# ECONOMIC PERFORMANCE AND COMPETITIVENESS OF THE KALININGRAD REGION: WHERE DO WE STAND?

Leading Institution:

Stockholm School of Economics

Dr. Christian Ketels

Investigator:

Dmitry Gavrilin

London

September 27, 2004

## TABLE OF CONTENTS:


Page #

**EXECUTIVE SUMMARY**

I. Where Do We Stand? ………………………………………….………… 3

II. Reasons for Moderate Performance ………………………………..………… 4

III. Policy Responses and Strategy for the Region ..…………………………….. 5

**I. ECONOMIC PERFORMANCE OF THE REGION**

1. Developments During the 1990s ……………………………………...….. 7

2. Current Performance …………………………………………………… 8

3. Kaliningrad's Relative Position in the Region ……………………….……… 9

4. Conclusions ……………………………………………………………….. 11

**II. COMPOSITION OF THE REGIONAL ECONOMY**

1. Beginning of the 1990s ………………………………………………… 13

2. Period of 1992 - 1998 ………………………………………………….. 14

3. Current Situation ……………………………………………………….. 15

4. Kaliningrad as Export Hub to Russia ……………………………………… 17

5. Conclusions ……………………………………………………………….. 19

**III. BUSINESS ENVIRONMENT AND COMPETITIVENESS**

1. Business Climate in Russia …………………………………………….. 21

2. Regional Specifics ……………………………………………………… 23

3. Infrastructure ……………...………………………………………………. 24

4. Regulatory Enviroment …………………………………………….…... 27

5. Skill Base and Institutions for Collaboration ……………………….....…… 28

6. Dynamics of the Foreign Investment Inflows ………………………………. 30

7. Conclusions ……………………………………………………………….. 32

**IV. POLICY CHALLENGES AND RECOMMENDATIONS**

1. Strategic Issues ……………………………………………………………. 35

2. Challenges for Policy Makers ………………………………………….. 35

3. Policy Proposals …………………………………………………………... 37

4. Recommendations……………………..……………………………………… 37

## EXECUTIVE SUMMARY

### I. Where do we stand?

The specifics of the Kaliningrad Region’s geopolitical and geo-economics situation are determined by the following key factors:

- *Location*. The Kaliningrad Region is the Russian Federation’s westernmost territory, the only one separated from the rest of the Russia’s territory by land borders of foreign states and international waters. Kaliningrad is the Russia’s only transportation junction that has unfreezing seaports on the Baltic Sea and services multi-modal transportation. Proximity to Europe creates both advantages and challenges for the Region.
- *Openness of the regional economy*. Due to the free customs regime for a number of years, the Region’s economy is oriented towards openness, enhancement of foreign economic activities and facilitation of manufacturing of goods that can serve as substitutes for imports. The Region’s per capita volume of export and import operations by far exceeds analogous indices of many of the Russia’s other regions.
- *Small size of the economy and fragmented industries*. With the population under 1 mln and GRP around $ 1 bln Kaliningrad economy is fairly small which makes it - together with its openness - vulnerable. Regional economic output remains insignificant compared to other Russian regions. Similar in its structure to economies of Eastern European countries, the region has many small businesses. Services account for around 50 percent of the Region’s GRP, and that percentage keeps growing.
- *Significance for Russia’s national defense*. The Kaliningrad Region is home of naval bases belonging to the Baltic Fleet of the Russian Federation. It has a major role to play Russia’s defense potential and assuring of national security. The Baltic Fleet is one of the best forces in the armed forces of the Russian Federation.

Kaliningrad is still searching for its comparative advantage and place in the Baltic Rim region. With its fragile economy the region has suffered particularly hard under the overall economic recession in Russia. Regional economy started to recover end of the 1990s. After considerable growth during the last five years the economy is getting more and more investment influx. But neither FDI at today's level nor current pace of the economic growth allow the region to compete with its neighbors. This is especially true since Poland and Lithuania have joined the European Union. Acceleration of economic growth, restructuring of the regional economy and ensuring sustainability of growth remain challenging tasks of the Russian policymakers at all levels.

