



Industrial Restructuring in the NIS: experience of and lessons from the new EU Member States (INDEUNIS)

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1. Project execution

Over one and a half decade of transition in the new member states (NMS) of the European Union, a whole range of systemic changes have been accomplished: markets have been opened up to competition, production and trade specialization patterns have changed, new trade relations with the EU and other market economies have been established, and the legal framework required to comply with the *acquis communautaire* has been implemented. In combination, all these changes have had profound effects on the structure of production and trade. In the Newly Independent States (NIS: Russia, Ukraine, Belarus, Kazakhstan and Moldova), transition and restructuring processes were delayed, and have progressed at much lesser speed (and partly also in different direction) than in the NMS. At the same time, the recent economic growth in the NIS has been as a rule much faster than in the NMS: e.g. GDP growth in Belarus, Kazakhstan, Ukraine and Russia – driven initially by high commodity prices, but with booming domestic demand and first signs of economic diversification emerging – continues to match, if not outperform, even the most successful NMS.

While the issues of industrial and trade restructuring, FDI patterns and policies, and economic (EU) integration – all crucially relevant in order to estimate the extent of systemic change in the East European transition economies and identify the remaining policy challenges – had been analyzed in both theoretical and empirical literature before (albeit less so for NIS), there was very little comparative research covering both groups of countries. Neither was there sufficient awareness within the NIS about the successes of the NMS in attracting FDI, restructuring their industry, and – last but not least – establishing proper (country-specific) domestic institutions such as property rights, regulatory structures, and the quality of legal and administrative systems (neither was there sufficient awareness, for that matter, within the NMS about the patterns of structural change in the NIS).

The crucial contribution of INDEUNIS, an international research project financed by the European Commission under the 6th Framework Programme, has been to fill these gaps via creating an international research consortium analyzing a broad spectrum of above issues, with the aim of formulating clear-cut conclusions and policy recommendations. The project consortium brought together a team of researchers from a wide range of countries, including:

- The Vienna Institute for International Economic Studies (wiiw), Austria, which acted as a project coordinator;
- Foreign Trade Research Institute (IBRKK), Poland;
- Institute of Economics, Hungarian Academy of Sciences (IE HAS), Hungary;
- Institute of Baltic Studies (IBS), Estonia;
- Turku School of Economics and Business Administration (TSEBA), Finland;

- Institute of Economy, Russian Academy of Sciences (IE RAS), Russia;
- Development Centre (DC), Russia;
- Center for International Economic Studies, Academy of Sciences of Belarus (CIES), Belarus;
- International Centre for Policy Studies (ICPS), Ukraine; and
- Olga Pindyuk, private researcher, Ukraine.

The consortium partners jointly investigated the experience with economic transition, industrial restructuring and integration in both the New EU Member States from Central and Eastern Europe (NMS) and selected NIS. More than 50 research papers providing a detailed and up-to-date analysis of the patterns of structural change, trade specialization, foreign direct investment, economic integration, and outlining the relevant policy implications are available on the project Internet website.¹ Another important aim of the project has been to intensify the cross-border cooperation and research networking between the partners from the EU and the NIS.

On the basis of research findings, the INDEUNIS project drew conclusions and policy recommendations related to restructuring prospects in the NIS, addressed the challenges of their WTO accession, and evaluated the prospects for a closer integration between the enlarged EU and the NIS, as well as for regional integration within the NIS, taking into account the discussions held at the project workshops in Vienna, Kyiv and Moscow, where diverging views frequently emerged. By disseminating the research results to the scientific community, policy makers and a broader public, the project not only attracted attention to the importance of trade and FDI for restructuring and integration in the NIS, but also stimulated and deepened the expert discourse. Last but not least, it also helped avoid possible pitfalls of poorly designed or implemented policies and raised the general understanding of analysed topics.

The project research findings were summarized in the final book, forthcoming in NOMOS publishing house. The book reflects the heterogeneity of the project team and covers both thematic cross-country subjects on transition experiences, industrial and trade restructuring, foreign direct investments, and country-specific (Russia, Belarus, Kazakhstan and Moldova) and even region-specific (Kaliningrad) studies. The most relevant policy issues dealt with in more detail are grouped into four broad areas: economic restructuring and integration, industrial policy, foreign direct investments, and European integration.

