



ICEG EUROPEAN CENTER

NEWS OF THE MONTH *on EU-10 and CIS*

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News of the Month, on EU-10 and CIS

The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

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The Kyrgyz Republic – Elections and Challenges

Olivér Kovács

The purpose of this article is to contribute to the current discussions on political challenges ahead of Kyrgyzstan beyond the macroeconomic problems. Although the new political economic theory suggests that the substantial changes of the given constitution are go to seldom count, we can find precedent for such process. The Kyrgyz Republic after violently vicious months had decided with a referendum – with 65 per cent of the votes – in June 2010 to become a more parliamentary system leaving behind the presidential form which is dominant in the Central Asian region.

As a corollary of this, Kyrgyzstan will hold parliamentary elections in October 2010. Having adopted a new constitution and the establishment of the parliamentary system are likely to be a crucial step towards fostering both the rule of law and the democratically elected and legitimised government. But the future development of the country mostly depends on the political stability providing transparent and well-functioning institutions. Therefore we argue that the peculiarity of the political system also has to be painstakingly considered among the major challenges of the Kyrgyz Republic.

Macroeconomic performance

The interim government of the Kyrgyz Republic, formed on 8 April 2010 and headed by Roza Otunbaeva, announced a National Referendum on significant changes of the formerly deployed presidential system. In order to make progress in the democratic process, Kyrgyzstan has to consider further constitution reforms, institution building, whereby it could promote prosperity for all citizens.

If we take a mere glimpse into the development of selected macroeconomic indicators, we can claim with reasonable certainty that the economy has seemingly faced a serious decline by 2009 due to the global financial meltdown; however, it did not turn into recession.

To dampen the negative effect of financial crisis on households' income, induced by the significant waning of remittances, the government applied real exchange depreciation. Beyond that, the economy was able to avoid recession as a result of *inter alia* the stern fiscal stimulus, the EBRD support to financial sector as well.¹

¹ It is worth noting that the EBRD is the biggest investor in the Kyrgyz Republic. The overall investments account for about € 252 million which focused on various sectors including infrastructure, energy and financial sectors.

Table 1. Selected macroeconomic indicators over the period 2002-2011 (% of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010*	2011*
Real GDP growth	0.0%	7.0%	7.0%	-0.2%	3.1%	8.5%	8.4%	2.3%	4.6%	5.3%
Inflation	2.1%	3.1%	4.1%	4.3%	5.6%	10.2%	24.5%	6.8%	8.4%	7.6%
Current Account Balance (% GDP)	-4.0%	1.7%	4.9%	2.8%	-3.1%	-0.2%	-8.1%	3.4 %	-15.4%	-12.5%

Note: The data for 2010 and 2011 are estimated by the IMF.

Source: IMF (2010).

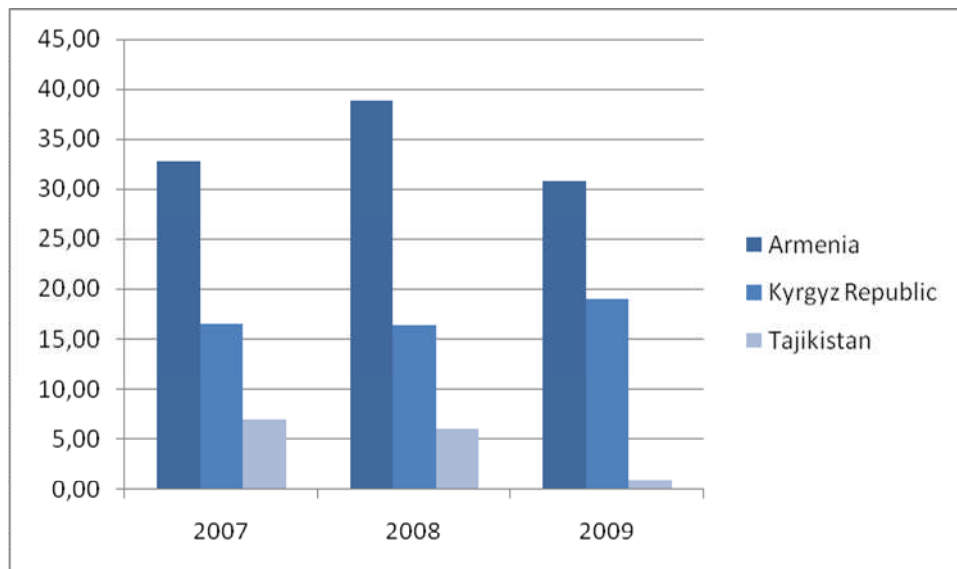
As *Table 1* depicts, the downturn in the real GDP was about 6.1 per cent by 2009. As a result of the still viable agriculture sector, growth remained in the positive range. Another equally important component was the construction and service sector. However, industry went through a perceptible drop due to the impaired domestic and foreign demand conditions. The real GDP growth data *per se* does not call for the inevitable reforms in the low-income and fuel importing economy; nonetheless there are certain signs for that.

