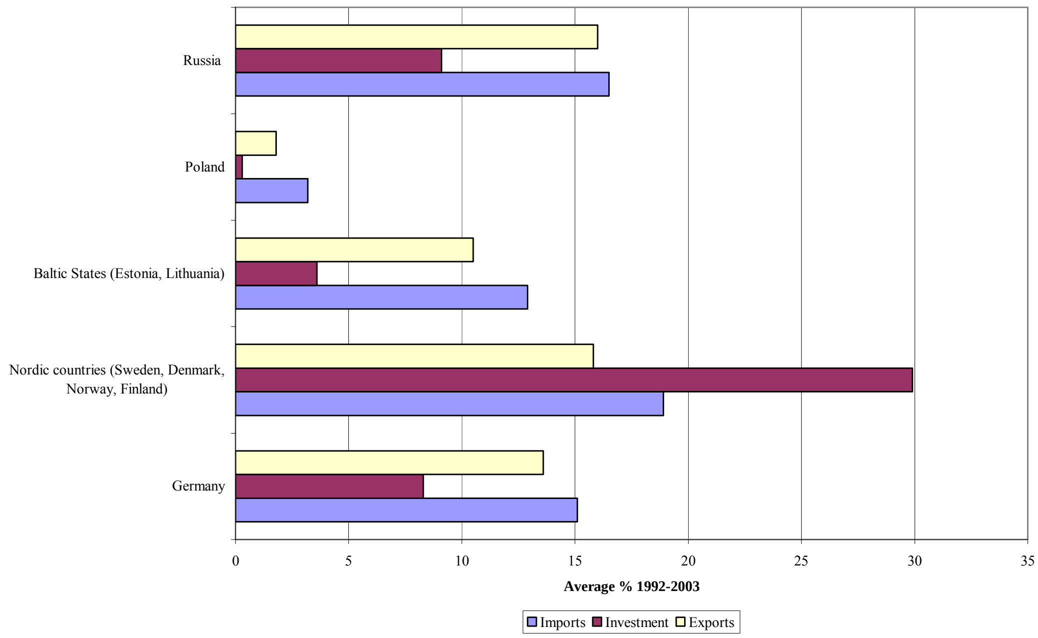


Source: Economic Development of Latvia Report, June 2004: 51

In terms of the qualitative investment flows into manufacturing, the largest investments were mainly made in the low technology sector (Fig. 3). Of the ND countries, Germany made the biggest investment into manufacturing or 14% of the total investment into manufacturing, channelling its investments mainly in the sectors of low and medium technologies. These sectors have also absorbed Swedish investment.

In terms of greenfield projects, involving introduction of new and modern technologies, in the sectors that have the highest potential to implement such projects, only that part of work, which requires a relatively low labour qualification, is currently being performed in Latvia. Latvia needs to create the preconditions for foreign investors to invest in knowledge intensive and high technology sectors by continuing to develop infrastructure and to make investments in education.

Figure 4: Trade and Investment in Latvia according to Origin, Northern Dimension Share of total Latvian Imports/Exports and Investments Received 1992-2003



From Fig. 2, it can be seen that ratio of Latvian trade to the foreign investment stock of ND countries in the current period does not vary as greatly as in the interwar period, only investments from the Nordic countries far exceeding either imports from or exports to these states. In all other cases, investments are a poor third to both imports and exports. In most cases (except for Russia), it would appear that investments in Latvia were accompanied by an increase in imports from the home countries, rather than an increase in exports to the home countries. This would suggest that the investments stimulated an increase in demand for imports from the investing country based on the economic growth stimulus of investments to the economy in general. The case of the Nordic countries would suggest that investments to a degree substituted for imports, while in the other cases it would appear that investments complemented imports.

Historical continuity and current prospects

The above brief analysis of the two time periods would seem to confirm Lasser and Schrader's findings that the reorientation of Latvian trade after the regaining of independence is largely through her ND neighbours and in a historical sense, a reintegration into previously existing markets. Certainly, the scale this time round is different as is the export product mix (although the import product mix remains substantively the same). Whereas Latvia in the interwar period was largely a primary producer with a small industrial sector, today Latvia's main exports to the ND countries reflect the importance of her manufacturing and industrial sector. That is, in contrast with the pre-war period, Latvia's main commodity exports to the ND countries in the post-restoration of independence period are forestry, metal industry and light industry products. In terms of more recent history, despite some fifty years of Soviet occupation, Latvia has managed to disengage its trade from Russia to a remarkable degree. If 25.8% of exports in 1992 went to Russia, by 2003 the percentage had fallen to 5.4%. Imports, on the other hand, had fallen from 27.8% to 8.7%. Thus, the task of re-integrating into the European economy has been achieved and trade flows in the region reflect this.

In terms of investment, Germany is no longer the largest investor in Latvia and its average percentage has fallen from 21.1% in 1925-1939 to only 8.3% in the period 1992-2003. Similarly, for the Baltic States investment now is less than half of what it was in the interwar period, while Polish investment is five times less now than it was then. On the other hand, investment from the Nordic countries is almost twice that of the interwar period, from 15.4% to 29.9%. Similarly, Russian investment is more than three times greater compared to the period 1925-1939.

A recent study of possible scenarios for the economic development of Latvia after accession to the EU[7] notes that since 1996 Latvia's economic development has entered into a new phase – from the macroeconomic stabilisation phase of the early 1990s to one of economic growth. In the period from 1996 to 2003, Latvia's GDP had increased by an average of 6.1% annually (Economic Development of Latvia Report, June 2004: 17). Growth was especially fast in the last years – by 8% in 2001, 6.4% in 2002 and 7.5% in 2003. Best forecasts of GDP growth by the Latvian Ministry of Economics for the period 2004 are 7.5% per annum, rising to 8% per annum for the period 2005-2009 (Economic Development of Latvia Report, June 2004: 20).

A recent study by Karnups (2004) predicts a 23.3% increase by 2008 of Latvian exports to the ND countries over 2002, the increase being concentrated in Germany, the Nordic countries and the Baltic States, i.e., within the expanded EU. Similarly, he predicts a 31.6% increase by 2008 of Latvian imports from the ND countries over 2002 again being concentrated in Germany, the Nordic countries and the Baltic States with only marginal increase in imports from Poland, i.e., within the expanded EU.

With accession to the EU, some 77% of Latvia's foreign trade (based on 2003 figures) has become domestic trade within the European Union (15 current member states plus 10 new states). Of the remaining 23%, which will now become Latvia's foreign trade, some 8% will be with the remaining countries of the ND – Iceland, Norway and Russia. Certainly, this will increase the importance of the ND to the future of Latvia's economic development, as well as creating new opportunities for both Latvia and the countries of the Northern Dimension.

[7] *Latvijas ekonomikas attīstības iespējamie scenāriji, iestājoties vai neiestājoties Eiropas Savienībā* [Possible Scenarios for Latvian Economic Development upon Joining or not Joining the European Union], Rīga: SIA Konsorts, 2003, www.konsorts.lv

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GROWTH TRIANGLES IN REGIONS BORDERING THE ENLARGED EUROPEAN UNION (2004)

A RESEARCH AGENDA

Zsuzsanna Vincze[1]

Abstract

This large-scale project is going to examine regional development processes in order to draw conclusions about the factors that facilitate and/or impede growth-triangle type of developments in the eastern part of Europe. The project understands this type of regional developments within globalization, as the trend towards increasing interdependencies among neighbouring markets through the diffusion of new ideas, technologies, products, services and lifestyles.

With the critical-realist perspective on regional development, we envisage studies on macro-, institutional-, industry- and micro-levels. The focus of the project is on strategic processes for growth-triangle type of developments and to how successfully such strategies attract new investment from local, national and foreign investors. In turn, how the specific regions will cope with shifting and volatile patterns of international demand? Will 'growth triangle' strategies create new job opportunities as well as increased incomes, in order to improve the living standard and quality of life of the population in Eastern Europe?

Keywords: Eastern Europe, growth triangles, critical-realist perspective

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Background

Both in Asia and Europe, processes of large-scale and formal regionalization (e.g., APEC, ASEAN and the EU) are taking place. At the same time, there are smaller scale 'informal' processes of regional integration, such as the formation of trans-border industrial districts, economic growth areas or 'growth triangles'. In Europe, too, economic growth areas are envisioned (e.g., Waldron 1997, Kivikari 2001, Commission of the European Communities 2002), with the assumptions derived from the experiences of growth triangles in Asia. It is believed that those Asian-type regional developments would enhance the competitiveness and attain high employment standards in certain regions of Europe. Strategies may be directed towards attracting new investment from local, national and foreign investors which, in turn, create new job opportunities as well as increase incomes. It is assumed that in such special areas, the actors would cope with shifting and volatile patterns of international demand better because of their diversified and flexible production. In other words, by clustering together, by sharing work, expertise, services and risk, inter-firm networks should be able to demonstrate their ability to resist market shocks and adapt to rapid changes. The ultimate aim is to improve the standard of living and quality of life of the population in certain borderline areas.