Economic restructuring and integration

Restructuring and integration can be seen as two sides of the same "transition" coin. Russia and other NIS have made considerable progress in both areas, yet they still lag behind the NMS. It is generally agreed that while the NIS lag behind the NMS in reforms and restructuring, the transition

paths followed are fairly similar. As the INDEUNIS project has shown, both groups of countries underwent during the last one and half decades an overlapping sequence of structural change, roughly in four stages:

- 1) geographical reorientation of trade,
- 2) change of commodity composition in output and trade,
- 3) integration into European (and global) markets based on comparative advantage, and
- 4) beginning of shifts up the ladder of comparative advantage.

Most studies argued broadly that the NMS-NIS lag – most visible in stages 2–4 above – is largely explained by the initial delays in market reforms and a subsequent slower pace and not by worse starting conditions or more “radical” reforms. Some papers on NIS qualify this, arguing that rapid liberalization without an accompanying policy for restructuring resulted in excessive resource specialization and a sort of “primitivization” of the economic structure (in particular the papers by Filatov et al., and Mironov and Dorogov.) It is nevertheless agreed that in the NIS, essential reforms started with a five- to ten-years delay. This was for many reasons, including extended policy debates, opposition of old and new vested interests, local conflicts, and the absence of EU accession perspective. That perspective was important for the NMS, as it reinforced the political determination to proceed with reforms. In contrast to Western Balkans (and even there with some important qualifications), the NIS are unlikely to obtain an EU accession perspective anytime soon (Russia does not even want that perspective since it considers itself “special” with own growth and integration strategies). Other available external institutional ‘anchors’ – in particular WTO membership – may have been too weak for a committed pursuit of reforms, partly also because the associated direct financial “carrots” may be too small.² One way to replace the lacking accession anchor is to offer better access to the European market and programmes to those who are not already members, i.e. to reduce the distance between membership and non-membership (Tsoukalis, 2007). Indeed, the international research cooperation within INDEUNIS can be seen as one of such “distance reducing” exercises.

The above points, elaborated in more detail in Oleh Havrylyshyn's contribution, lead to two “simple ” **policy recommendations** for the NIS:

- follow the reform path of the NMS and complete the policy transition;
- look for the best available external anchor.

¹ See: <http://indeunis.wiwi.ac.at/>.

² Direct trade and welfare effects of EU enlargement and WTO accession are generally small – albeit positive, but indirect positive effects of increased competitive pressures can be much more important. One observes a harmonization of the NIS legislation with the EU standards. It is not clear whether the adoption of specific EU standards will contribute to faster growth in or modernization of the NIS. In the NMS the legislative convergence turned out to be a profitable investment (EU membership, transfers from the EU budget, attraction of FDI). But, as already pointed out, the association of NIS with the EU cannot be assumed, even in the long-term perspective.

The lack of an accession anchor also means that other available and compatible anchors should be attached as soon as possible – in particular WTO accession (though in Moldova the latter was not sufficient to outweigh political obstacles). The Baltic strategy in the early 1990s before the June 1995 Europe Agreements, acting “AS IF ACCESSION” would come and proceeding with Accession-like reforms, may not have a very high probability of attaining Accession agreements for the willing NIS, but the risk or cost is very low, while the benefits of reform progress are high. That the Baltics did pay a small cost for such a unilateral Acquis implementation is shown in some INDEUNIS papers (Tiits, 2006); they have done better than the NIS but were so far less successful than other NMS in restructuring.

Looking forward, the policy choices are best seen as a **set of non-exclusive options**:

- proceed with the liberalization and institutional development process as the NMS have done;
- provide more government budget for renewing and expanding infrastructure in roads, telecommunications, scientific research;
- establish an Industrial Policy (IP) to promote priority sectors, hi-tech exports, using budgetary and tax-relief mechanisms;
- use tariff and other protection under an IP policy for temporary support to infant-industries or a revival of old industries.

The bottom line on the experience of structural change (illustrated i.a. by Peter Havlik) and policy implications for the future is that the NMS have been very successful, and provide an object lesson for the NIS – albeit the latter is not unequivocally accepted in Russia owing to its claim to be “special” (Grinberg, Filatov et al. and others argue this; Hunya’s contribution suggests it should not try to be so special, then more FDI could be attracted.). The major component of NMS success has been the steady progress in market reforms, including liberalization, all with a small lag in institutional development. For the NIS, following the same path – despite the problems early delay has caused – would seem the best recommendation.