## II. Reasons for moderate performance

Reasons for the Region's modest performance have its roots in both composition of the regional economy and relatively restrictive business environment. After introduction of the special economic zone regime the economy got boosted due to ruble devaluation, import substitution model of the economy and - increasingly - investment from the mainland Russia. Russian investors are finding the region attractive as a gateway to the European markets and are willing to invest as result of several years of economic growth in Russia. Tiny portion of the foreign investments has been accumulated mostly through companies that are taking advantage of the free customs regime to reduce their costs of entering the Russian market. The current set up of the economy might be beneficial for the recovery and short term growth. However, in the long run, the position of an export hub to Russia does not guarantee sustainable growth based on created wealth and innovation. One of the indicators of that is the small amount of FDI that the region received so far. Therefore, the most important task for Kaliningrad is to shape its comparative advantage and to secure such competitiveness profile that would allow its integration into European markets.

Russian Federation does not offer most favorable conditions for investment. Even though the country has made considerable progress in improving investment climate during the last five years, the country is attracting a dismal portion of FDI (about 1% of GDP) in international standards. Kaliningrad business environment to full extent reflects regulatory and infrastructural deficiencies that lead to such modest performance. On the regional level, administrative constraints, regulatory instability and protectionist approach of the regional authorities create additional barriers for investment influx. Although the fixed capital investment is growing in absolute terms since 1999 and strategic investors from the mainland are arriving in Kaliningrad, the region will have hard time competing with its neighbors unless economic policies will be in place towards improvement of the regulatory framework and active investment promotion.

## III. Policy responses and strategy for the region

Kaliningrad region has gained a great deal of attention by both Russian and European politicians in the last several years. Labels like "pilot region" or "showcase" are being used frequently, which demonstrates the willingness of both sides to make best use of the situation and to come to an agreement as to how to deal with the region. Kaliningrad is also being considered appropriate target for the strategy of accelerating economic growth that is being produced in the Putin’s Administration. This reflects momentum building towards shaping a strategy that would allow the region to enhance its competitiveness and to economically integrate in expanding Europe. Among policy proposals that are being debated on both federal and regional levels the following should be emphasized:

- *Off-shore zone*. Part of Moscow politicians are proposing to introduce a financial off-shore in Kaliningrad that would be able to compete with other well-known off-shore countries and tax heavens in attracting capital.

- *Switching to export orientation*. Abandonment of the existing import substitution model of the economy seems to be currently prevailing policy approach in the Presidential Administration. It includes nullification of all the custom privileges and stimulating export oriented economic growth.
- *Deepening import led model*. Regional authorities and part of the federal elites are favoring sticking to and further promotion of the current economic set-up.

In our view only an export oriented economy with several strong and competitive sectors and clear investment promotion approach can make for competitive region that is able to sustain growth and successfully integrate in European markets. The strategy for Kaliningrad should therefore include the following approaches:

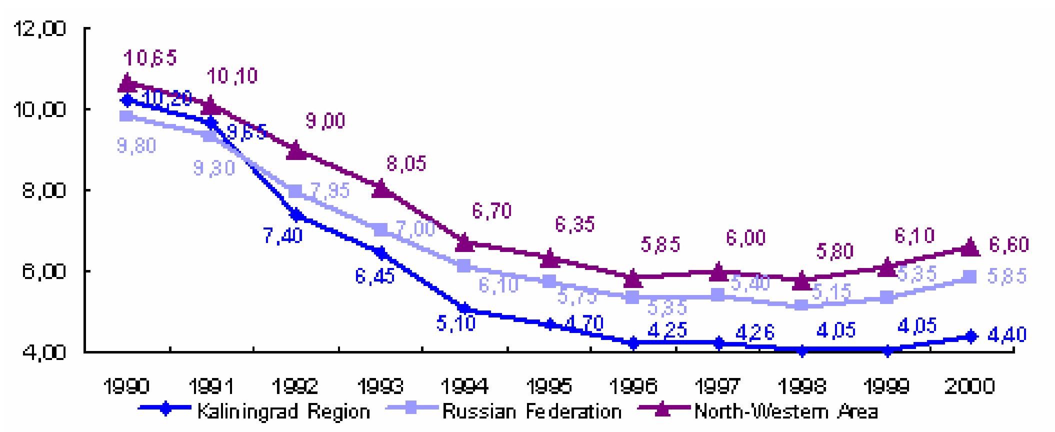
- *Cluster development and export orientation*. The region has clear potential to develop several strong clusters. Among candidates are pulp and paper industry, furniture and engineering manufacturing, tourism and hospitality sector. Capacity of these sectors need to be stimulated by clear and consistent policies based on cluster approach.
- *Regional cooperation*. The regional authorities should support the idea of Kaliningrad being developed as a pilot region of EU-Russia cooperation. Deeper involvement in the Baltic Rim region cooperation should allow Kaliningrad to develop its infrastructure and benefit from the Baltic region institutions for collaboration.
- *Get a big multinational to invest in the region*. Bringing one of the major international companies in the region should become one of the priorities of the current regional Administration. Only examples of successful engagement in the region will send a strong signal to investment community and stimulate further investment inflow.
- *Consistency in policies*. Further expansion of the region's economy will depend on the continuity and stability of the federal government's policy towards the region and political consensus between Russia and EU on issues concerning Kaliningrad.