Major challenges

One of the major risks could be the high *foreign investment dependency* (23.2 per cent of the GDP in 2009) during the financial crisis. Recent studies accentuate the central role of foreign direct investment on economic growth through the distinct improvement of total factor productivity especially in the financial sector (Alfaro et al. 2008). Until last year, FDI has largely flowed into the financial sector of Kyrgyzstan reflecting the lack of necessarily diversified economic conditions and productivity disadvantages in other sectors.² The thriving current account deficit also demonstrates the fact that the Kyrgyz Republic is generally financed by foreign resources.

Furthermore, the economy *relies on remittances* especially from Russia. The Kyrgyz remittances stood at 23 per cent of GDP in 2008. In comparison, the same data for Armenia, Georgia, Moldova and Tajikistan were 9, 6, 31 and 52 per cent of GDP in 2008, respectively. As a consequence of the surpassing FDI dependency, the economy is exposed to the risk of quick capital outflow generating a rise in borrowing cost in parallel with narrowing credit activity. It is rather telling that the country needs to be supported by international organisations (e.g. EBRD, UN) in order to stabilise the imbalances and to vivify the anaemic credit.

² This was shown by IMF (2004).

Chart 1. Development of the foreign direct investment (% of GDP)

Source: World Investment Report 2010

Despite the sound fiscal policy of the government prior to the crisis (*Chart 2, Chart 3*), there is still room for improvement regarding the deleterious gap *between expenditures on social programs and the revenues*. The Kyrgyz Republic increased the government spending on social programs by 33 per cent in 2009. While the perspective of an outbalanced budget would be able to guarantee the long-lasting sustainability of the Kyrgyz public finances, the above circumstance may potentially lead to difficulties in financing the economy. The shrinkage in private consumption and investment suggests that the government by no means had the necessary fiscal latitude to alleviate the recession pressure by running deficits. In the absence of sufficient domestic resources, external financial resources were needed to make the larger fiscal deficits manageable.

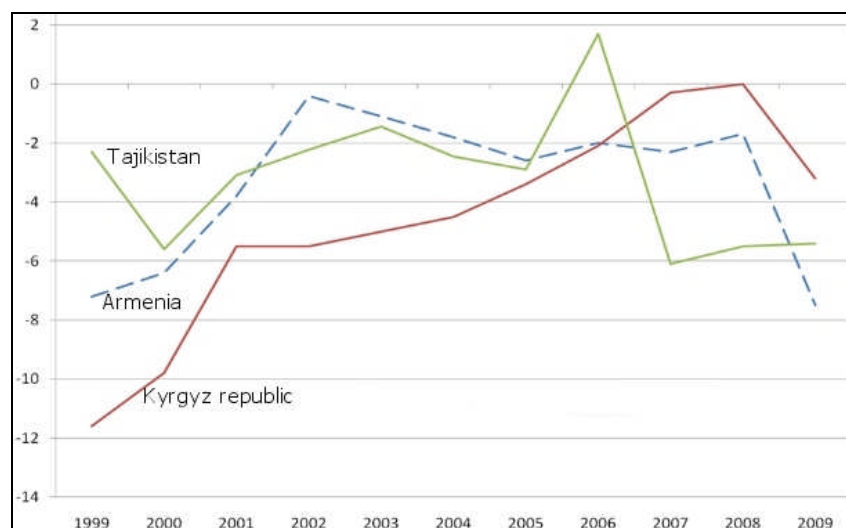
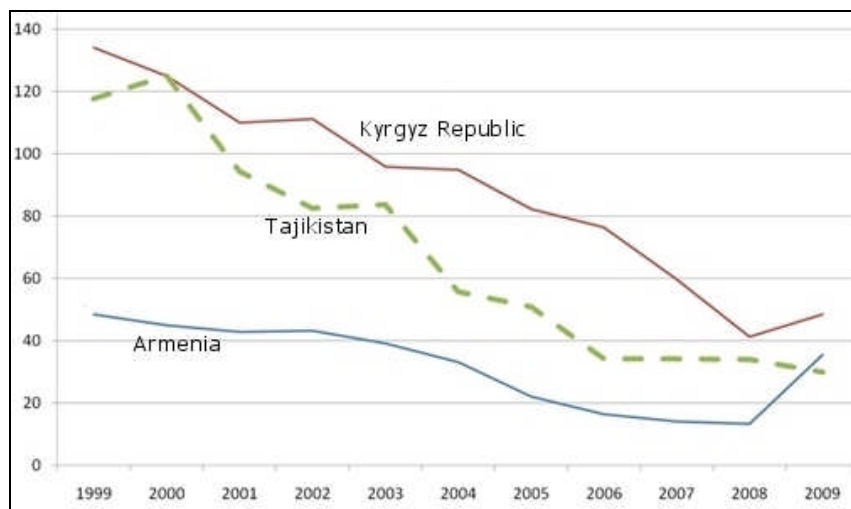
Chart 2. Fiscal balances in Armenia, Kyrgyz Republic and Tajikistan, 1999-2009 (% of GDP)