Keeping these assumptions in mind, our objective is to examine European regional development processes with a critical-realistic perspective, in order to draw conclusions about the factors that facilitate and/or impede growth-triangle type of developments in Europe. In the project as a whole, the units of analysis will be the smaller scale, more informal regional integration, i.e. existing and potential growth triangles in the area of the north-south borderline between the European Union member countries by May 2004 and the non-member countries. We define growth triangles as smaller scale, more informal regional developments, which integrate the activities of business and other actors, in order to exploit complementarities between geographically contiguous areas of different countries and enhance competitiveness. In terms of enhancing competitiveness, such adjacent trans- or sub-national region(s) may seek a niche or express a common interest, probably within the framework of the surrounding mezo and/or macro region. All in all, the project understands this type of regional developments within globalisation, as the trend towards increasing interdependencies among neighbouring markets and the diffusion of new ideas, technologies, products, services and lifestyles through the neighbouring markets.

This paper is devoted to present the initial arguments in terms of understanding growth triangle type of developments that may carry some potential for economic growth and prosperity in certain parts of Eastern Europe. The paper is structured as follows. In the second section, we discuss the success factors of Southeast Asian regional developments and compare them to factors that may support or impede similar kind of developments in Europe. Next, we outline the objectives and main questions of the research project. These lead us to key variables in terms of the research design. In the final sections, we propose the necessary pre-studies of the project and a short summary ends the paper.

Regional developments

The Southeast Asian example

Growth triangles, it is argued, are a distinctly Asian form of regional co-operation, which has evolved from the area's experience in export processing zones, industrial and technological parks (Dahles 2003). These growth triangles are localised economic co-operation zones that exploit complementarities between geographically contiguous areas of different countries to gain a competitive edge in export promotion. Trans-border areas are comprised of elaborate network relations, public-private partnerships, in forms of subcontracting, outsourcing and franchising. Concurrently, these relations of economic co-operation bind together large-scale and small-scale enterprises as well as multinational corporations.

The factors, which determined success of such growth triangles in the Asian context are well known (e.g., Hroshi 1997).

- Asian growth triangles, *at large, are informal developments*, with the ideology in that of shared growth spreading the benefits of growth to all.
- Along with geographical proximity and complementarities *strong cultural and social ties* are key factors.
- High degree of political commitment to the growth-triangle concept is a characteristic of these developments in Asia. The *political commitment* is to ensure a functional institutional framework for co-operation among the central and local governments, the private sector and the residents of a growth triangle.
- There must exist *complementary relationships in resource endowments*, labour, technology and location.
- *Private sector* is to become the engine of development.
- Regions belonging into a growth triangle must be contiguous with each other and the national boundaries must be easily accessible if not completely permeable.
- There must be at least one *metropolitan centre* - capable of emanating dynamic spillover effects of trade and investment on adjoining areas.
- A growth triangle requires reasonable *well-developed infrastructure* and the finance for that infrastructure requirement i.e., projects, aiming at infrastructure development, must be justifiable on the basis of net financial internal rate of return on capital.

As can be seen, the traditional notions of comparative advantage can not fully explain Asian success. For example, Singapore's and Hong Kong's (in)actions reflected state and firm concerns about their relative-absolute positions in the regional-global hierarchy and show how small states can change their position in the division of labour. Based on these experiences, one may conclude that choices about what to sell and make are not templates of natural resources (Chong 1996). In other words, relative domestic scarcities of capital and labour needs to be seen as products of development, not simply as inherent features of a given territory. Further, a country's position in the global division of labour is a cause of development, not only a result.

Doing business across borders implies not only relocation of production processes but also relocation of labour and management models and strategies, i.e. it also means dynamic relationships between organisations and people with different cultural backgrounds, both within and outside their states. Constructing greater comparative advantage, through growth zones, requires an understanding of social and political institutions because a simple assessment of relative resource endowments will not indicate which states have comparative advantages in services and manufactures. For example, some economic sectors seem to have higher profits and capital accumulation and they can mould political interests into a developmental coalition and facilitate the achievement of social welfare goals.

Comparison of Asian and potential European growth triangle developments

The differences between Asian and European regional developments may be that trans-border organisational co-operation, i.e. coalitions between organisations, emerge more on the basis of rational ('capitalist') choices that enhance efficiency, cost-reduction and risk avoidance in Europe. In Asia, on the other hand, the formation of coalitions seems to be influenced by 'cultural' considerations that prioritise personal relations, family obligations and trust. Furthermore, the cross-border flows in the most successful growth triangles of Southeast Asia could only occur because of the (implicit) co-operation by states to provide the institutional framework for markets to flourish. The Asian examples suggest that there may be room for agents and economic hierarchies are not all structurally determined by comparative advantage.

Further comparisons can be made in considering similarities and differences between Asian and European developments. It has been argued that Japan was the local model in Southeast Asia. While Japan protected its infant industries, Japan's post-war strategy was to acquire latest technology via licensing and commercialise that into successful products. Japan did not merely imitate, as far as the techniques of commercialisation, arrangements of production processes and plant-layout techniques may be considered as Japanese innovations (Ozawa 2002). Therefore, it may be relevant to compare the Asian situation - of Japan being knowledge source (cf. flying geese pattern Kojima 2000, Ozawa 2002) to the European situation of today.

Moreover, there was a willingness of the United States to disseminate growth stimuli overseas and provide demand for Asia's trade surpluses three-four decades back (cf. Product life-cycle theory by Vernon 1966, 1979). Also, Singapore and Hong Kong as city-states have specific demand for hinterlands. All in all, in Southeast Asia the supply-side and demand-side relationships both developed at the same time. In contrast, the EU may not be so much for demand-side relationships - members of the EU do not want mass production imports. Rather, they want markets for their own mass-production.

Growth depended on relative cost factors, NIEs (Newly Industrialised Economies) for example, had lower production costs during much of the post-war era and could out-compete more expensive producers in developed countries. In contrast, we witness a relatively short period, considering labour cost increases in the eastern part of Europe.

The production profiles in the Southeast Asian countries became such that high-tier, low-tier industries and low and high-end goods in each tier industry exist. During the turn of the Millennium, there are several industry behemoths in the Eastern borderline region of the EU still, which may not have high and low end goods as the result of the socialist planning system (cf. COMECON, Council of Mutual Economic Assistance).

One can also easily argue that the European political framework, today, is not similar to those in the Asian growth-triangle areas in which the macro-economic stability required control of personal consumption and standard of living. Those were/are constrained democracies, while commercial expansion was not hurt. Further characteristics were the relatively high level of national saving, while resources were geared into industrial growth. Such a constellation in a constrained democracy may not be so easy for the countries that just fifteen years ago escaped from the political regime of socialism. It is highly improbable that these new democracies would apply similar political systems that made Southeast Asia successful.

Liberalised trade regime, export oriented FDI (foreign-direct investment) and actors' commitment to export characterised the Asian national developments, which meant of making use of the free market elsewhere. The question is whether the enlarged EU will provide free market for productions in the eastern part of Europe, e.g. industries of countries left outside of the Union in 2004.

Interdependence does not always lead to co-operation or have favourable consequences. Even in the cases of Hong Kong and Singapore the ties with their neighbours have special attributes. Indeed, the economic flexibility of Hong Kong and Singapore, based on coherent, strong, insulated ruling authorities capable of adapting to both short and long-term pressures, is an important influence on their decision to participate in the creation of these triangles. The logic behind state intervention was that when the competition between states changed, authority of society and economy became asymmetrically diffused. The actions of Hong Kong and Singapore, in terms of sub-regional growth zones, can therefore be seen as a realist effort to manage the erosion of sovereignty and emerging complex interdependence, arising from scientific and technological advances in communications and transportation. The participating governments in each zone, then, tried to manage the change or uncertainty, maximise benefits from international exchange, maintain policy autonomy and occupy a desired niche in the Asian production hierarchy. However, the capacity to create new economic opportunities and comparative advantages for other triangle participants is still not that obvious (cf. Asian crises in 1997).

We should remember that the successful Asian states did not adopt free market policies, as understood in Western Europe and North America. Their domestic economies' flexible rigidities allowed firms to upgrade their products and technologies through learning. This includes the capacity to change the public policy framework within which the economy operates, without undue social upheaval. Private sector behaviour and industry policies both created individual, sector or national rigidities that laissez-faire economists expected to dampen growth but aided the long-term flexibility of actors to deal with future change.