The alternative of a strong state intervention in the form of IP selecting and providing support (and/or temporary protection) for priority sectors is tempting, but it provides no assurance of success and creates a large risk of abuse, corruption and budgetary costs. A second component of NMS success, the EU accession anchor, is not in the medium-term likely for any of the NIS. Some weaker substitutes like an enhanced ENP+, EUFTA, may be developed. But a workable surrogate is always to emulate the Baltic experience before 1995 and act “AS IF” moving towards Accession, which means an even more vigorous effort on completing the liberalization and institutions reforms. Better state intervention for improved infrastructure, a sort of ‘soft’ IP can be more effective, not least because it may be less costly than conventional IP and has less risks of corruption and capture by vested interests.

The experience of NMS shows that the creation of general economic circumstances favourable for both foreign and domestic investors (businesses) is crucial. In the creation of such conditions, progress in the NIS has been rather limited, and without such progress, sustainable economic, industrial and trade development cannot be achieved. Building up the modern market economy's institutional system has to be continued in the NMS, and has to be accelerated, starting from a still rather low level, in the NIS. All of the above requires strong and independent judiciary power. Corporate governance and other crucial aspects of institution building, in which differences between NMS and NIS countries are even greater than for market liberalization, may be more important in explaining NMS-NIS differences in performance than trade or market liberalization or macro policies, which are by now well advanced. Corporate governance problems are particularly strong in deterring foreign investors (as exemplified by Hunya) – be it in privatisation, in becoming outside owners of private (privatised) enterprises, or in establishing new firms (green field investments).

Industrial Policy

The Russian government recently endorsed long-term development strategies for several industries and set national priorities for mid-term development. These are, however, not sufficiently supported by any effective policies for encouraging investments in the priority areas, and have so far failed to markedly redirect the overall economic policy. The present industrial policy *à la Russe* is understood as a set of government measures influencing business entities, exercised in order to encourage their active involvement in structural and technological modernization or a rapid development of individual industrial sectors. Specific investment programmes in various priority areas are to pool financial and technological resources for economic modernization, financed via special development institutions including the wide involvement of private capital within the frameworks of public-private partnership (significantly, FDI policy is not mentioned). The argument of possible IP inefficiencies and the danger of corruption is not accepted: it is argued that the “strong state” will prevent abuse and the “quality of bureaucrats will improve together with tasks they handle”.³

Important counter-arguments are provided i.a. by Soos and Fertö quoting Mille, 2006:

‘Rather than wishing for “more honest” officials, or prioritizing stricter controls and penalties (as do the public) or higher salaries (as do officials) as solutions to the problem of corruption - the analytic findings point to the importance of reducing the situations in which corruptibility is most likely to be translated into corruption. Reforming situations means providing clients with alternative access points and better appeal procedures. It means more clearly and publicly set out rights for clients on the one hand and more clearly and publicly set out user charges, tariffs or “price lists” on the other.’

Economic arguments in favour of targeted industrial policies are controversial, though in some circumstances such policies may succeed in fostering growth of national companies. Indeed, it is

³ See Grinberg, R. (2007), “Restructuring and economic reforms in Russia: a plea for an effective industrial policy”.

fair to say that after some disappointment with horizontal industrial policy, there has been a revival of interventionist instincts also in the EU. However, the authors find that the likelihood of failure in picking the winners is particularly great in high technology sectors, where the risk of making wrong choices is particularly high. Supporting research and innovations, the access to technology by small and medium sized enterprises is certainly beneficial and much less controversial. Contributions by Grinberg, Mironov and Dorogov, Havrylyshyn, Soos and Fertö provide more extensive discussion of issues involved.

Foreign Direct Investments

The weakness of FDI inflows into the NIS is recognized as a serious deficiency – despite recent signs of an upswing. Though FDI cannot be the predominant source of investment financing, they play multiple important roles in the NMS, and the way to that would be open to NIS, too. NMS nowadays attract both new FDI projects and upgrading investments from simple efficiency seeking to more complex network-type integrated production (exemplified by Hunya). New FDI concentrates in the more internationalized industries such as automotive and electrical engineering. Foreign penetration has supported the upgrading of industrial structures and improved competitiveness. Empirical analysis shows that industrial integration through FDI led to considerable increases in productivity, technology and quality, as well as in sales and exports whereas the evidence for positive spillovers to domestic economy is not straightforward.