Chart 3. External public debt in Armenia, Kyrgyz Republic and Tajikistan, 1999-2009 (% of GDP)



Source: IMF (2010)

The Kyrgyz Republic succeeded in mobilising the indispensable external financial resources, so that the government could implement a substantial fiscal stimulus program. Hardly had the different European countries applied this kind of reaction to the crisis, when a debate aroused on the exit strategy. The efficiency of the stimulus mostly depends on the reaction of private sector expectations. When people assume that the stimulus is able to merely push the public debt higher, they prefer to refrain themselves from considerate consumption and investment because of the imminent tax increase. If the overspending leads to the distortion of domestic demand, the government should curb its repercussion by exiting, i.e., consolidating the stimulus.

Without forgetting the planned and currently running political changes of the Kyrgyz Republic, it would be instructive to overview what we have learnt about the empirical consequences of such political shifts concerning the consolidation.

Political system also matters

The political economic theory conveys that the political system also has an influential power on the macroeconomic performances such as fiscal outcomes and economic growth. The economic performance differs across various forms (presidential, parliamentary). The parliamentary form can be treated as a prevailed system in the European perspective. The reason why the different countries perform well comparing to others is very complex, but the election system and the social dimension seem to be pivotal in this issue (Lizzeri – Persico, 2001; Milesi-Ferretti et al. 2001; Persson et al. 2007).

These factors are able to exert influence on governments and institutions. The election system may have an effect on the number of parties (the proportional election system is more likely to result coalition governments than the majority electoral system). The number of parties mostly

depends on the fragmentation of the society, which is determined by cultural factors and personal history. Large number of parties, in the parliament or in the coalition government, could be a massive stranglehold of timely interventions because of the plethora of distributional conflicts concerning the burden-allocation on various voting groups.

In the Kyrgyz case, the society is extremely fragmented (Abazov, 2005), thus one could expect the continuum of the proportional electoral system in the aftermath of the planned elections in October 2010 (according to the available data there will be 57 parties contesting with each other in the parliamentary election of the Kyrgyz Republic). The more parties in the government, probably the more interest groups lobbying for financial resources and lower burdens of consolidation. They can easily deteriorate the fiscal discipline by delaying the consolidation even if the overspending would result in soaring deficit and debt.

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Internationalisation of innovative small and medium sized companies in the Hungarian medical precision instruments industry

Magdolna Sass

Introduction

The medical precision industry has a long history in Hungary. It stands out among manufacturing companies with a high presence of Hungarian owned small and medium sized enterprises. It is highly innovative, can be characterised by a high number of patents and R&D employees and a relatively high level of R&D expenditures. Its innovativeness is at a relatively high level even in international comparison.

This research³ aimed at analysing the internationalisation tendencies of the small and medium sized companies of the sector. Internationalisation here is perceived as a concept involving a relatively high range of activities: from imports, exports and higher level of internationalisation, including establishment of a foreign representative office, or foreign direct investments and various forms of R&D cooperation with foreign economic and non-economic actors. The level of internationalization of SMEs is understandably usually lower than that of large sized companies (Hollenstein, 2005). However, in the medical precision instruments industry which is less “plagued” by global value chains compared to the automotive or electronics sectors, many smaller market segments emerge continuously, which provide good opportunities for flexible and innovative SMEs to establish and/or increase their worldwide market shares (OECD, 2007).

Methodology

The method of research was an e-questionnaire survey, from which data and information from 23 small and medium sized companies were received on their innovation and internationalisation activities and semi-structured interviews with high level managers of 12 small and medium sized companies were taken based on the same questionnaire supplemented by open questions. The database gained from e-questionnaires was then supplemented by the data acquired from the interviews. Thus at the end our database contained detailed data on 35 companies. The questionnaire contained parts of questions on innovation activity, participation of the company in networks, competitiveness of the company, and internationalization of the company. Because of

³ This research was undertaken in the framework of the KKVENT_8 project „The chances of domestic small and medium sized enterprises in the era of internationalising knowledge economies 2008-10” (NKTH INNOTARS_08) at the Finance Research Ltd., led by Dr. Annamária Inzelt. The author is grateful for those company managers who helped the research either by taking part in the interviews or by filling out the e-questionnaire.

the low number of the companies in the sample, no statistical methods were used; only numbers of distribution and percentage shares were calculated.

The industry

There are different definitions and perceptions of the medical precision industry. Here we define it as 2651 (Production of measuring precision instruments), 2660 (Production of electronic medical equipments) and 3250 (Production of medical instruments) in NACE'08 or 3310 (Production of medical instruments) and 3320 (Production of measuring precision instruments) in NACE'03. However, there are many goods, parts and components which can be used not only in this but also in other industries. This makes the use of statistical data somehow problematic.