Any investigation concerning European regional developments needs to be placed in the changing economic and political contexts of the European Union. Also Russia has influential role in the whole Europe and beyond. Any regional configurations, undoubtedly, will be tied to the European Union and Russia, whether or not they are able to facilitate expansion of intra-regional investment. At the same time, the participants of cross-border regional developments also may pursue a large variety of polities.

The objective and questions of the research project

We suggest a critical-realist approach, with the aim of understanding the disparities in regional developments, and accordingly analyse the possibilities for growth triangles in the newly shaping borderline areas of the Europe Union. The significance of the critical-realist perspective in creating alternative explanations of regional development processes may be manifold.

First, it is about giving a realist consideration of the applicability of Southeast Asian examples to the European areas of today. Further, our concern is, whether imitating complex multifaceted strategies of Asian countries, which were implemented during two to three decades, would be a competitive strategy in Europe. However competitive the Asian form of regional co-operation used to be during almost four decades, should that be promoted as a strong option for successful regional co-operation in CEE and the surrounding EU countries of today. It might be that there are other options for Europe.

The critical evaluation of the theory that suggests the possibility of implementing those Asian strategies in Europe may raise our capacity of offering novel alternatives. Admittedly, our belief is that we may achieve relevant understandings by contrasting alternative solutions, both in practical and scientific terms.

The starting question still may be that to which extent the Asian examples are applicable in CEE and the surrounding EU countries. This means, we need to search for the success factors, which may be equally present in the areas in question, Asia and the corridor area of EU. Further questions rise when and how these factors might occur? Answers for these questions may be important also for companies to consider when they assess global-local mixes in a particular region.

Among the purposes is the explicit analysis of the dynamic relationship that emerges between different actors, within and without organisations, in potential cross-border arrangements. This to be seen in relation to further questions, such as how and why certain countries in Europe may or may not react to various economic changes by developing sub-regional economic growth zones.

In the next sections, we suggest that the enlargement of the European Union can be seen as intervening, while participants' production profile is independent and the potential growth triangle development is the dependent variables, in terms of the overall research design for the project.

Research Design

In general, growth zone development may be seen as a result of responses to external events, with the concern of maximising relative and/or absolute gains and minimising losses to their production profiles. The proposition is that growth triangles are driven by changing production profiles in their core states or metropolitan hubs and are responses to external economic changes. The emergence of growth triangles could be seen as an example of co-operation in managing economic interdependence. They may be a part of a changing regional and global division of labour, where industrial restructuring in growth zone participants' economies is driven by political, technological and economic factors.

As for anchor point for the series of regional development studies (see the last section) it can be argued that the outmost important international event is the enlargement of EU with the ten new CEE members at present. Other important events remain to be identified, internationally as well as domestically.

In part, we aim at testing the theory that growth areas develop in response to external stimuli, as the countries' respective production profiles within the region changes. In other words, this theory says that external changes spur the relocation of manufacturing production to nearby jurisdictions. Firms moving first from the more developed areas to nearby hinterlands are those in declining industries in their home bases. They aim at shifting their production to areas in which production costs are lower, as well as avoiding host market entry barriers and circumventing export markets' (non)tariff barriers.

Our argument is that in the European context, potential growth-zone developments may, to a large extent, differ from those prosperous ones in Asia and that in some of the envisioned European regions such development is not even achievable. Consequently, we propose that any regional development within Europe needs novel strategy.

In line with the argued critical realist perspective, next we discuss the role of the natural resources and FDI in terms of these being potential facilitators of regional growth in the Eastern borderline area of the EU (2004).

The role of natural resources in regional development

Arguably, one of the possible routes concerning economic development is connected to the large reserves of the natural resources in specific regions of Eastern Europe. This does not mean that economic growth based on natural resources is a clear cut strategy for any countries' business actors and policy makers for success.

Staple product is defined as being based on natural resource extraction. Such products require little processing prior to export to industrial countries where they are usually used in the production of manufactured products. The general belief concerning a resource-rich country's growth is that its growth is stimulated by the direct investment in the extraction of the staples and the spill-over effect of staple development.

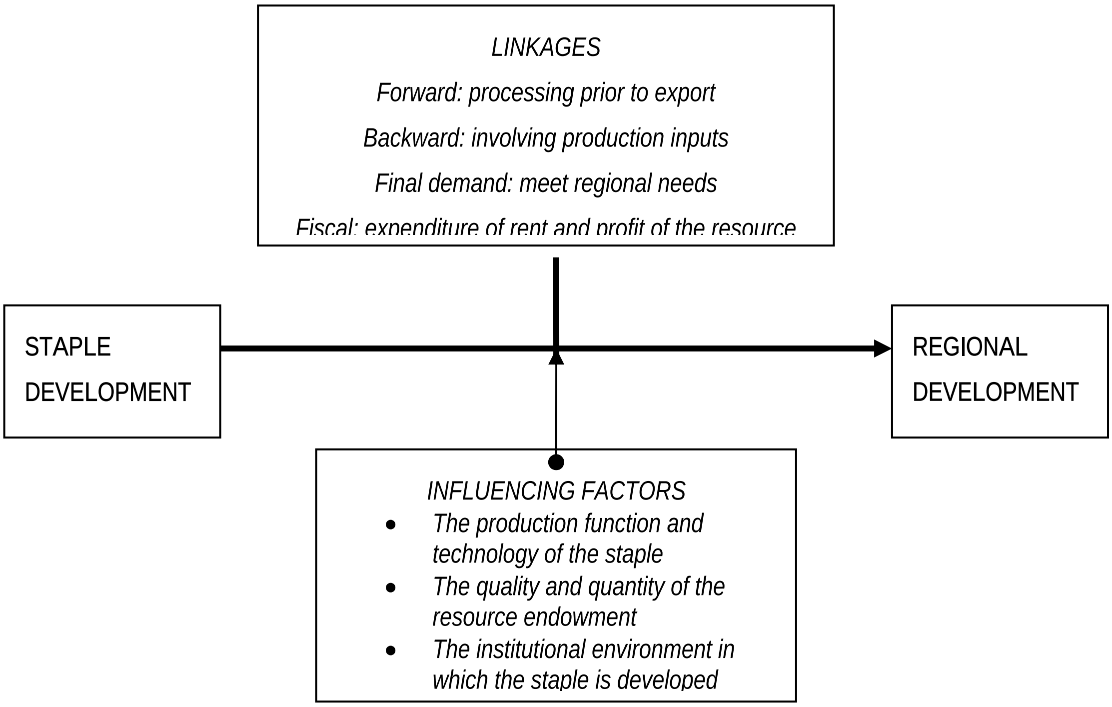
However, dependency theorists strongly argue that natural resources impede development by creating an unhealthy economic dependence. This school mainly point to the risks of such development route. According to it, staple products incur high fixed costs because they are capital intensive. This is the reason behind that staple development is often undertaken by large foreign-owned investor companies.

The foreign investors may have a strong bias towards locating backward and forward linkages (Figure 1) outside the staple region because the linkages are often already established in the home location of the foreign owned firm. In that case, the resource-rich host economy lacks *forward /processing linkages, backward/supply linkages* and higher-order management and research and development functions. Foreign dominance of staple extraction distorts the emergence of a strong independent entrepreneurial class. The only type of entrepreneurial class, which may emerge is simply a service supplier of the foreign-owned industry and incapable of pursuing new independent enterprises that are to diversify the economy.

Income earned from the staple leaks in the form of payments of profit and dividends to the foreign owners. *Final demand and fiscal linkages* are therefore also underdeveloped. Further problems are related to demand linkages because staple demand is subject to highly volatile international commodity market in which inelastic demand leads to large price-fluctuation and regional economic instability. The spatial manifestation of the dependent staple economy is the emergence of isolated, single industry towns organised around the extraction of the staple. These resource towns are vulnerable to downsizing and closure. Governments are in a weak bargaining position because they are dependent on the large foreign companies.

All in all, the risks in resource-led growth thus, include the propensity to dissipate rent (i.e. the surplus income generated by the natural resources above normal returns after compensating for all other factors of production). In turn, there is great danger of increasing community instability by building surplus capacity. The economy remains dependent on a narrow export base. Financial crises occur because of volatile export revenues, which are insufficient to cover fixed-debt charges of financing the extraction. The economy will collapse when the staple is economically or physically exhausted. These interconnected results are often called as the staple trap

Figure 1: Studying the relationship between staple and regional development



By accepting these arguments, one may conclude that the resource-led growth is a very risky development strategy and probably cannot provide sustainable growth.

One question may arise, however. Are these risks to come true is inevitable or such is the result mainly because of poor management of resource development?