In Russia and other NIS, much of the investment inflows recorded so far probably stem from Russian-owned assets held offshore and reinvested in Russia or NIS, rather than from investors outside the region bringing fresh capital, technology and management know-how. Russian FDI policy is still to a high degree protectionist and the infant industry arguments prevail over benefits of economic freedom. FDI policy is not considered as an integral part of industrial policy (and the same can be said for Ukraine). Russia's greatest untapped potential lies in efficiency-seeking FDI. With its technological capabilities and labour skills, Russia could become a major international engineering hub. But the success may prove difficult under a scenario of intense global competition for FDI projects, in which case the country would also need to accelerate its investment promotion efforts, including the liberalization of FDI. The use of targeted incentives should be considered with great caution. If a better FDI policy is developed, Russia could multiply its inward FDI stock within a relatively short period of time.

European Integration

The conditions of a desirable development between the enlarged EU and the NIS include further mutual liberalisation and encouragement of industrial (but not only industrial) cooperation, where the stronger side – i. e. the EU – has to be the initiator. The contrasting view is that Russia is different from both NMS and other NIS: it is big and does not want to be integrated with the EU (for this argument, see Glinkina and Kulikova). According to this view, Russia should develop its own integration space covering a large portion of the post-Soviet area and regenerate the multisectoral

economic structure aimed, in the first place, at the domestic market across the entire CIS, though the big question is whether other NIS, particularly Ukraine, want the same.

The relationship between the enlarged EU and the NIS on the post-Soviet space requires a more intensive search for constructive approaches to the interaction within the triangle of Russia-EU-CIS countries. A view shared by all INDEUNIS partners is that turning the space of the common "near abroad" of both Russia and the EU into a conflict area would be the worst possible outcome. Both Russia and the EU should therefore develop a coordinated policy of neighbourhood. Such a policy should recognize the futility of "competing integrations" in relation to the NIS where Russia tries hard to involve its major partners in the Customs Union of the "Four", and the EU hinders this in any way possible while offering those countries no clear prospects of a deeper EU economic integration. Single Economic Space (SES) integration should be an "interface" project between the EU and the CIS, as a part of a gradually evolving concept that we may label the Common European Economic Space (CEES). On this space, prerequisites for free capital flows, cross-border investments in productive and infrastructure projects should be established. One of the key problems is linked to the institutional approximation of EU and NIS legal regulations which is taking place by the harmonization or unification of NIS legislation towards EU laws (see "AS IF" policy approach above). The question is to what extent does this promote the NIS economic growth and economic modernization given no opportunities for using EU structural funds.

The example of **Kaliningrad** analysed in Smorodinskaya's contribution illustrates that the traditional algorithm "them and us" or "native and alien", increasingly dominating foreign and security relations of the two parties, is not appropriate. Both Russia and the EU will have to revise the existing distrustful style of interaction and try to model some positive common values from a mass of presently conflicting interests. Russia's current policies towards the enclave have so far been counterproductive to its sustainable development. **Kazakhstan** and **Moldova** are two very interesting examples for the resource dependency problem. Rakhmatulina in her contribution describes the increased specialization of Kazakhstan in resources, and outlines the official Industrial Policy strategy intended to achieve diversification towards sectors with higher value-added. An earlier INDEUNIS paper (Libman, 2006) looked at the factors explaining this tendency, pointing out two: the natural comparative advantage especially as new fields were discovered; and the political economy dynamics of vested economic interests which benefited from the resource boom. Contribution by Libman on Moldova shows that both countries are among the most successful from the point of view of implementation of reforms (at least in the NIS context). The main challenge also remains the same: continuation of institutional reforms necessary for the establishment of a functioning market economy. The classical instruments of "structural policy", which became extremely popular in Kazakhstan since 2004, do not seem to be appropriate solutions because of the structure of interest groups influencing the economic policy. Moldova's restructuring and development is, apart from a number of inherent problems, hampered by the persistent Transdnistria conflict. It is practically impossible to achieve any success in economic restructuring without solving this political problem.