## I. ECONOMIC PERFORMANCE OF THE REGION

*1) Developments over 1990's.* Despite its advantageous geographic situation (unfreezing harbors, proximity to the Soviet Union's most developed regions), favorable climatic conditions, rather developed infrastructure and a high density of population Kaliningrad[1] had only an average level of socioeconomic development as compared to other regions of the Soviet Union. After it became a Russian exclave in the 1990s, the Kaliningrad Region has been facing new challenges.

Because of its location, the specialization of the Region became obsolete. Kaliningrad's economy was even more inadequate to the new conditions than it was the case in most other regions of Russia after disintegration of the Soviet Union. In the 1990s Kaliningrad's GRP fell more steeply than Russian GDP. Kaliningrad Region lagged behind other regions of the North-Western Federal District (Chart 1).

**Chart 1 - Kaliningrad's GRP per capita as compared to Russia and NW region**




Source: Institute for Economies in Transition (Zhdanov et al.)

Deeper recession in Kaliningrad Region can be explained by the fact that sectors like engineering (with a large proportion of military-industrial complex industries), fisheries and agriculture have been playing a particularly significant role in the Region's economy prior to

[1] The terms "Kaliningrad", "Kaliningrad Region" and the "Region" are used interchangeably throughout the paper.

the disintegration of the Soviet Union. After planned economy has fallen apart, these industries were, therefore, hit especially hard due to sharp fall in demand and destruction of the all-Union in economic ties. Consequently, the recession in the industries, agriculture, and construction was deeper in the Kaliningrad Region than elsewhere. In 1998, industrial output in the Region only amounted to 29 percent of the 1990 figure (while the national average was 46 percent), output of agricultural produce, to 48 percent (with a national average of 56 percent), while retail trade turnover, to 42 percent. The volume of capital construction was only one-sixth of the 1990 figure[2].

Also because of the Region's production isolation from "mainland" Russia, there emerged considerable difficulties both in production interaction and in delivery of goods to the Russian national market. Transportation and transaction costs of the Region's economic entities grew dramatically. While in 1990, the Kaliningrad Region's per capita gross regional product (GRP) was 4 percent higher than the national average, in 2000, it was 25 percent below the national average[3].

*2) Current performance.* Russian economy has been boosted through the ruble's devaluation (following the August, 17, 1998 crisis) that has brought capital back into the economy and induced industrial growth as opposed to imports of the European goods. The drop in the ruble's exchange rate also had a mostly favorable effect on the growth of output in the Kaliningrad Region. In addition to this general consequence of the national currency devaluation, Kaliningrad was able to capitalize on its Special Economic Zone status, that started to function right after the crisis.