In contrast to the resource dependence theory, the comparative advantage theorists argue that natural resources can expedite development, i.e., they are important catalysts. During the early development phase, the staple pays for the products that the 'new' economy cannot yet produce economically itself (cf. flying geese pattern in Southeast Asia). Development is expedited by foreign capital, entrepreneurship and technology. Without borrowing, the process of development would be reduced to the slow process of domestic savings and the development of local inventions. The Canadian Staple Theory tries to integrate the two views – resource dependence and comparative advantage - in order to understand the role of natural resources in the process of regional growth. The significant role of natural resources is that demand, capital and entrepreneurship are supplied by external export markets for the staple product, instead of being restricted by regional consumption and saving rates. Manufacturing linkages develop by the economic logic of processing resources prior to export in order to reduce weight and transportation costs. The regional economy expands through these spill-over effects to achieve the economies of scale necessary to diversify through import substitution and other non-staple-related growth. Over time, the region may become less dependent on a narrow staple export base and become self-sustaining. From this perspective the natural resources may have the potential to provide significant comparative advantage relative to other economic sectors by virtue of generating resource rent.

There is no doubt that development of staples is complex. There are other factors to be considered (Figure 1) such as the production function and technology of the staple (in term of determining the nature of the potential linkages), the quality and quantity of the resource endowment, the institutional environment in which the staple is developed.

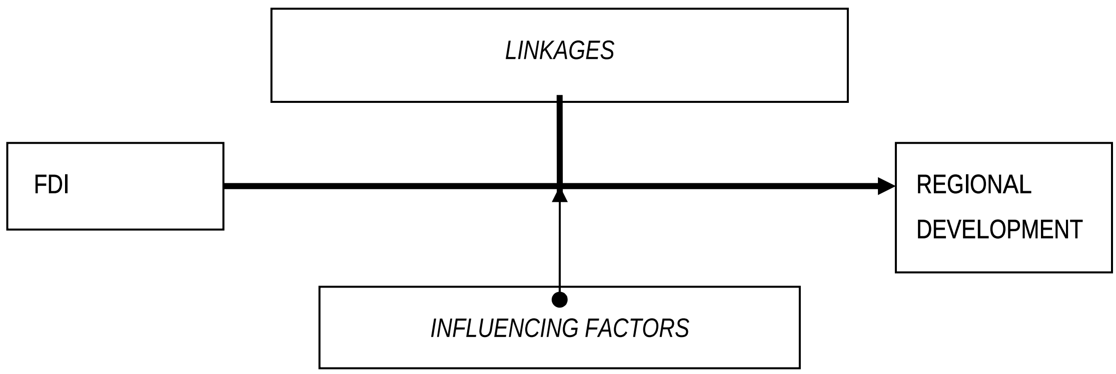
The role of FDI in regions bordering the enlarged EU (2004)

Foreign-direct investments – into natural resources or otherwise - may be a regional integrator, too. Proponents of formation of preferential growth triangles argue for optimising the potential benefits that the status as new frontiers for efficiency-seeking FDI may offer and maximising the prospects to attract companies that choose to move to lower-cost locations within CEE.

It is a very possible scenario that once the acceding Central European countries are accepted into the European Union in May 2004, the new geographical configuration will reshape foreign-direct investment distribution, pushing the investment frontiers closer to the Balkan and CIS countries. A boost of both FDI in and outflow may be expected, along with increasing differentiation and specialisation between the two groups of Central Eastern European countries, the accession and the non-accession groups (International Herald Tribune, online 15.10. 2003). This expectation is based on these countries gross domestic product per capita differences and by trying to foresee that the 'flying geese' pattern is establishing in Europe, too. However, doubts prevail about the consistency of such pattern, especially in comparison to the Asian developments. Although it seems a logical assumption that the non-accession countries are the candidates for a new frontier of labour-intensive activities, we cannot be sure whether present signs point to a long-term structural change or it is a short-term cyclical one, related to the cycles in large-scale privatisation.

The extent to which FDI is growth enhancing appears to depend on country-specific characteristics (Zhang 2001). For Eastern European countries, it is imperative to improve the business environment fast and radically since the FDI absorption capacity depends on building the institutions to deal with increased financial and legislative demand (cf. Kalotay 2000 and 2002). Furthermore, free trade is inevitably crucial to the investment success, since most of the countries in the region are too small to attract significant foreign investment just to their own local markets. In these respects, we may draw the similar figure (Figure 2) for the relationship between FDI and regional developments (e.g. growth triangles) as we did for the relationship between natural resources and regional developments (Figure 1). To be able to increase our understanding of the role of FDI in regional economic growth a systematic analysis of linkages and influencing factors seems to be necessary.

Figure 2: Studying the relationship between FDI and regional development



Further research routes

As can be seen, our focus is on the processes of regional development. However, as we set our objectives, we cannot hide our concern about competitiveness of certain regional areas. Whether competitiveness can be created and sustained by imitation of the example set by regions of Southeast Asia or not? In accordance, we understand that a strategy is always about creating something new and an approach to implement something that already exists may not bring real strategic results. We take this argument as the point of departure in all stages as well as in the macro-, institutional-, industry- and micro-level studies - related to this project.

First, the publicly available data from international organisations, governments, industry organisations, labour unions and universities can be analysed in simple, descriptive terms and through partial or multiple regression where possible and suitable. Value-added and firm size statistics, for selected industries in the potential regions, may indicate an increasing integration and shifting production profiles. Employment data of the borderline areas can include indicators of increasing integration and shifting production profiles, e.g. unionised and non-unionised segments of labour.

The project as a whole needs to be supported with historical studies. Those are to review selected European countries post-war economic development. The transition to export-led industrialisation and the impact of internal and external shocks should be examined for each potential region. At the same time, indicators of increasing integration and shifting production profiles should be searched for, e.g. official policy statements regarding regional developments, mergers and acquisitions. We need to elaborate on cultural affinity and kinship ties within European regions. What role did/does culture (in terms of personal connections, family obligations, ethnic affinity, religion and trust) play? In respect of kinship ties, a preliminary assumption may be that the type of ties, which created success in Asia, might not exist in Europe and to develop them would take a long time. The historical studies should, anyway, be able to map the potential metropolitan centres and their complementary and contradicting interests while our focus extends not only on the potential core states, but on that how other countries play a role in growth zone emergence. In this sense, the zonal-trade and investment partners need to be considered.

Beyond analysis of the available statistical data and historical descriptions, we intend to conduct survey and case studies about the regions in focus. The focuses, the preliminary assumptions and the research questions of the particular studies are not the subject of this paper since the project is in its initiation phase.

Summary

The research aims at elaborating on the possibilities of growth triangle type of developments in the new borderline area of the European Union. We aim at reviewing factors of developments in the specific area of Europe during the beginning of the new millennium. For us, it seems necessary to take the critical-realistic perspective on this subject matter of regional developments in the Eastern borderline area of the European Union.

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GOOD GOVERNANCE AND PROSPECTS FOR LOCAL INSTITUTIONAL STABILITY IN THE ENLARGED EUROPEAN UNION AND THE NEW MARKETS[1]

Ilari Karppi

Introduction

Governance and governance reforms at stake

Good governance as a term cannot be avoided in the contemporary administrative thinking and conceptual engineering. It – as it is widely believed – is revealed through the rule of law and transparency in administration. Reforms embracing these attributes are eagerly exported from their Western home-turf anywhere in the world where democratization and market economy are being assisted to gain a foothold. Business, for its part, makes its commitment to good governance visible to the public through proclamations about ethical codes of conduct and corporate social responsibility.

A key element within the latest wave of governance reforms, carried out as an externally driven process since the early 1990s, is the decentralization of formerly centrally governed societies. Such reforms have been implemented particularly in transitionary and developing economies, often jointly referred to as *new markets*. Local administrations in these societies have been empowered to take a strategic grip on the developmental needs of their respective territorial settings. Coinciding with this restructuring, local trajectories for economic growth have been sought, even if this has taken place at the expense of widening regional disparities between those regional economies that have succeeded in attaching themselves to vital resource flows and those that have not. Fostering such an administrative diversity and grassroots build-up of institutions that facilitate the association of individuals into social entities – ranging from voluntary civic organizations to enterprises – has been an elementary part of the introduction of market-based economic cultures (cf. Braudel 1995, 18) to the new

[1] The paper is to a great extent based on an article that will be published in a forthcoming special issue of the *Journal of East West Business*.

markets. It now prevails practically unchallenged throughout East and Central Europe, as well as Asia, Latin America and Africa.

This paper builds on a series of empirical studies reported e.g. in Karppi (1998), Böhme et al. (2001), Karppi and Lähteenmäki-Smith (2001), and Luukkanen et al. (2002). One of their key common findings emphasizes the need to be careful with the *time scales* of administrative transformations. Most radical governance reforms are typically implemented in conditions where old regimes have lost their legitimacy – as happened in post-1989 Europe. Typical of these circumstances are widespread popular insistence on instant and veritable changes. However, what is needed for the reforms to be sustainable is continuity, sometimes called *institutional memory* (cf. Luukkanen et al. 2002, 212), that enables learning from the subsequent steps of finding the new developmental trajectory.