This broad definition shows that the production of many different instruments, equipments, materials etc. is carried out in the industry. Thus even the complexity of the products is differing. There are many products which are the results of innovative activities, the use of special know-how and skills. Overall, the indicators of the sector show higher value added, high export intensity and higher wages than the manufacturing average.⁴ The sector can also be characterised by a higher than average frequency of cooperation with universities and research institutes due to the research intensive nature of activities.

The industry showed an above average growth rate recently, which can be explained by both demand and supply side factors. On the demand side, aging populations, the increase of the years “spent with” illnesses and the increase in chronic diseases are the most important factors. Besides these, the fall in the relative number of healthcare workers also plays a role. On the supply side, developments in ICT and in medical sciences offered further opportunities. It is important to note that the interaction of the sector is high with other sectors, for example innovative ideas, new products of the sector can be used in other industries as well (and vice versa).

In terms of market players, the US is the most important producer and consumer country. However, the European Union as a whole is in a very close second place. Hungary has a long tradition in the industry from the pre-transition period. Many present companies are built on the “ruins and remnants” of MEDICOR a big state-owned firms. Newcomers to the industry are usually spin-off companies.

The Hungarian medical precision industry can be characterised with a smaller than EU average but higher than the New Member States (NMS) average absolute and relative importance of the sector in terms of output, value added or employment and with a high number of domestically owned small and medium sized companies even in EU comparison. The competitiveness indicators⁵ of the sector indicate a relatively high (though not top) position among NMS. Compared to other

⁴ NRC, Hamburg Institute for Economic Research, and Kiel Institute for World Economics 1996; Tassey 2000

⁵ Calculated on the basis of EUROSTAT data.

manufacturing sectors in Hungary, the medical precision instruments sector is an R&D intensive sector both in terms of employment and expenditures and the average firm size in terms of the number of employees is smaller than the manufacturing average. However, SMEs can be characterised by higher per capita value added than the manufacturing average.⁶

In 2007, according to the data of the Central Statistical Office, in NACE 3310 there were 1824, in NACE 3320 785 companies active in Hungary, which represent 4.4 % of the total number of manufacturing companies. In the first quarter of 2010, 12457 employees worked in the two sectors, representing 2.4 % of total manufacturing employment.

Selected results of the research

The majority of the analysed companies internationalized in stages, especially those with a longer history. However, the majority of these firms stopped at an earlier stage of internationalization (usually at regular foreign trade) and from there it cannot or does not want to go further. The explanation of this lies in barriers of internationalization, which are usually not financial (similarly to the results of Greenaway et al., 2007), but more human and absorption factors (similarly to Zuchella, 2009). An element of critique of the stages approach was also reinforced by our research: there were companies, which used different stages of internationalization at the same time: for example one company sold its products on the same market directly and through an agent. Thus one cannot determine, it reached which stage of internationalization (this result is similar to that of Turnbull (1987), who analyzed British companies). There are even companies which stepped back in the stages of internationalization (the case of the unsuccessful representative office in Moscow which was later closed down).

There are at least two “born global” companies in the sample (both in the questionnaire survey and among the interviewed companies), which jump stages of internationalization, immediately investing abroad. The interviews showed that also for “born globals” personal, informal (scientific) connections and links are very important. They also showed, that not in all, but in the certain cases, the similarly to the observation of Madsen and Servais, 1997, the legal date of establishment does not correspond to the real date of establishment, thus the experience, knowledge of the market is in most of the cases already accumulated in those actors who found the firm. At the same time there was one case where a successful “born global” was born without previous business knowledge. In that case, the innovative nature of the product, strong personal links explain the quick internationalisation of the company. The existence of “born globals” shows that even less developed countries can bear successful ‘born globals’. It was reinforced that ‘born globals’ venture further away from their original locations, and have plants/representative offices in developed countries, while ‘stages internationalisers’ stick to the neighbouring countries/region.

⁶ Calculated on the basis of the data of the Hungarian Central Statistical Office.

There are also companies which decide not to internationalise. As for the “dividing line” between the internationalisers and non-internationalisers usually the internal resources of the company (financial and human), the stability of the company (in terms of market share) are important factors, which determine whether the company builds up its internationalization strategy in stages, slowly (even if this remains implicit), or it decides to concentrate on the domestic market, and does not want to export or invest abroad, and does not spend the resources of the company or that – or, on the other hand, internationalizes immediately. The results of network theory are reimbursed mainly by the cases of those companies, which internationalized at a high level (investment abroad, R&D cooperation with foreign firms or universities or research institutes), and especially in those cases, where there is a previous relatively strong personal connection, cooperation. This corresponds to the results of Welch and Welch (1996), who made a connection between the network of connections and the network of knowledge.

The main ownership advantage of the analysed companies lies in their continuously innovative nature and as a result constant and successful research and development, resulting in many cases in (international) patents. The main source of innovation is inside the company (similarly to Inzelt, 2004 and contrary to what is presented for manufacturing companies in (former) transition economies by Balczerowicz et al. (2009).