Economic growth of the last four or five years both in the Region and in Russia as a whole is encouraging. A comparison of the performance of the both reveals that, whereas

[2] Lamande V., Vinokurov E. Formation of Kaliningrad Trade Specialization (Formirovaniye torgovoy spezializacii Kaliningradskoy oblasty), in: Voprosy Ekonomiki, No.2, P.53-63.
[3] V. Zhdanov, O. Kuznetsova, V. Mau, V. Plyukhin, S. Prikhodko, M. J. Wojciechowski and A. Hecht

until 1998 the Kaliningrad GRP tended to fall faster than the country average, it grew faster since 1999. This tendency has held constantly in 1999-2003[4] enabling regional economy to make significant progress both in terms of industrial production growth and real incomes growth (Chart 2). The growth rates of GRP in the Region were higher than the growth rate of Russian GDP. Industry, the construction sector and transport grew rapidly and were the main contributors to the fast growth of GRP (their combined share in GRP was 46.4% in 2002).

**Chart 2 - Indicators of Russian GDP and Kaliningrad GRP**

| | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|
| Kaliningrad GRP, in current prices, RUR billion | 24.6 | 34.0 | 41.1 | 51.1* |
| Changes in real GRP, y-o-y, % | 15.2 | 3.4 | 9.5 | 9* |
| Changes in real GDP of Russia, y-o-y, % | 10.0 | 5.1 | 4.7 | 7.3 |
| Kaliningrad GRP per capita, RUR thousand | 25.9 | 35.1 | 43.6 | 54.5* |
| Russian GDP per capita, RUR thousand | 50.2 | 62.4 | 75.2 | 91.8 |

Source: Goskomstat[5] (2004), Kaliningrad oblkomstat[6] (2004)
* Estimate of the Regional Administration

Since 2000, when the rate of growth of industrial output in the Region amounted to 32 percent as against 11 percent national average, industrial growth exceeded that of Russia (Chart 3). The main catalyst for the industrial growth in 2003 was the machine-building and metal industry. Development of this industry has been very dynamic: its sales have gone up more than fourfold in the past 5 years[7]. A few visible and fast growing enterprises in this industry have recently been established and are actively using the SEZ regime to sell their goods to mainland Russia. The two largest and best-known of these are Avtotor (the KIA and BMW car assembly plant) and Telebalt (a manufacturer of TV sets and vacuum cleaners).

Problems Related to Development of the Kaliningrad Region As an Exclave Territory of the Russian Federation, Institute of Economies in Transition, Moscow 2002

[4] Vinokurov Y., Economic Prospects for Kaliningrad. Between EU Enlargement and Russia's Integration into the World Economy. CEPS Working Document No. 201/June 2004, p 5

[5] State (Federal) Committee of Statistics (Goskomstat)

[6] Oblast (Regional) Committee of Statistics (Oblkomstat)

Their production growth was especially impressive. For example, car assembly grew by 62%, production of TV sets grew by 52% (836.4 thousand TV sets were produced in the region in 2003 – more than one third of the total Russian production), and production of vacuum cleaners was up by 110%[8]. Output in other major industrial sectors has not experienced significant changes, not counting the construction materials industry, which grew by 17% as a result of the expansion of new construction in the region. The fuel industry is expected to show considerably higher growth in 2004 as the Russian oil giant Lukoil started commercial mining at the oil field D-6 (Kravtcovskoe) at the beginning of 2004.

**Chart 3 - Changes in industrial production, % y-o-y**

| | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|
| Kaliningrad oblast | 32.4 | 12.9 | 10.2 | 14.5 |
| Russia | 11.9 | 4.9 | 3.7 | 7.0 |

Sources: Goskomstat (2004), Kaliningrad oblkomstat (2004) t t

For the first half of 2004 the figures are even more impressive: industrial production index is 124 % to the same period of the last year, fixed capital investments has grown by 2,6 % and foreign trade turnover increased by 43 %[9].

Positive economic trends are reflected in unemployment statistics. The level of unemployment, according to the ILO methodology, has been gradually lowering since 2000. The increased unemployment in 2003 (it raised by 2%, Chart 4) and concurrent swift growth in many sectors of the economy can be explained by an increase of labor productivity, growth in the active population, statistical errors and structural unemployment (dissimilar structure of demand and supply of labor)[10]. For example, although the number of people employed in the trade sector has been declining steadily since 1999, sales in the sector have increased slightly.