In many instances the creation of local administrative entities capable of turning good governance as an idea into good governance as a practice has appeared to be a complicated task (cf. Goodin 2003, 70-81). Also here we face the question of time-spans. Especially the European transition economies that joined the EU as New Members in May 2004 were, since the mid-1990s, given an extremely tight time frame to replace their defunct institutional set-ups, inherited from the socialist governance model, with models based on free-market liberal democracy and imported from the West. Some of the problems can be attributed to geographical scales. (Re)vitalizing hundreds and in some cases even thousands of units of local and regional administrations with new, fresh-thinking and market-minded public managers verges on a Herculean task (cf. Lillstrang 2004). Finding and assigning professionals to the needs of national key offices and agencies in charge of state-level judicial and administrative institutional restructuring was remarkably easier due to these offices' higher profile and status. Even here clashes between old and new generations of key civil servants and the ideas they stood for were frequent.

Finally, the institutional strengthening that needs to be carried out in the New Members' local economies may still face a problem with its roots in the way public sector reforms have been carried out in the *West* of Europe. These reforms have created a kind of conceptual model that has been passed on to the transition economies, as it has been embedded in an overall framework of 'Europeanization'. Multi-layered systemic imbalances may – as an argument to be processed in the course of this text – risk the creation of new local economies that can contribute to the all-European competitiveness and long-term societal stability.

Limited government, negotiated transparency

"So, let the economic man flourish and so then will the polity. Let us disregard the shrill criticism of those progressive intellectuals who decry the materialism which affords so many of them (and us?) a comfortable living."

David A. Roberts, Manchester Metropolitan University

"Dictators do not hesitate to break the constitution, cast doubt on and overturn relationships, and also reach for the property of every citizen. No, it need not mean immediate

expropriation and nationalisation, but enemies of freedom use all the instruments of an undemocratic regime to dominate and regulate everything and everybody."
Michal Kováč, President of the Slovak Republic

These two differing perspectives on the relationship between the "politics" and "economics" of liberty and freedom were proclaimed some ten years ago, November 1994, in the Fifth Bratislava Symposium with the theme of "Economics and Politics". Whereas Roberts (1995) adopted a (post-)Thatcherist Hayekian approach emphasizing economic freedom as an engine for civic liberty, the then President of the Slovak Republic, an economist by education, saw the relationship slightly differently in his message to the Symposium. Building on an extensive personal experience of a totalitarian regime, Kováč (1995) stressed the risks of a political power becoming coercive to ruin democratic and economic freedom – with the regular tools needed for the governance and administration of a modern society.

These approaches do have a common denominator. A balance must be struck between the government and its regulatory powers on the one hand and the possibilities of "the regulated" to monitor and control the public institutions on the other, to prevent them from becoming coercive in the first place. The prescription for achieving this goal suggested by the two schools of thought differs, however. The one cherished by the New Right, in particular, builds on the traditional demands for limited government and minimization of the regulatory tools that might prove dangerous in the wrong hands. The one nowadays embedded most firmly in the Continental European corporative and Nordic universal welfare state thinking emphasizes the culture of political participation and social sustainability in a form referred to sometimes as a "negotiated economy" (e.g. Amin & Thomas 1996). A contemporary catchword to encompass the control of the regulatory mechanisms to fetter their spontaneous sprawl and the transparency of the various participatory, representative and negotiating bodies is good governance.

A general question to be touched upon in this paper concerns the administrative heritage of Central and East European transition economies. As the defunct socialist states were all-encompassing societal actors, they inherited broad administrative sectors that had to be restructured in their entireties with a true role given to elected and representative bodies. Moreover, especially in the beginning of the transition period, the states and public sectors at large were key owners of production facilities, distribution channels, infrastructure and utilities, and so on. In this situation it was necessary to ask which of the two main roads to renewal was to be chosen: limiting the sphere of government, or enhancing the "big governments'" transparency, accountability and trustworthiness to the citizens through participatory and representative institutions and bodies. The governmental sphere was effectively limited as privatization made administrative actors retreat from many activities beyond the direct and actual use of public power. On the other hand the first prospective and then actual membership of the EU brought with it complex administrative questions and added a supranational layer to the Central and East European countries' administrative apparatuses. This appears to have watered down the limited government argument as a self-evident direction to be followed.

A more explicit question set forth in this paper deals with the developments in the local and regional spheres of the European societies. After all, the "Europe of Regions" ideology that started to gain substantial ground in the 1980s, assumes localities and regions as the particular fora for European renewal and development processes (e.g. Sharpe 1993; Karppi 1996). Moreover, and what is of particular importance, the regionalized processes of renewal are seen to allow individual citizens and their organizations to have a particular say on both the developmental goals and the means for achieving them. Through this question this paper joins a relatively modern tradition of tracing and analyzing the impacts of globalization and its controversies in actual places and as actual functioning of individuals and institutional actors (cf. e.g. Drainville 2004). The global perspective widens the approach and the scope of the specific question thematically to all regions, localities and their actors that face globalization as a challenge to change their traditional ways of operating.

The issues discussed in this paper draw on the experiences and findings of several research processes with a local orientation that have been carried out between 1992 and 2004 in European, Asian, African and Latin American country contexts. They have scrutinized local administration and/or the adaptation of individuals and larger societal entities to changes in their external operating environments. Some of their overarching findings are briefly described in Section 2 below. The aim of the paper, however, is not to summarize the empirical results produced by these studies. Instead, it seeks to develop an argument concerning the challenges faced by policy prescriptions emphasizing the need for decentralization as a means to streamline the administrative structures of economies and polities that wish to thrive in the midst of the global economic and competitiveness pressures.

Globalization: regional adaptation and strategic management

Territorial governance and self-determination as challenges faced by regional analysis

A fundamental topic within the discipline of international relations since World War II has dealt with nations' right to self-determination. As Ronen (1997, 63) points out, this right was originally not limited to national entities represented by *states*. It was accorded to the promotion of self-determination of *peoples* in non self-governing territories as well. Friedman (2000, 22) describes how he began to cover topics like this and their intersections with economics and finance in the *New York Times* under the heading of "Commercial Diplomacy" or "Foreign Affairs and Finance".

The Cold War years were followed by increasing global interaction and interconnectedness. At that point the question of the self-determination rights of population groups such as ethnic/linguistic minorities and (other) territorially specific groups became more and more acute. The break-up of the former Yugoslavia with ethnic cleansing and genocide taken as tools for settling scores among territorially specific ethnic groups was among the first reminders that even in Europe the new region-building was a process not to be taken too lightly (cf. e.g. Glenny 1993). It had a serious political content.

The mainstream European Cold War era developmental trajectory in ethnic relations within nation states had been somewhat different. In democratic societies, most ethnic and/or territorial minority groups appeared to integrate in the fabric of nation states during a forty-year period between the late 1940s and late 1980s. Yet it became obvious that such an "ethnic tranquillity" is not to be taken as an *automatic* outcome of the democratization process in any given society. Even less can we speak about linked equilibriums that can be reached after extensive series of trial, error and learning in the management of ethnic relations in national contexts. As soon as the national frameworks gradually opened up in favor of a European-wide setting (with a European political space created through the 1993 Maastricht Treaty), another process became visible. It was increasingly fuelled by territorial populations' self-determination.

Some signs suggest that the regional mobilization as described above is a more "global" process. At least it is not limited to the democratically mature institutional environment of the European Union, but can be observed, for instance, in the relationships between Moscow and the institutionally diverse Subjects of the Russian Federation (e.g. Gessen 1997).

One should not deny the importance of nation states as key actors in the international community and in the international legal order. However, a crucial question built into the contemporary ideas on governance deals with the role and position of regional and often territorially specific communities as they face the adaptive pressures posed by globalization. To do so a great deal of policy research (see below) has already focused on environments that constitute particular fault-lines in human communities' historical or contemporary socio-economic development in different parts of the world.

In his analysis of ethnic diversity and self-determination Dov Ronen (1997, 117) makes an interesting suggestion. He postulates that just as human beings feel "comfortable" while interacting in satisfactory socio-political environments, there is also a human tendency "to stay within or seek out physically-economically-'comfortable' environments" (ibid.). In other words, physical space would matter and constitute a component while a territorial community defines its position and determines its goals and adaptive pressures *vis-à-vis* the changes and transformations in its external environment. This adds another vital dimension to the analysis: institutions capable of dealing with the spatial aspect of societal governance are needed while the territorial communities face the pressures of globalization, adapt to some of them and turn some of them into deliberate strategic action.