The most important motivation of internationalisation and investing abroad is market-seeking: appearance on new markets, the narrowness or narrowing of domestic market. This is similar to the results of Svetlicic et al, 2007 for SMEs from (former) transition economies. However, due to the specificities of the sector, ‘knowledge-seeking’ investments (Hollenstein, 2008) are also important. This is indicated by the high marks given to the following factors: acquiring new knowledge, improving competitiveness, getting access to information and tracking latest developments and market trends. The efficiency seeking, relocation motive is not very important in our sample.

On the basis of the interviews, the smaller firms go to neighbouring countries both with exports and investments, while the larger companies venture further away with exports (usually not with investments). On the other hand, in international scientific cooperation the target country is usually further away: either the US or a Western European country (mainly Germany) which can be explained by the dominant role of the scientific institutions and universities of these countries in international science.

We could not prove the connection between various indicators of innovativeness and internationalisation because of the small size of the sample, but most probably this link exists on the basis of cross tables and interviews.

Table 1. Motivations of internationalization

	Very important	Important	Not important	Not relevant	Average*
<i>Factors connected to company processes</i>					
Reduction of production costs with cheaper labour	0	5	13	11	1.3
Reduction of production costs with access to cheap infrastructure	4	5	10	10	1.7
Appearance of foreign investor	0	0	12	17	1.0
Acceleration of R&D and innovation processes with access to modern infrastructure	2	8	8	11	1.7
<i>Geographical factors</i>					
Reducing distance from consumers/buyers	4	2	18	5	1.4
Reduction of transaction costs (e.g. tariffs or technical standards)	5	8	10	6	1.8
Supporting foreign production or sales	2	7	14	6	1.5
Taking advantage of EU membership	5	12	9	3	1.9
<i>Competition related factors</i>					
Appearance on new markets	19	6	4	0	2.5
Following competitors	3	11	8	7	1.8
Acquiring a producer of a brand product	1	17	0	9	2.1
Following the largest/important buyer abroad	0	9	11	7	1.5
Going abroad because of domestic competition pressure	2	3	16	6	1.3
Going abroad because of the narrowness/narrowing of domestic market	16	3	3	5	2.6
Avoiding being crowded out from the market	5	7	10	5	1.8
Improving competitiveness	14	4	8	1	2.2
<i>Widening knowledge base</i>					
Acquiring new knowledge	15	1	11	5	2.2
Acquiring new technology	8	6	12	1	1.9
Employing highly skilled experts	6	7	10	4	1.8
Extension of capacity in R&D employees	3	3	14	7	1.5
Access to information	8	9	9	1	2.0
Tracing the latest developments, market trends	10	7	9	1	2.0
<i>Other factors</i>					
Obtaining references	6	9	10	2	1.8
Getting known	7	11	8	1	2.0
Domestic economic policy	8	5	9	5	2.0
Avoiding tax burdens	3	4	11	9	1.5
Participation on public tenders abroad	5	3	10	9	1.7
More favourable R&D or innovation environment or regulations	0	9	11	7	1.5

Source: e-questionnaire survey in the framework of KKVENT project

* Very important=3, Important=2, Not important=1, Not relevant=0

Policy recommendations

The young, innovative, internationalising companies have an overall positive impact on the economy and on the balance of foreign trade. At the company level, internationalisation of small and medium sized firms is connected not only to risks, but is also helps the company in quickening up its development, improving its performance, increasing its adaptability etc. These companies,

amongst worsening conditions as for example the present crisis, have greater chances to survive and to operate successfully. As we could see, these firms could face a kind of virtual cycle, in which innovativeness and internationalisation help and strengthen each other. (Filatotchev, Piesse, 2009). The existence of this virtual cycle was reinforced by the interviews in the case of the most innovative and most dynamic companies. Thus internationalisation is a potentially positive process, which enhances competitiveness even in the case of small and medium sized companies, and thus it is worth reducing its barriers in a market-friendly way and economic policy may play a part in this.

According to the results of the interviews, the medical precision instruments industry in many cases suffers from setbacks in Hungary – compared to other foreign players. There are many market segments, which are distorted (for example hospitals or public tenders) In many cases it is the narrow domestic market which induces companies to internationalise (“push factor”). It is also obvious, that those companies which survived up till now without any help in such a distorted market are really competitive, the majority of them internationally as well and flexible. The bases of the sector are there, and because of its innovative nature and dynamism it deserves more attention from the economic policy – at least as much as in the most important competitor countries.

One of the important results of the questionnaire survey is that from an economic policy point of view it would be important to handle the group of small and medium sized companies not as one, but to separate the companies into sub-groups. For example the barriers of internationalisation can be very different in different company groups. For example, the role of financial barriers is of secondary importance except for “born global” companies for which this barrier is the most important and in many cases causes delay in their growth and internationalisation. In solving these financial problems, both bank credit facilities and various venture capital schemes were criticised to a great extent. For other companies, financing is not a barrier, it is more important for them that they do not have enough knowledge of the market in question (for example they use very frequently related help from ITDH), lack of management knowledge and capacity for internationalisation, and for the smallest companies lack of language knowledge. Many companies voiced their concern over the lack of lobbying activities of embassies which is also very frequent in other countries.