Ukraine (and to a lesser extent Moldova) may have better prospects of EU integration and even eventual accession – though only in the long-run. In the medium-term, it is possible to see new modalities developed, which do not quite reach accession perspectives but go well beyond the so-far ineffective process envisioned in the European Neighbourhood Program. This may start with a deeper free-trade approach that includes services and financial sector integration, and perhaps even labour mobility elements. But even for Ukraine, this is by no means a certainty, hence it too must fall back upon the domestic reform option including “AS IF”. One new problem - though often seen in the experience of emerging markets - is that the continuation of very high GDP growth rates creates complacency amongst policy-makers and a view that “we don’t need any reforms, integration.”

Last but not least, Vassilevsky et al. argue in their contribution on **Belarus** that its present highly monopolized economic system has no chance to adjust to any global, regional or even domestic market challenges and clearly needs to be reformed. Yet the internal market liberalization under the WTO accession must correspond to the financial durability of specific industries as well as to the fact that high value added industries - which are deemed strategic for country’s future development - need additional protection in forms compatible with the WTO rules. The weakest point in Belarus’ current economic model is located in the investment policy. In this context, FDI from the EU would be more favourable (rather than FDI from Russia) as they offer better prospects for acquiring new technologies and know-how. Attracting FDI from the EU will require also the “establishment of European standards” (read: “institutional reforms”) in banking and insurance services which in turn, implies an ongoing liberalization.

Conclusions

Trade and investment integration of the European economy has been rapidly progressing yet there is a clear mismatch between (mostly successful) activities of individual companies and the existing contractual and institutional framework at the inter-state level. It can be realistically assumed that all major NIS (including Russia and perhaps even Belarus) will become WTO members in the next 2-3 years. However, neither WTO membership (see example of Moldova) nor Partnership and Cooperation Agreement (PCA) can be seen as sufficiently strong and credible institutional anchors for stability, further restructuring and consequent institutional reforms.⁴ An equally sober assessment regarding the anchoring impact of an envisaged Deep Free Trade Agreement with Ukraine, not to speak about the uncertain post-PCA deal with Russia, has to be made.⁵ The existing regional trade arrangements such as CEFTA in Western Balkans or the CES in the CIS (in both plays the EU a key role as a major trading partner of the countries concerned) are not

⁴ Even a distant perspective of EU membership may not be sufficient as a factor of stability.

⁵ A recent (not yet published) study on the feasibility and general economic impact of a free trade agreement between the EU and Russia by CASE argues that both parties would benefit, particularly if it is a deep one – see CASE e-Newsletter July/August 2007.

sufficient alternatives to a broader integrated Common European Economic Space (CEES) encompassing both the enlarged EU, Western Balkan countries and the CIS either.

Although the CEES is economically preferable (another major conclusion from the INDEUNIS project), it is currently for various reasons not a realistic option – at least in the short and medium run owing to diverging political interests and the existing bilateralism in EU's external relations. Still, this does not preclude pursuit of partial integration steps in selected areas of common interests. Among these are such urgent issues as: energy supplies (including problems of energy security and transit); further liberalization of trade and investment flows; labour market challenges affecting European growth and competitiveness (emerging shortages of skilled workers, including labour migration, in both East and West); institutional developments (in particular corporate governance issues); and further financial markets integration. Furthermore, the very important proposition raised especially by Russian INDEUNIS partners, namely that "Russia is different" and can pursue its own development and integration strategies, must be more thoroughly investigated.⁶

Given the strong evidence regarding beneficial effects of EU integration, in particular (but not only) for the NMS,⁷ as well as important – though often lopsided – EU-Russia-NIS trade links, there is an urgent need for a move towards a broader and smoother European economic integration. From the outside it appears that Russia now represents the main (though not the only) stumbling block. It seems to be no coincidence that Russian external relations with most of its neighbours have recently deteriorated: not only with the EU (where some NMS have been blamed), but also with Ukraine, Georgia and even with Belarus. Joint actions are needed by all parties, with the EU as a stronger partner taking the initiative, along with Russia, for only it can take effective actions to address the concerns of other NIS in creating the conditions for an improved partnership in a wider common European economic space. Indeed, this should be one of the key parts of a new EU-Russia agreement following the expiry of current PCA. In any case, the current confrontation must be overcome and turned into a new cooperation which is urgently needed for the stability and economic growth in Europe.

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http://www.wiwi.ac.at/e/research_networks_indeunis.html)

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⁶ For the context see Zhuravskaya, E. (2007), as well as a broad current discussion in Russian press.

⁷ See Gligorov and Richter (2007).