The question of transformation as a general context-describing concept for actors' and communities' adaptation as well as their taking of strategic initiatives links this study to an impressive body of research in institutional changes in the modern world. A particular reference point is Karl Polanyi (1944/1957) on the major transformation of the world economic order after the maturation of the industrial era. Other key figures include Dietmar Rothermund (1996) with his analysis of the spread of financial disturbances across the different economies of the world in the aftermath of the 1929 Wall Street Crash. Claus Offe (1996) provides valuable comments on the nature of European post socialist transformations and Paul Hirst (1994) on changes in the democratic decision-making structures to which the communities as territorial entities may access.

The "regional" embedded in the "global"

Globalization has caused different adaptive needs to emerge in all regional economies and within all territorial communities. This is particularly obvious in regions that are peripheral or semi-peripheral in one or several senses:

1. in geographical or/and geopolitical terms;
2. in terms of their position in the international division of labor; or
3. in terms of their capacity to govern the various resource bases required for efficient coping with changes in their environment.

In recent discussion it has been virtually taken for granted that "globalization" and "regionalization" are closely inter-linked phenomena (e.g. Kohler-Koch 2000, 69). The same school of thought emphasizes regions as key arenas and regional integration as a central process in our attempts to understand globalization. Finally it is sometimes assumed that institutions that facilitate integration – such as the EU in a great part of Europe – deliberately align with the "regions" and carve out the nation states' political and judicial status in international relations and international law.

In Europe the widely discussed "renaissance of regions" is regularly attached to an-other strand of development publicized by a particular intellectual narrative: the reorganization of capitalism (cf. Le Galés 1998). This is particularly obvious in the European-wide networks designed among regions economically and industrially successful in their national contexts, such as the "Four Motors". However, the opening up of the nationally set market-based institutional orders is the definite interlinking dimension of global integration. It is also an elementary part of the still continuing transformation towards an emerging new model of governing socio-economic relations in national, sub-national and transboundary regions in various parts of Europe and beyond.

Institutional reorganization has changed and continues to change the patterns that regional entities develop as forms of territorial governance for both adapting and making strategic decisions in the face of global transformations. Recent research in the traditional EU-European context has contributed to the development of important conceptual tools for analyzing the units and entities that ultimately facilitate, intermediate, cushion and/or utilize the impacts that constitute the dynamics through which "the global" affects "the regional". One of the most interesting is the idea of multilevel governance in its variant that emphasizes the *importance of interplay* among a vast number of different kinds of actors (Hooghe & Marks 2001, 6).

Another important discussion elaborates the “goodness of fit” (Börzel 2001; cf. Risse et al. 2001, 6) while analyzing the adaptive pressures encountered by the different actors on different levels of action that jointly comprise the space in which regional integration takes place. The issue has been mostly studied in the current EU-European context. However, the approach can well be widened to territorial entities and environments within the sphere of European interest either due to their geographical proximity (Northwest Russia) or due to the economic dynamism that they represent (Southeast Asia). Taking advantage of the virtues of comparative policy research, other kinds of territorial cases can also be included. One of the recent studies focuses on the processes of creating a new area for strategic co-operation in the Baltic Sea Region and its policy environments. They encompass both traditionally well-interlinked sub-regions (particularly among the regions of the Nordic countries) and forms of territorial co-operation that still are in the process of finding and taking their post- Cold War shape (Karppi and Retailleau 2003; cf. Böhme et al. 2001).

Obviously, empirical analyses are still needed to extend, apply and test the viability of the current concepts in new environments. Moreover, institutional analysis is needed to enhance the understanding of the eventual common logic that local and regional actors may need to subscribe to in order to manage the adaptive pressures of globalization in their particular territorial settings. Thus, three ultimate questions to be taken into account by subsequent regional analysis of the institutional aspects of the global/regional nexus can be set as follows:

1. Is it possible to identify a common logic and adaptive pressures, transcending the territorial and functional environments and boundaries in the first place?
2. Is it possible to articulate this logic and face these pressures in a uniform manner regardless of the apparent differences in socio-economic, geographical and institutional environments?

and, fundamentally

3. Is regionalization such a paramount aspect of globalization that much of the contemporary discussion supposes it is?

The Challenge: How to empower the Regions and localities?

The challenge of building viable local economies

Localities are challenged more and more as global actors. They have ceased to be players in national struggles over budgetary resources, central government spending and appropriations for each financial year. As emphasized by some of the multilevel governance models, political changes that have made national boundaries more permeable have been a catalyst for finding out new areas of co-operation, business opportunities, and learning from each other's experiences. The decline of the peculiar modes of national regulation, replaced in Europe with common EU policy frameworks, has opened up various regional and local operation environments more than ever to direct international interaction.

This opening up is a global phenomenon, and it has given rise to new policy discussions all over the world. Many of them touch upon the new relationship between enterprises and the communities in which they are located. Communities, particularly in the industrialized North, have become more and more aware of the threatening outflow of vital resources due to increasing globalization (Craypo 1997; cf. Wolman & Colamosca 1997). Good governance and public-private partnerships as ideals cherished within management sciences and among policy practitioners have emerged to capture the challenging situation and to find possibilities that might lie within the reach of the public sector and especially the local administrations to do something about it. Thus, since the early/mid 1990s aspects of *institutional quality* have become key themes in discussions and debates on regional development and possibilities to enhance local and regional economies' competitiveness. Likewise, institutional strengthening was also given a core position in Western industrialized nations' policies vis-à-vis transition and developing economies. Limiting the size of the "big government" is not a panacea in either case. Rather, what appears to be needed is intensified co-operation and flow of information as well as promotion of trust among different actors, public and private.

Even if liberalization is an elementary catchword in the global economy, enterprises also have become aware of institutional vulnerabilities that may undermine their own status in various locations. This may be the case both with the traditional industrial locations that may once have provided them with specialized labor force, and the new ones that only recently have come to host their production, distribution or procurement facilities. Indeed, enterprises have created mechanisms of their own to bridle the extreme defects made potentially deployable by the asymmetric relations among territorial economies physically scattered across the globe but closed as internal organizational spaces by dense corporate networks. Corporate governance and corporate social responsibility models, as central elements of good and ethically sound corporate citizenship, comprise the mechanisms for the internal use of corporate power and the relationships between the enterprise and its environment. Global corporate social responsibility has been essentially necessitated by the Western consumers' increasing environmental consciousness as well as their aversion to goods produced with child labor in inferior conditions, however far away in terms of geography.

Thus, despite the overall globalization, localities, local economies and enterprises' participation in local development processes has increased in importance. In most American cities this has been reflected in the roles and responsibilities of local institutions in such a way that mayors themselves or other top units of local administrations have taken the lead in promoting economic development (Clarke & Gaile 1998, 71). A similar trend of an "entrepreneurial city" development is clearly visible in Europe as well, and several research institutions, for instance, in Finland produce a plethora of competitiveness indicators for localities and city regions. New qualifications are needed within local administrations. Those derived from European competition laws (and hence one of the leading ideas of European integration) associated with public procurement constitute merely one example.

A fundamental issue while discussing the changed context of running and developing localities lies in their newly sharpened responsibility to identify and raise resources for their own development (cf. Karppi 1996). As the global and European tax competition is likely to intensify, partly due to the 2004 and 2007 enlargements, the stock of transferable budgetary resources within the Union or its Member States may well diminish. Thus policymakers need to retreat closer to the grassroots of basic socio-economic processes for support for locally designed strategic development schemes. National spending will go mostly to basic educational, health, social security, infrastructure, and security targets, while the attempts to intensify integration increases the pressures on the Union budget. What seems to thrive is the variant of good governance and new public management that emphasizes public financial administration.

Nowhere else in Europe are the local administration challenges greater than in the former socialist economies, and in the localities of the Russian Federation in particular. In Russia the problems have started with the ambiguity of municipalities as institutions with defined territorial contents (Karppi & Lähteenmäki-Smith 2001). Susiluoto (2001, 154-155; 277) has studied extensively developments in the Republic of Karelia, the Subject of the Russian Federation bordering Finland. He identified two parallel trends. For the first, the importance of Governors as regional strong men has grown since the 1998 financial crash. For the second, many of the local economies verge on deteriorating into subsistence economies with nearly non-existent resources for the kind of "entrepreneurial" or "developmental" planning that was deemed crucially important for localities struggling for success in the global economy.

Public administration transformed: a new orthodoxy

But where did the idea coined as good governance in its present meaning originally come from? The guiding principles of the rule of law *can* be traced back to Locke and our inherited routine to shun everyone's war with everyone to Bentham. The social contract formulating the *raison d'être* for a political community was originally designed by Rousseau and the idea of checks and balances between different public bodies first by Montesquieu and then in a more particular form by de Tocqueville (cf. Dunn 1993). Yet, compared with these historical roots, the present-day debate on good governance and what it should stand for is clearly an ideologically toned practical management issue rather than a philosophical project.