[7] V. Zhdanov, et al. Op. cit., P. 24
[8] Turku School of Economics and Business Administration - Kaliningrad Regional Development Agency, Kaliningrad Province in 2003, May 2004, Biannual monitoring review. P. 5
[9] State Committee of Statistics (Goskomstat), 2004
[10] Turku School of Economics and Business Administration - Kaliningrad Regional Development Agency,

**Chart 4 - Level of unemployment (end of year)**

| | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| Registered unemployed, in thous. | 6.6 | 8.1 | 9.7 | 8.6 |
| Level of official unemployment | 1.4% | 1.7% | 2.2% | 1.9% |
| Unemployed according to ILO, in thousands | 75.2 | 43.0 | 31.3 | 41.2 |
| Level of unemployment according to ILO | 15.6% | 10.6% | 7.1% | 9,1% |

Source: Kaliningrad oblkomstat (2004)

The income and salaries of the population grew quickly in the last five years. The average nominal monetary income per capita was 3,394 million rubles per month in 2003 (Chart 5), representing an increase by 35% (in nominal terms). In real terms, the income increased by 15%. Real wages also grew quickly. Nevertheless, the average wage level in the Kaliningrad region remains one of the lowest in the Northwest Federal District. In November 2003 the highest wages were in the fuel industry (15,270 roubles) and in the financial and insurance sector (12,220 roubles). The lowest wages were in agriculture (2,747 roubles) and trade (3,180 roubles). Because wages grew faster than the industrial output in 2003, profitability in the industry declined from 14% in 2002 to 11% last year.

**Chart 5 - Monetary incomes and wages**

| | 2000 | 2001 | 2002 | 2003* |
|---|---|---|---|---|
| Monetary income per capita, RUR/month | 1,952 | 2,173 | 2,511 | 3,394 |
| Change in real monetary income, % | 19 | -10 | -1 | 15 |
| Nominal wage, RUR/month | 1,750 | 2,852 | 3,703 | 4,947 |
| Change in real wage, % | 15 | 21 | 15 | 17 |

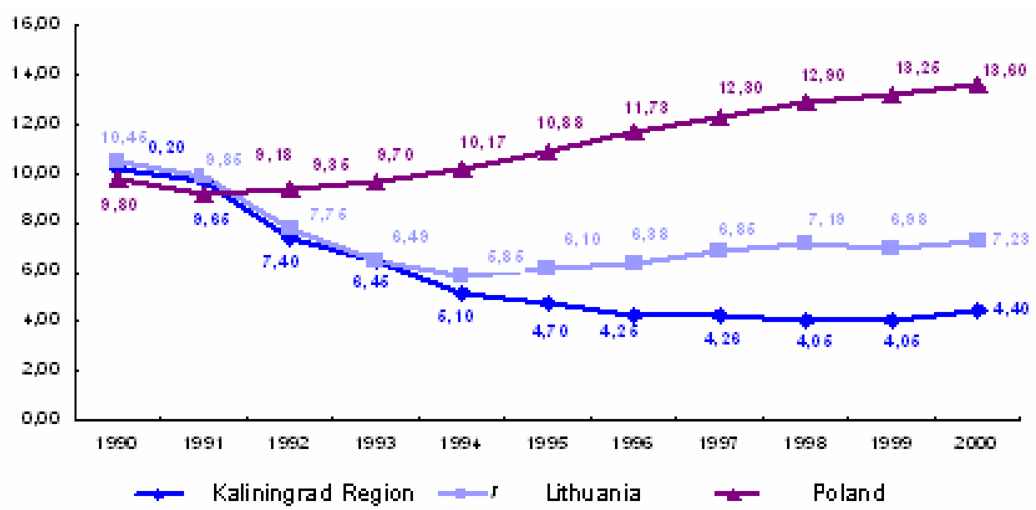
Source: Goskomstat (2004), Kaliningrad oblkomstat (2004)
* Estimate of the Regional Administration

Kaliningrad Province in 2003, May 2004, Biannual monitoring review. P. 5

*3) Kaliningrad's relative position in the region*. The Kaliningrad Region's economy has but an insignificant role to play in Russia's national economy. The Region's per capita GRP amounts to a mere 72.5 percent of Russia's national average (State Committee of Statistics). The Kaliningrad Region lags significantly behind its five industrialized neighbor-countries (its performance is five times worse than that of Germany).