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2. Dissemination and use

2.1 INDEUNIS Press release

Results of a joint study of restructuring in the NMS and NIS: Conclusions and policy recommendations for the NIS

By wiiw/IE RAS, 18 May 2007

Executive summary

INDEUNIS, an international research project coordinated by the Vienna Institute for International Economic Studies (wiiw) and financed by the European Commission from the 6th Framework Programme, brings together researchers from **Austria, Poland, Hungary, Estonia, Finland, Russia, Belarus, Kazakhstan and Ukraine** who jointly investigate the recent experience with economic transition, industrial restructuring and integration in both the New EU Member States from Central and Eastern Europe (NMS) and the selected Newly Independent States (NIS: Russia, Ukraine, Belarus, Kazakhstan and Moldova). More than 50 research papers analysing patterns of structural change, trade specialization and economic integration are already available on the project Internet website. The main **conclusions and policy recommendations for the NIS** can be summarized as follows:⁸

Not very surprisingly, a key **INDEUNIS** finding is that while the NIS lag behind the NMS, the path being followed is in fact fairly similar and the lag is largely explained by a slower pace of market reforms. A considerable progress has been made since the late 1990s - after many delays and reversals. There are "only" two key **differences** in the experience of the NMS and the NIS:

- NIS lagged 5-10 years on reforms;
- NIS did not have the discipline of the EU Accession targets to reinforce political will for reform.

These points lead to two "easy" **policy recommendations** for the NIS:

- follow the reform path of the NMS and complete the policy transition;
- look for the best available external anchor.

⁸ See: <http://indeunis.wiiw.ac.at/>; in particular Work Package (WP) 6.

The lack of an Accession anchor also means that other available and compatible anchors should be attached as soon as possible - in particular WTO accession (though in Moldova the latter was not very helpful).

The "AS IF ACCESSION " policy (Baltic strategy from early 1990s) may not have a very high probability of a win, but the risk or cost is zero or very low (though a unilateral Acquis implementation can be costly and, as some INDEUNIS papers show, the Baltics were less successful than CEEs in restructuring).

Looking forward, the policy issue is best seen as a set of non-exclusive options:

- proceed with the liberalization and institutional development process as the NMS have done;
- provide more government budget for renewing and expanding infrastructure in roads, telecommunications, scientific research;
- establish an Industrial Policy (IP) to promote priority sectors, hi-tech exports, using budgetary and tax-relief mechanisms;
- use tariff and other protection under an IP policy for temporary support to infant-industries.

The bottom line on the experience of structural change and policy implications for the future is that the NMS have been very successful, and provide an object lesson for the NIS. The major component of NMS success has been the steady progress in market reforms, including liberalization, all with a small lag in institutional development. For the NIS following the same path, despite the problems early delay has caused, would seem the best recommendation.

Corporate governance and other crucial aspects of institution building, in which differences between NMS and NIS countries are rather obvious, are the key to explaining NMS-NIS differences in performance (and not trade liberalization, macro policies, etc.). Corporate governance problems are particularly strong in deterring foreign investors, both in privatisation, and in becoming outside owners of private (privatised) enterprises, and in establishing new firms.

The alternative of a strong state intervention in the form of Industrial Policy is tempting, but it provides no assurance of success and creates a large risk of abuse, corruption and budgetary costs. A second component of NMS success, the EU Accession anchor is not in the medium-term likely for any of the NIS. Some weaker substitutes like an enhanced ENP+, EUFTA, may be developed. But a workable surrogate is always to emulate the Baltic experience before 1995 and act "AS IF" moving towards Accession, which means an even more vigorous effort on completing the liberalization and institutions reforms.

The creation of general economic circumstances favourable for both foreign and domestic investors (businesses) is crucial. In the creation of such conditions, progress in the NIS has been rather limited, and without such progress, satisfactory economic, industrial and trade

development cannot be achieved. Building up the modern market economy's institutional system has to be continued in the NMS, and has to be accelerated, starting from a still rather low level, in the NIS. All of the above told requires strong and independent judiciary power.

Summary recommendations from the INDEUNIS research focus largely on three key policy areas (**Industrial Policy, the Role of FDI and European Integration**) which are both the most relevant while at the same time most controversial – particularly for the NIS (and especially for Russia). Selected country-specific issues for Kazakhstan, Moldova and Belarus are briefly addressed as well.⁹

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2.2 The consequences of WTO accession for Belarus

By Kiryl Kurilionak, Stanislav Vassilevsky and Vitaly Medvedev, CIES

Executive summary

In this paper, the authors consider the possible consequences that accession to the World Trade Organization (WTO) bears for Belarus. Their approach is based on partial equilibrium. They have applied a method of locating specific 'sensitive' points in the economy and treating them as separate items: specific elements in the economic system on which WTO access will have an appreciable impact.