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Geopolitical changes and shifts in relations with neighboring countries led to economic benefits for Russia

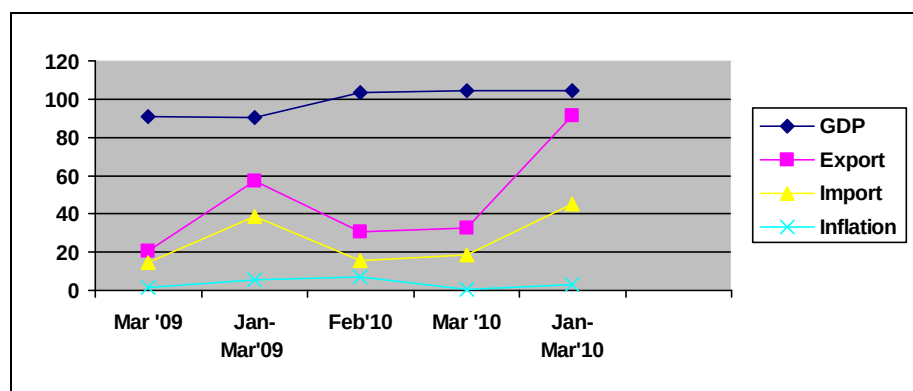
Liliya Levandovska

The Russian economy in 2009-2010

In 2008-2010 the Russian economy faced a number of challenges due to the world economic crisis. The biggest problems affected the foreign direct investment activity, construction, crediting, banking, and entrepreneurship, namely small and medium business. Russian economists believe that anti crisis measures taken by the government proved to be highly inefficient, as focus on social payments increase (for example, pensions were raised by 40%) cannot be justified when most industries are stagnating and import cannot be substituted by competitive national products. Experts criticize consumption and export orientation of Russian economy, excessive state monopolization of major industries, underlining the need for modernization and state support of SMEs and R&D.

However, major macroeconomic indicators demonstrated a tendency of slight improvement already in the first quarter of 2010 (*Chart 1*).

Chart 1. Macroeconomic indicators, 2009-2010



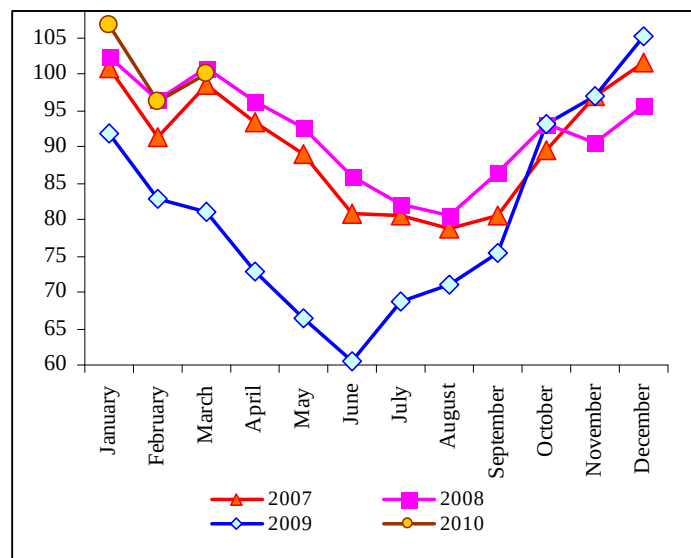
Note: Compiled on the basis of statistic data provided by the Ministry of Economic Development of the Russian Federation,
Source: http://www.economy.gov.ru/minec/activity/sections/macro/monitoring/doc20100427_02

We can see that over January-March 2010 Russia showed a positive GDP growth, an increase in export and import activities, as well as a decrease in the rate of inflation, which was still quite high in February 2010. Inflation drop was also noted by International Monetary Fund as a positive sign for further (rather slow) revival of the Russian economy in 2010.

Economic growth in the Russian Federation is conditioned by gas and oil industries, as Russia is the main gas and oil supplier to many CIS countries and EU Member States. According to the Ministry of Economic Development of the Russian Federation, the beginning of 2010 proved to be the most successful quarter for gas industry: gas extraction was by 1.1% higher, demand for gas

supplies has grown and consumption of Russian gas in Europe has been stable (unlike gas crisis in winter 2006). In March 2010 Gazprom which takes up 78.6% of the whole gas market in Russia extracted the amount of gas which is by 22.6% more than the relevant numbers for 2009. Table 2 demonstrates significant improvement of gas extraction over February-March comparing to the drastic decrease in January.