In its present form the kind of governance reforms as recommended to and required of economies on their way to a market-based system of international interaction are attached to the overall changes in the international division of labor. Institutions for the co-ordination of industrialized nations' economic policies and their multilateral developmental interventions such as the OECD, IMF and the World Bank with its more specialized sub-organizations started these reforms in the 1980s, with most of the world still divided into two hegemonic camps (cf. Chua 2004, 232). Reform policies started with the introduction of new private sector-derived management tools for public administration in some key industrial countries, particularly the US and UK. Later on, as for instance Martin (1994) has shown, such reforms were exported to third countries, especially to those within the US sphere of interest. Administrative reforms entered the theater of the Cold War contest.

After the Cold War the pro-reform interventions run by the US now increasingly paralleled by the EU, were extended to the Central and East European countries (*op. cit.,* 99). From that point on we can speak about a certain new orthodoxy, a truly global mainstream paradigm of how administrative systems should be reformed into cost-efficient public management bodies. They are supposed to concentrate on a "core businesses" consisting of the use of public power and to act as a patron who contracts out all other functions to the corporate sector clients (cf. Karppi 2002). This is quite possible, if only adequate time frames for both mental and practical reorientation are granted and if learning from various organizations' experiences is made possible through gradual transformation from one systemic practice to another. However, certain institutional prerequisites should be assumed, such as the existing administration's tradition of operating in an established democratically governed market-based environment. This has been the weak spot in the attempts to implant administrative reforms in several transition, newly industrialized, or developing country contexts.

Instead of a gradual transformation in a mature institutional set-up it is often required that administrative reforms are to be carried out as landslide changes with all aspects and sectors of administration to be turned over in a programmatic manner, and, possibly, even renouncing the legitimacy of the pre-transformation regime. Chua (2004, 195) reminds us that the kind of instant mixture of free-market promotion and requirements for a hypothetical textbook-bred majority democracy model brought to transitional and developing economies throughout the world is unique in one particularly important aspect. None of today's world's stable market democracies ever had to digest the principles of liberal democracy and free-market economy as cornerstones of good governance in an equally abrupt systemic restructuring. In fact, the Western market democracies have followed a gradually unfolding developmental trajectory up to the market-centered local public management. These gradualist steps, strictly contrasted by the New Markets' landslide transitions, can well be traced back to John Stuart Mill's (1980, 347) classical writings [1859-1863] on the principles of necessary balancing between organizing and securing liberty while founding a viable and legitimate society. This is no less than the point that the discussion set forth in this paper started from.

The fact that the established Western market democracies seem to require much more of the economies in political and economic transition than they would have been ready and willing to accept themselves must not be interpreted as sheer naiveté. Hence we come back to the question concerning the origin of good governance as a particularly promoted set for thinking about administration. Gunn and Bell (2003, 203), who studied the development of the English middle class, go nearly as far as to describe the transformation as an entrepreneurial revenge on those having their careers in administration, fuelled by the Thatcherist fury of the 1980s that inspired the New Right. It has been assumed that this fury was particularly disastrous to the ethos of the middle classes, widely perceived key sources of social stability. Heavy involvement in local administrations and management of communities' local affairs has been one of the traditional backbones having set the middle classes apart from the "revolutionary" working class or the "demoralized" or "self-centered" landed gentry. It had the responsibility, tradition and education to rule (*ibid.*, 102-103). Citing R. D. Kaplan, Chua (2004, 261) maintains that the middle classes and civil institutions are preconditions for democracy, so much is at stake with policies that may carve out those segments of the society – particularly if it is done in the name of good governance.

An intriguing question is to what extent the reformed ways of thinking about public management in general and local and regional administration in particular affects the restructuring of localities in transitional environments. The new orthodoxy, with tools for monitoring and evaluating all the more detailed operations within administrative organizations, certainly makes public service less an ideological or ethically motivated choice and more a step on one's career ladder. Yet, much of the stability factor, as mentioned above, has stemmed from long-term commitment and willingness to serve the local community with the voter-taxpayers' mandate and with the guidance of a strategic even if tacit consciousness of the common good. However wistful such an image of a public servant is, there must be something to make highly educated professionals remain within the limits of a rational choice while going for a modestly remunerated career in local administration instead of being headhunted by the corporate sector.

If this rationality has been based on an idea of long and secure careers, the new orthodoxy, with fixed-term tenures and various kinds of performance assessments, seems to do much to alter the basic setting. In such an atmosphere a question arises whether the local and regional administrations needed to run the Europe of Regions can be portrayed as competitive and tempting workplaces, especially to the New Member States' educated professionals.

European policy challenges identified

Ultimate consequences for the European regions' pursuit of competitiveness

In the last decade European scholars and policymakers have started to identify linkages between economic performance and factors that constitute wellbeing – both as an individual experience and as a goal of socially sustainable development (e.g. O'Leary 1995; Pakaslahti 2001). Governance tools and concepts have been developed to deal with this nexus, but the issue remains politically tense. Hence, concepts such as European Social Space4, that could be important for working on the spatial dimension of competitiveness policies, are still far from being realized as comprehensive policy frameworks (cf. Bonoli et al. 2000, 159). Competitiveness policies constitute regulatory frameworks, however entrepreneurial strands of public management they stand for. That such regulatory interference in the dynamics of European spatial development is needed reflects at least short-term market failures rather than successes in securing resource allocation capable of bringing about balanced development and redressing existing biases in the regions' performance profiles.

In the 2004 Cohesion Report (CEC 2004) the European Commission extended its concerns for balanced European development to the area of justice and home affairs. In this instance the Commission makes a reference to particular regions that, due to poor management capacities, might be at risk of becoming vulnerable to organized crime (or possibly, in the contemporary lingo, terrorism) and a source of European-wide societal and security fluctuation. The need to counteract organized crime or terrorism with specifically targeted measures may reflect the overall dissipation of solidarity and waning of structures that could be called the cement of European societies. Yet, the threat of terror taking a firmer grip on entire community structures is seen to particularly threaten those nations that have now joined the EU, and via that link to the entire functional texture of an enlarged Europe. Such concern is typical of the storyline in the current enlargement discourse. In it the New Members are seen to increase vulnerabilities while the "Rumsfeldian Old Europe" is threatened with being besieged by epidemically diffusing pathologies the New Members' eventual institutional weaknesses stand for.

These concerns show that public management and governance reforms leaning on it cannot be seen as mere questions of financial administration. Capacities to govern go well beyond the scope of entrepreneurial local policies, which is made very obvious by the traditional Western geopolitical thinking that has surfaced anew in the way of thinking localities and their governance in an enlarged Europe. European cohesion policies address the topic within the context of justice and home affairs, emphasizing cross-border co-operation as a forum to facilitate the policies to counteract possible consequences of local deficiencies in capacities to govern. Enlargement is seen to exacerbate the problem of corruption, insufficient institutional capacities, or deficient maintenance of stable political and economic environment as a *European* phenomenon. Measures embedded in cross-border co-operation may, as one might anticipate, enable Old Europe to widen its efforts to combat these menaces to all-European stability to the territories of the New Members, confining the pathologies to the identified hot-spots and eradicating them location-by-location. The particular area of concern to Old Europe comprises new external borders and border localities as well as the necessary measures for blocking their permeability to the pathologies of terrorism or trafficking in drugs or illegal immigrants. This exemplifies co-operative or newly "Europeanized" geopolitical thinking (e.g. Karppi 2004).

It is obvious that enhanced permeability will also bring with it positive border-related activities and newly available economic potentials through a widened palette of interaction. Overcoming impediments to economic growth by alleviating the "frontier effect" both among the Old Members themselves and particularly between the Old and New Members is an obvious challenge. The frontier effect refers to de facto cultural, linguistic and institutional barriers to interaction even in the Common Market institutional environment, and overcoming them has proved to be a decades-long project, as they are still visible in all Old Members' internal border regions. When it comes to managing the local cross-border relationships between the Old and New Members an extra factor has to be taken into account. The two country groups used for decades to be cut off from each other as far as spontaneous cross-border interaction is concerned, which widens the gaps in cultural, linguistic, institutional and several other fields. Empirical evidence (e.g. Karppi 1998) suggests a relationship between the degree of absoluteness of a boundary's closed character and individuals' assessments of their abilities to cope with work organizations and the overall cultural configurations on the other side of the boundary.

A common European space is far from coming true through "automatic" or self-organized developmental pathways. Many burgeoning issues that require common policies, interventions and regulatory measures are brought to the fore. They include extensive networking and learning from each other's view of the world, fostering the European knowledge-based economy and measures to support the development of human capital. For all of them, enlargement poses challenges, as it reveals major cleavages that stem from differing capacities of technical infrastructures in the two parts of Europe but also from differences in ethnic relations or public health. One of the key issues here is the state of public finances for coping with policy issues that fall within the sphere of Member States' national policies but that contribute to European prosperity and welfare as a whole.