The research focuses on Belarusian manufacturing. The authors first determine possible changes in access to foreign markets associated with the cancellation of discriminatory non-tariff, antidumping and other restrictive measures introduced by WTO members. Total losses to the Belarusian manufacturers are currently estimated to be of the order of USD 230-250 million a year. Lifting those barriers will constitute the immediate short-term benefits to Belarus on accession to the WTO.

In order to assess the short-term impact of WTO accession on Belarusian manufacturing, the scenario used assumed a reduction of tariffs, complete removal of discriminatory measures and a lowering of market barriers to Belarusian exports. A quantitative assessment was made of the gains and losses by manufacturing branch, followed by a simple sensitivity analysis. The latter revealed the Belarusian manufacturers' ability to withstand increased import competition up until such time as the requisite restructuring measures have been introduced. Summary conclusions are drawn for each branch in the light of those findings.

⁹ Direct economic effects of EU enlargement and WTO accession on the NIS (also investigated by the INDEUNIS) were small (albeit positive) while their medium- and long-run effects on increased competition and reform pressures are probably more important.

One section of the paper focuses on the implications for Belarus of the Russian Federation's accession to the WTO. Consideration is given to the possible impact on Belarusian exports to the Russian market. The analysis shows, however, that Russia's joining the WTO does not incur the risk of Belarus losing its share of the Russian market.

In the final section, consideration is given to state support for agriculture and the development of service markets, with a discussion on possible forms of, and limits to, liberalization.

The final conclusion of this paper is that liberalizing the imports of certain items is very much in line with the need to revise the current structure of trade specialization in Belarus. Import liberalization should not be seen simply as a trade-off for the non-discrimination of Belarusian exports. If the economy of Belarus is to benefit, the country must pursue a consistent policy of cutting back or closing down those manufacturing activities that are unlikely to evolve into internationally competitive industries. Liberalization of the domestic market in the wake of WTO accession must be in keeping with: (a) the financial viability of specific industries; and (b) the need to provide in a manner compatible with WTO rules and regulations additional protection to those industries with high value-added that are of strategic importance to the country's future development.

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2.3 The impact of EU enlargement on economic restructuring in Russia and future relations between Russia and the European Union

By Svetlana Glinkina and Natalia Kulikova, IERAS

Executive summary

Russia is shown to have every reason to seek special consideration of, as well as express its concerns over, the impact of the European Union's (EU) eastern enlargement. The latter relate, in particular, to the current and expected negative repercussions of the changes in the political and economic situation in Europe. Closer study of crucial EU enlargement issues arising as a result of the new member states (NMS) having shifted to the EU common customs tariffs and preferential systems, their adoption of the EU foreign trade regime and the standardization of cargo transit rules and regulations applicable across the EU-25 as a whole demonstrate the need for a comprehensive approach to EU enlargement. That would make for a better understanding of the multifaceted and controversial impact that enlargement will have on the economic transition and industrial restructuring processes in Russia. As the EU penetrates more deeply into the markets of the countries of Central and Eastern Europe, Russia's share in bilateral and multilateral trade as well as other joint economic activities could be reduced still further.

Russia is trying to promote its own specific vision of European integration based on two pillars: the European Union in the West and Russia-initiated integration models in the East (e.g. a Single Economic Space). By taking that route, Russia could retain its political and economic influence in those post-Soviet

European countries, where its strategic interests lie. The EU subscribes to a markedly different approach. In late 2002 it began pursuing its European Neighbourhood Policy (ENP) that was specifically aimed at the eastern neighbours of the enlarged EU. It has demonstrated its growing political and economic engagement with those CIS member states that are now part of the ENP.

The ENP transmits a clear message to Russia; it clearly signals the European Union's specific interests and objectives in Eastern Europe. The policy is quite explicit; it reveals that the EU intends to discuss all issues directly with the countries concerned, while the mediation of Moscow is totally or mostly ignored. As a result, a conflict of interest is becoming increasingly apparent in Eastern Europe, with the EU adhering to its ENP and Russia promoting its integration model. Numerous indicators of the state of relations between Russia and the EU show that however important it may be, economic cooperation is increasingly fraught with ambiguity and competition, which, in the final analysis, can but have a negative impact on the efficiency of that joint relationship.