**Chart 2. Dynamics of gas extraction (natural and associated)
(December 2006 – 100%)**



Source: Rosstat

It should also be mentioned that while Russia managed to conclude new long term agreements for gas supplies, the position of Gazprom on the world market is significantly weaker, caused by European attempts at diversification (supplies from Norway and Qatar, construction of new pipelines excluding Russia, extraction of new types of gas – discussed below).

Geopolitical changes and their significance

However, the main changes appeared on the geopolitical arena. Significant rotations of political elites in neighbouring countries and shifts of focus in relations with its strategic partners to some extent strengthened economic perspectives for Russia.

The tragedy in Poland may lead to potential changes in Polish foreign policy and it is already testified by recent agreements with Russian Gazprom: the agreement between Gazprom, Polish Company PGNIG and EuRoPol Gaz which extended Russian gas supplies to Poland till 2037, increased the volume of supplies and extended the transit of natural gas to Western Europe via the Polish section of the Yamal – Europe gas pipeline until 2045. The agreement was criticized by the Polish Minister of Foreign Affairs for higher dependency of Poland on Russian supplies, while the economic benefits for Russia are quite obvious: it received a stable long term contract for its leading industry. On the other hand, potential projects involving drilling of the non-traditional shale

gas Poland is rich in, bears a threat for Russian energy industry, as it may decrease the demand for Russian exports. Experts from oil and gas research group Wood Mackenzie, estimate that with shale gas production Poland can boost Europe's gas reserves by 47%. Shale gas already affected Russian gas industry, i.e. the USA ousted Russia from top position among world leaders in gas mining.

Drastic changes and dramatic events in Kyrgyzstan demonstrated that the new government, unlike the former president Bakiyev, will be loyal in its relations with Russia and the rent for Russian air base located in Kant town is not to be increased or introduced at all (in 2009 the renting period was prolonged till 2049 and according to different sources Russia is using barter schemes instead of rent payments).

The customs union with Belarus and Kazakhstan which has been functioning since July 2010 opens new markets for Russian export and trade. However, taking into account recent disagreements with Belarus, the union may start functioning only in bilateral format – between Russian Federation and Kazakhstan. Russia rents 7 military objects in Kazakhstan as well. It is obvious that contracts with Kazakhstan are quite beneficial for the Russian defence industry – the long-term contract till 2050 presupposes payment in the form of military training, ammunition and modernization of Kazakh military infrastructure.

Belarus is hesitant about its participation in the custom union and it demands lifting of custom fees on all Russian oil supplies exported to Belarus. In addition, the most recent “gas war” with Belarus in June demonstrated that even though politically the countries declare close cooperation on friendly terms, economic relations are rather controversial. At the moment Belarus is the country receiving Russian gas at the lowest price in Europe (however, official Minsk continuously stated that such benefits are threatened by potential Russian monopolization of strategic enterprises in Belarus). Mutual claims concerning the debt for the supply (USD 187 million on behalf of Belarus) and transit (USD 228 million on behalf of Russia) led to a temporary 15% shortage of gas supply to Belarus and consequently transit to Europe. The situation was resolved and both sides paid out their debts, but the prices for gas supply are to increase in the third quarter of 2010 (to USD 193-194)⁷. Minsk also expressed its dissatisfaction with the fact that Russia still makes use of military bases located in Baranovichi and Vilejka areas without any rent fee.

Agreements with Ukraine – economic advantage or political pressure?

The biggest changes both in political and economic spheres took place in relations with Ukraine as a result of Presidential elections, when the new President of Ukraine Viktor Yanukovich announced

⁷ During the first two quarters Belarus was paying USD 150 per thousand of cubic meters, though the agreement stimulated USD 169 for the first quarter and USD 184 for the second. According to Gazprom, such underpayments resulted in the debt on behalf of Belarus. Gazprom also admitted its debt for transit calculated on the basis of the contract between Russian Federation and Belarus (USD 228 million instead of USD 260 as was demanded by Belarus officials).

his plans to strengthen strategic cooperation with Russian Federation. A series of meetings in March-May 2010 were followed by a number of bilateral declarations and agreements, the most important of them is the agreement signed in Kharkiv on April 22nd, 2010 which prolonged the Russian Black Sea Fleet base till 2042 (according to previous agreements signed in 1997 the Fleet was to leave in 2017) in exchange for gas supply discounts. The Agreement was heavily criticized by Ukrainian opposition and civil society as the contract bearing a threat for Ukrainian sovereignty (their main argument was that the issue of security and defence can't be traded for any commodity). The Agreement was ratified by both parliaments, however with significant regulatory breaches on behalf of Verkhovna Rada of Ukraine. According to the Agreement, the prolongation of the Fleet location in Crimea was promised in exchange for gas supply price: the discount of USD 100 is presupposed if the gas price will be higher than USD 330 per one thousand of cubic meters, or the discount may amount to 30% of the contract total, if the price is lower than USD 330.