Throughout the 1990s, the Kaliningrad Region was below the national average both in the principal socioeconomic indices and in its residents' standard of living. In the extent of economic development, the Region lags far behind both the neighboring states and industrialized Western European countries. While in Poland, economic growth began in 1992 and in the Baltic states in 1994, in Russia a slight growth began only in 1997, while in Kaliningrad recession continued till 1999, after which a certain growth in industrial and agricultural output began there[11]. The gap in economic performance between Kaliningrad and its neighbors has been widening for almost decade (Chart 6). Due to accession of Poland and Lithuania to the EU, the gap is likely to grow further.

**Chart 6 - Kaliningrad's GRP per capita as compared to the neighbors**




Source: Institute for Economies in Transition (Zhdanov et al.)

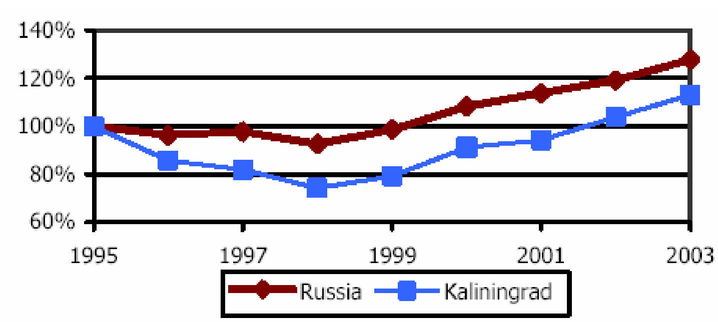
[11] Samson I., Elisseva I. Kaliningradskaya Oblast: inoy vzglyad [Kaliningrad Oblast: a New Look], Voprosy Ekonomiki, No.2, P. 44

Both European neighbors and Russian regions that are part of the North West Federal District have been doing better job recovering from the recession. Despite the economic growth in the region of the last 5 years that is promising, it remains to be seen whether this growth is sustainable and will enable the region to catch up with the rest of the region.

*4) Conclusions*. The region used to be highly integrated into the Soviet economy which deteriorated the economic recession after the demise of the USSR. The region has been through difficult period of decline and restructuring the economy that has led to its re-orientation and adaptation to the needs o a market economy.

Even though the economic and social consequences of the recession were considerably harder in Kaliningrad as opposed to the mainland, since 1999 Kaliningrad region has been recovering at higher pace than an average Russian region. Gross regional product grew 6.8% in 1999, 14.4% in 2000, 6.4% in 2001, 10.1% in 2002 and 14,5% in 2003. Although growth rates in the region in recent years exceeded those of Russia and gradually reduced the gap in performance, overall expansion of the output in the mainland (driven by the most FDI attractive regions like Moscow and St. Petersburg) has been faster due to difference in starting position in 1995 when the levels of GDP/GRP converged (Chart 7).

**Chart 7 - Changes in Russian GDP and Kaliningrad's GRP**




Source: Kaliningrad Oblkomstat (2004)

The trend of economic growth has continued during 2004. According to the Regional Committee for Statistics industrial production has grown by 24 % during the first half of this year. Annual economic growth is expected to be hogher than 7%.

The current per capita gross regional product and residents' monetary incomes are close to the national average though. Also with respect to the social and economic indices, the Kaliningrad Region is a "statistical mean" region[12]. Despite some encouraging developments with regards to economic recovery Kaliningrad's economy is still far from its neighbors. Current leadership of the region has set the goal of improving living standards of the regional population up to Poland's level by 2010[13]. This goal is hardly achievable given the current moderate economic performance, vulnerability of the regional economy to external factors and the economic boost given to the new EU members after their entry the Union. The lag is likely to increase unless serious changes will be implemented towards enhancing the region's competitiveness. What is going to be important for both federal and regional policy makers is to sustain growth and to secure stable development of the region.