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2.4 Structural change and trade integration on EU–NIS borders

By Peter Havlik, wiiw

Executive summary

This paper investigates the process of trade integration between the enlarged European Union and the Newly Independent States (NIS), focusing on the new EU member states (NMS) and selected NIS (Russia, Ukraine, Belarus, Moldova and Kazakhstan). The paper analyses the evolution of the regional and commodity composition of trade in the countries concerned. A detailed market share analysis reveals the emerging trade specialization patterns. There has been a general trade reorientation of both NMS and (less so) the NIS towards the West. The recent trade developments on EU–NIS borders indicate a closer trade integration among the NMS, declining trade integration among the NIS, as well contradictory shifts in NMS–NIS exports and imports. The importance of the NIS as export markets for the NMS is growing, in particular for the NIS neighbours. The bulk of EU exports is made up of manufacturing products. By contrast, EU imports from the NMS and NIS display a much more diversified pattern. The key NMS manufacturing export commodities to the NIS are chemicals, machinery & equipment, motor vehicles and food products, whereas NMS manufacturing imports from the NIS are dominated by basic metals, refined petroleum, chemicals and fabricated metal products, and there is a high concentration on just a few basic manufactures. The NMS increasingly specialize on high-tech and medium-high-tech products. The wide-ranging modernization and industrial restructuring in the NMS has been facilitated by the process of EU integration and by massive inflows of FDI whereas in the NIS the resource specialization generally increased as reforms and restructuring were delayed. It is questionable whether the NIS will be able to

revamp their industrial structure without significantly stepping up reform efforts, trade integration and attracting more FDI.

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2.5 Moldova: structural change, trade specialization and international integration

By Alexander Libman, IERAS

Executive summary

After fifteen years of economic transformation, Moldova still remains a mostly agrarian country. The industrial sector is only successful in connection with agriculture (such as the production of food or beverages). The country's agrarian structure seems to be a legacy of Moldova's former role in the division of labour within the Soviet Union. Although the absence of the 'resource curse' facilitated Moldova's relative success in economic and political institutional reforms, there are still significant drawbacks in the quality of the economic order which prevent the institutional factor from compensating the 'geographical' deficits. An additional problem is the Transdnestrian conflict, which has resulted in the existence of a 'split state' and a 'split society'. High labour emigration in the wake of rising poverty, deficits of the labour market and the advantages of social integration within the post-Soviet space have a twofold effect on economic transformation: they reduce internal demand and workforce potential, but also create a permanent and significant inflow of migrants' transfers and establish opportunities for learning effects.

Moldova's geographical structure of trade is still dominated by the CIS. The European vector of its foreign trade remains underdeveloped, partly because of EU agricultural trade restrictions, but to a great extent because of internal trade barriers. Moldova's major comparative advantage (with respect to both the CIS and the EU, as well as globally) lies in agricultural production – food, beverages, tobacco, animal and vegetable oils – which is reflected in a very low diversification of exports. Imports are by far more diversified; the major imported goods are fuels, machinery and equipment. The energy intensity of the Moldovan economy makes the country extremely dependent on Russian gas and oil.

In order to achieve positive structural shifts and move away from agricultural specialization, Moldova needs to continue economic and political reforms and improve the quality of the investment climate in order to attract FDI. A peaceful resolution of the Transdnestrian conflict is of vital importance from the point of view of investment risks. Further consolidation of democracy could help to reduce rent-seeking and state capture (which is still very high in the republic). The evolution of the Communist administration since 2001 has been very promising in this respect. Moldova seems to be a natural benefactor of 'open regionalism' solutions in the Eurasian space, which could give it an opportunity to simultaneously improve its trade relations with the EU, the CIS and Southeast Europe. The EU Neighbourhood Policy could act as a trigger for internal reforms and as a factor of external re-orientation (if major problems such as Transdnestria

could be resolved). On the other hand, Moldova could benefit from a redesigning of post-Soviet integration to make it compatible with the Western vector of integration, reduce political aspects of the 'protective integration' currently inherent in the CIS and similar groups, and focus on the opportunities of open regionalism solutions.

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