At first sight the advantages for both countries seem quite significant (considerable gas price cut for Ukraine and long term guarantee to continue maintenance of the Fleet for Russia), but more detailed analysis reveals an obvious tendency to mix political and economic motives: the discount is valid for certain political and economic groupings (big oil and gas companies in Ukraine), while Russian ships require large investments due to the outdated infrastructure. The presence of the Russian Fleet in Crimea is regarded more like an obvious manifestation of Russian impact in the region. Political consideration is testified by the fact that the President of Russia underlined that such economic offers in return for military agreements are valid only for Ukraine and not for all energy partners of Russia.

Russia expressed its readiness to invest in social, transportation and local infrastructure of Crimea and Sevastopol in particular (support Russian schools, media, etc.) as well as cooperate with Ukraine in increasing the number of ships and staff; Ukrainian experts are rather skeptical about the volume of Russian investments and are worried about potential decrease of European funds as a result of such agreements.

The opponents of the agreement state that the announced gain of Ukraine amounting to USD 3-4 billion per year is devaluated by the low rent price Russia pays (about USD 97,85 million) and the potential drop in world gas prices. Besides, Russian firms included into the complex of the Fleet owe payments to the Ukrainian Pension Fund and the local budget (the debt for utility bills is significantly high, according to certain estimates it amounts to UAH 17 million). The claims of new working places for the local population created by the Fleet are disputed as European investments could improve tourist industry in the region to a larger extent, whereas Crimean territory is occupied by the foreign naval base for another 25 years. Decrease in the transit rate and increase in the quantity of contracted gas ties Ukraine to Russian supplies more, though the penalty provision (for the gas which was not taken) is excluded.

The lobbyists from both countries claim absence of tariffs of the gas exported from Russia (this provision is included in the Agreement, however, the specific contract is to follow which will create a precedent for Russia, since practically it will subsidise the export tariff from its own budget). The rent fee was also negotiated – before 2010 USD 97.85 substituted Ukrainian debts for natural gas and Ukraine planned to pay out its debt till 2017 (i.e. Russia would not pay the rent) when the Fleet was supposed to leave. The new Agreement lists important advance rent payments on behalf of Russia and a slight increase of the rent fee (up to USD 98 million) starting from 2019 which is to be paid in cash. In addition, lower gas prices are to entail rapid growth in chemistry and metallurgy industries of Ukraine.

The “bonus” acquisition of a Ukrainian missile cruiser by Russia (included as a part of the Agreement) will release Ukraine from state expenditures on its maintenance (UAH 5 million per year) and give Russia the chance to enhance its naval capacity at a much lower price (since the cruiser was planned back in 1984 which decreases its market value). In this case Ukraine loses potential profits as it held negotiations with potential buyers from India and China.

While the Agreement is still highly criticized in Ukraine, it is a success for Russia. It will not only confirm its importance in the security policy of the region, but also will make most use of economic opportunities: proposed cooperation in ship construction on the territory of Ukraine is to provide Russia with huge profits, as many Crimean ship construction companies are owned by Russian businessmen.

What form of cooperation is next?

The rapid conclusion of the Kharkiv agreements enabled Russia to strengthen its influence in Eastern Europe and encouraged it to offer cooperation in other spheres, which are quite controversial for Ukraine. For example, the idea of creating a common strategic enterprise in the context of modernization of the Ukrainian pipeline system is clearly asymmetrical in terms of economic benefits for the countries: Ukraine risks losing the opportunity of transit pipeline modernization according to European standards within the framework of an EU consortium, as well as losing control over its main gas company Naftogaz. Russia is not ready to participate in a common enterprise on the 50/50 share principle, emphasizing the difference between the potential of Naftogaz and Gazprom (Russia would agree if Ukraine owned 10% of the future corporation). That is why Ukrainian authorities are still reluctant to let Russia take over control of the most important Ukrainian company, as well as state oil and gas reserves. While benefits for Ukraine are rather ambiguous (potential cuts on gas prices), the advantages for Russia are undoubtful – by controlling the transit country (Ukraine stands for 80% of transit supplies to Europe), Russia as a monopolist, will practically be able to increase the European dependence on its supplies and prices

it sets. Certainly, such rapid shifts should serve as an impulse for Europe to work more on oil and gas supply diversification in order to avoid overdependence on Russian supplies.

The proposed merging of Ukrainian and Russian companies in the energy, nuclear, air construction (investments in the Antonov plant are badly needed in Ukraine, while Russia will be able to claim lower prices for aircrafts constructed in Ukraine than their average market value), and even sport industries testify to the changes in geopolitical focus of Ukraine and readiness of Russia not only to invest, but to take control of the key industries of its neighbour.

Though the Russian economy faced certain internal turbulence in 2010, the international arena opened new opportunities for it. Nevertheless, official Moscow should avoid a protectionist policy of supporting exclusively big energy companies, as well as a populist economic approach aimed at raising social payments; it should focus more on development and modernization of its infrastructure and SMEs, and promoting fair competition in cooperation with neighbouring countries and strategic partners.