We are now brought back to the question of the human resources needed for a successful transformation into a Europe of Regions where localities as local economic spaces constitute the decisive arenas through which Europe can strive for a leading role in the global economy. As the European Commission notes in its Third Cohesion Report, regional economies that perform well in terms of high employment levels are characterized by some distinctive factors, such as high incomes and employment structure leaning heavily on various services. Another important finding is that well-performing regional economies tend to be run by highly qualified people. The finding adds extra challenges to those faced by the New Members' regional economies. Their income levels are typically lower than those in the Old Members. In many cases their employment structures are, moreover, biased towards the more traditional industries with duly required educational standards. One of the eventual consequences as identified by the Commission is that the New Members, in the absence of adequate human resources and institutional basis, may not be capable to efficiently implement the Structural Funds and other all-European policy frameworks – including those aimed at enhanced competitiveness and global excellence.

Concluding and extending remarks

Many of the challenges now faced by Europe seem to require innovativeness, flexibility and endurance of the strata of population that has traditionally constituted the middle classes. Their particular role in modern societies has been to be a source of social stability, and their class-bound lifestyles built on trust in education followed by lifelong careers, home-ownership and social responsibility *vis-à-vis* the surrounding communities have been crucial and economically significant factors for living up to this role. The need to educate oneself is still there, but the lifelong careers, that for many members of the middle classes meant lifelong careers in the service of the local administration, are seriously endangered. With personal economic certainty removed, many other lifestyle features of the middle classes seem to be losing their ground, which in turn comes to contribute to the overall privatization of societal life.

In a given situation one is tempted to ask whether the kind of public service attitude that has helped to create socially and institutionally strong environments may have any future. In a starkly pessimistic pamphlet during the country's gloomiest recession years of the early 1990s, the Finnish philosopher Paavo Haavikko (1992, 83-84) went as far as to claim that the age of the middle classes was over together with the age of nation states. As the middle classes created, he writes, the European welfare state project for their own benefit, the fall of the middle classes inevitably meant the fall of the welfare state and vice versa. Just as it has been done in this paper, Haavikko also regards the middle classes as an administrative class that counted on pre-set norms and predictable future developments. Now these features have been replaced with resource adversity and requirements for retrenchment, and an aggressive edge shown in the use of public management tools created for controlling, monitoring, evaluating and auditing those responsible for creating competitive local economies.

In these circumstances it is no wonder that research on social capital, the dynamic force of economic systems embedded in trustful relationships and strong ties among individual members of typically imagined communities has gained such momentum in virtually all industrialized economies. In fact, social capital as a concept whose operationalization has sought to assess the economic value of trustful relationships among actors is a genuine concept of the era that created new public management ideology. Ronald Burt (1995) suggests that an agent that senses problems and possibilities in relationships and asymmetries that create a scope for reaping economic returns is no less than an entrepreneur operating in a maze of eventual links among other actors. Such an entrepreneur is an obvious role model for an organizational man in the good governance/new public management nexus – and his attachment to things that happen in his environment.

However, too much analytical information on the components of the whole coined as social capital, or on the institutional quality of well-functioning communities, may turn the qualitative, holistic and tacitly understood phenomenon into an instrumental and atomistic set of best practice recommendations to be delivered to localities that are deemed to lack it. Faithful to the new public management prescriptions, one should then duly evaluate, how "good" results and how "sustainable" long-term impacts the implemented recommendations would yield. This example shows, however provocatively, the limits of new public management even in the field of striving for enhanced competitiveness. In such a circumstance a pressing question easily emerges: with what kind of practices trust and a new sense of belongingness could be revitalized in the local and regional communities of Europe.

For the first, it should be acknowledged that stability is an asset and not a liability – even if it is easily interpreted as rigidity in social structures. As an example one could try to list the virtues of a "general instability policy" designed for European nations and for its regions and localities. For the second, it should be understood, as Niklas Luhmann (1995, 128) has noted, that as an actor's strategy of choice an ability to trust enhances one's potential for action. Trust in other actors' intentions is thus an important element in decisions taken in the midst of major uncertainties. Here we have two of the key issues while trying to understand the features that contribute to the sustainability of some locally particular decision-making systems in the face of global pressures – in addition to the hard factors such as qualified labor force, logistical advantages, dynamic enterprise structures and the like.

What it is important to understand is that stability and trust are no one-way streets to benefit only the unproductive or revenue-gorging administrative apparatuses. For instance Karppi (1999, 98) and Chua (2004, 285) have in different instances suggested that local units of the globally operating enterprises should become (and should be *allowed* to become) more embedded members of their communities of location. Meaningful and symbolically significant participation in the local civic institutions' operations could in many cases alleviate local populations' distrust and in some cases even hatred towards an actor whose operational logic differs essentially from that of most members of local populations. Hence, in a world equipped with the principles of good governance such as transparency and freedom of speech, and with public management courses of action such as accountability and control, such pro-trust and pro-stability measures should even be good for the business.

The alternative to this is hardly alluring. Globalization has asymmetric relations between different regional economies as one of its driving forces, as well as enhanced possibilities to exploit these asymmetries to the full. Such a setting may at its worst only underline a dynamic of an unbridled dual model of metropolises and satellites, with a networked metropolis comprising the strongest economic and financial centers and the satellites of the dependent periphery, whose resources to develop are in the hands of the centers. As Amy Chua has convincingly shown, add to this economic imbalance democracy as majority rule – promoted for instance through global campaigns of good governance – and you create a breeding ground for ethnic hatred, terrorism and ruined dreams of sustained economic growth.

… But is there something else to be really learned?

New public management has introduced new instruments and work methods for the development of administrative systems. New public management generally acknowledges the importance of market-led processes and the need for a cooperative division of labor between market actors and administrative entities. Thus, many of the new generation administrative processes are geared to deal with the problem of competitiveness and the challenge of adaptation in the face of the global economy. In Europe the European Union has been a major promoter of administrative evaluation, monitoring and assessment procedures.

A certain centralizing, or "Europeanizing", tendency has emerged while the new public management tools have been put into practice. The European Commission requires that structural policy programs are regularly evaluated, and the "Brussels bureaucracy" is easily seen to order these evaluations for *its* own reasons. Such a setting is problematic as it tends to alienate many of the grassroots actors who run the EU-sponsored processes from the positive impacts and the value added that the evaluations and other public management tools would at their best grant them. Instead, in the current casting of roles those are being evaluated easily regard the external evaluators as enemy detachments whose job is to entrap the local actors struggling to put the Europe of Regions ideal into practice through projects and programs with a European character.

One obvious implication that follows from the above-described setting is the need to create a mindset that would emphasize evaluation procedures as tools for *learning from European diversity*. Evaluation processes would need to be made more communicative with each other, whereas they are now geared mainly to transfer control information from the grassroots to the Commission controllers. For Western political thinking the central administrators tendency to "busy themselves" with local affairs is a long-known phenomenon, polemized by Mill in his 1861 volume on representative government. It should thus not come as surprises that as a means of more horizontal, local-to-local communication and as tools for learning among localities the evaluations in their current form – centralized collection of control information – are distinctively defective.

Conceptually feasible solutions to the problem are relatively easy to find. If Europe's key asset in the global competition is its diversity, then tools to handle this diversity and deal with it in European-wide administrative and policy procedures are needed. This can be seen as a major knowledge management and governance challenge. Linkages need to be fostered between the bureaucratic interests and technological emphasis given by the external evaluators and the tacitly designed knowledge of the "art of having things done" in different social and spatial contexts and scales. However, here we face an elementary problem of European integration: the difficulty of making the enthusiasm for and commitment to a joint European project trickle down from the EU institutions to the grassroots, to the everyday lives of regions and localities.

As far as the uneasy setting for handling the diversity and communication among the Member States and institutions of the Union is concerned, the recent eastward enlargement has only complicated the scenario. As policies for enhancing European unity are designed, a crucial aspect to keep in mind is the heritage of finding morally consistent ways of behaving with regard to the repressive public institutions shared by millions of new EU citizens. In the pre-1989 socialist regimes many of them found suitable ways to "live in truth" by playing intellectual games against the distrusted governments (cf. Konrad 1991). If the enlarged EU cannot find ways and tools to communicate with its institutional and individual members and to identify issues they are concerned about, the intellectual games may be resumed – this time against a regime that rides beneath the flag of democracy. To a certain extent and with a slight modification of scales this is a threat faced among virtually all recently democratized New Markets worldwide.

There are clearly no easy fixes to the problem, even in Europe. Possibly something to begin with, however, could be about reducing the number of initiatives for taking new issues into European-wide regulation. Reworking the subsidiarity principle on the division of labor between the EU institutions and the Member States in a way that acknowledges the importance of extended governance of basic processes on local and regional levels would be its natural sequel.

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