[12] The rather widespread belief that the Kaliningrad Region is a "poor" region is ungrounded. See for example Zhukov et al. p. 34

[13] Smorodinskaya N. Kaliningrad exclave: prospects of transformation into a Pilot region. East-West Institute. Moscow 2001, P 51

## II. COMPOSITION OF THE REGIONAL ECONOMY

*1) Beginning of the 1990s*. Kaliningrad Region had an industrial-agrarian economy whose level of development was average as compared to the other regions of the Soviet Union[14]. In industry, the principal specialization was in fish processing, engineering and pulp-and-paper production. As much as 70 percent of the goods produced in the Kaliningrad Region were exported to other parts of the country[15]. Also the local extracting industries (amber extraction and oil production) were of considerable significance. Raw materials, fuel, machines, consumer goods and foods were imported from the mainland.

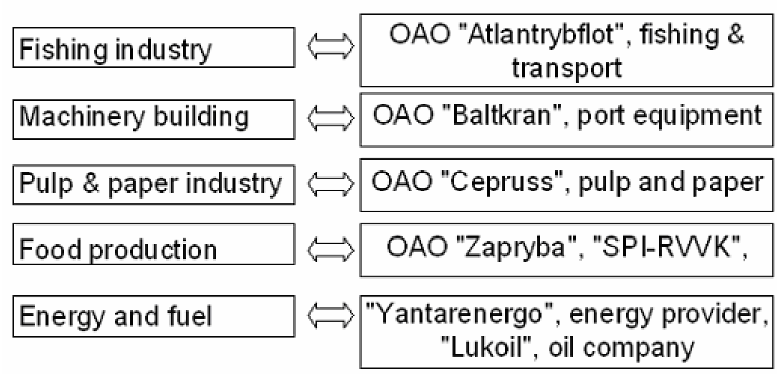
Following geographic isolation of the Region and the beginning of economic transition the old structure of the Region's economy proved inadequate to the new conditions. The industries that benefited by that situation were the "natural monopolists" that set prices for fuel, power and raw materials in accordance with the prices on the international markets rather than the domestic price proportions. With state subsidies withdrawn in such a situation, the very existence of many industries was jeopardized (in particular, of the oceanic fisheries with their great fuel costs). At the same time, the situation favored development of oil production and pulp-and-paper industry in the Region.

*2) Period of 1992-1998.* During that period the region faced a threat of de-industrialisation against a background of the setback in production. However, the SEZ mechanism contributed to the significant and rapid restructuring of the industry which resulted in forming new import-substituting and (to a lesser degree) exporting enterprises. Two main sectors of the regional industry have arisen. First, the most sustainable sector working for export and satisfying the demand in raw materials and energy comprising. the fuel and energy sector (power industry, oil industry), pulp and paper industry, and light industry. Some enterprises of Kaliningrad managed to enter international markets with their

[14] V. Zhdanov et al.p 21

products (Chart 8). Second, machine-building and metalworking industry, woodworking and food industry. Some of them were able to sustain competition with the imported products.

**Chart 8 - Main sectors of the regional economy**




Source: Kaliningrad City Hall

The key growth sectors in the region were infrastructure development, tourism services and infrastructure, food processing and packaging, construction and real estate, agriculture production, furniture manufacturing and production of auto components. Kaliningrad-based companies involved in meat processing, assembly of electronic products and cars, furniture manufacturing, and fish processing started to play a significant role on the Russian market.

*3) Current situation.* Establishing SEZ in 1996 and the financial crisis of 1998 favored industrial growth through import substitution, slow development of agriculture (almost insignificant except fisheries), trade boom as well as slow but steady growth of services is (public catering, tourism). The SEZ regime in the Kaliningrad Region facilitated intensive development of the food and furniture production, machine building, fuel industry and metalworking (Chart 9).

[15] Fish products, pulp and engineering products were exported from the Region to 50 foreign countries Ibid. P. 25

**Chart 9 - Changes in industrial production by sectors, % y-o-y**

| | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| Industrial production, | 32.4 | 12.9 | 10.2 | 14.5 |
| including: | | | | |
| Power industry | 30.3 | 95.5 | 9.6 | 0.6 |
| Fuel industry | 5.6 | -0.9 | 0.4 | 1.5 |
| Machine-building and metal industry | 64.4 | 25.9 | 36.1 | 38.1 |
| Forest, wood-processing, and pulp & paper industry | 72.2 | 7.4 | 5.6 | 0.9 |
| Construction materials industry | 55.9 | 52.9 | -5.4 | 17.0 |
| Light industry | 34.2 | -4.4 | 46.7 | 3.4 |
| Food industry | 21.1 | 45.0 | 14.1 | -3.0 |
| Flour, grits and fodder industry | 18.7 | -3.4 | -16.5 | 13.2 |

Source: Kaliningrad oblkomstat (2004)

As of early 2004, some 60% of the local industrial output was based on assembly of passenger cars, TV sets, electric vacuum cleaners, refrigerators and other electric equipment, production of furniture. The following sectors have benefited from creation new businesses and modern production or re-launching already existing facilities:

**Machine engineering and metal processing:** car assembly production, production of trade equipment, TV, vacuum cleaners, refrigerators and other home appliances, production of packing for the food-processing industry, among others. The most prominent companies being Avtotor (see Insert 1) and Telebalt (TV sets assembly).

**Furniture sector:** production of upholstered and frame furniture and assembly parts. Furniture production has also grown in significance in the region. Several dozen furniture manufacturers and furniture assembling lines have appeared in Kaliningrad. The furniture producers are very successful and have managed to capture a good share of Moscow's market, and are now starting to look to export their products.

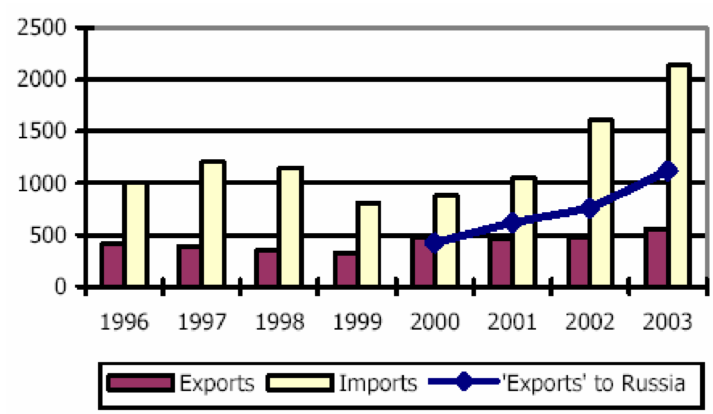
**Light industry:** production of knit works and ready-made garments, and floor covers;

**Food-processing industry:** meat products, beer, fisheries.

The most important sectors of the region's economy became food processing (mainly meat and fish), oil extraction and power generation, ship-building and machine-tool manufacturing, wood processing and pulp and paper, and agribusiness. Sector distribution of industrial output is as follows: power generation - 10% of total industrial output (the electricity supplier is Yantarenergo), fuel industry - 20% (the bulk of production belongs to LukOil' subsidiary LukOil-Kaliningradmorneft), machine building and metal working - 15%, wood processing and pulp and paper - 11% (biggest company is Cepruss), food processing industry - 40% (VestRybflot- fish processing, SPI-RVVK - alcohol), and construction materials - 3%[16] (Chart 8).

*4) Kaliningrad as export hub to Russia.* Foreign trade plays a very important role in the economic life of the Kaliningrad region. Customs concessions created by the SEZ law resulted in a sharp growth of foreign trade and, primarily, of imports while its exports remain incomparably small (Chart 10). 2002 imports made up to 1.6 billion USD, or 130% of Kaliningrad's gross regional product (GRP), and exports – only 43 % of GRP, and even much less, 20%, if we exclude transit Russian flows. Imports continued to grow very rapidly throughout 2003 and were up by 33% (in Russia by 24%).

**Chart 10 - Foreign trade of the Kaliningrad Region (in USD ,millions)**




Source: Kaliningrad Oblkomstat (2004)

[16] Prihodko S., Kaliningrad as a pilot region for Russia-EU cooperation. Institute for Economies in Transition.

Over the last few years the value of imports to the region has exceeded the regional GRP, and Kaliningrad's share of Russian imports reached 2.8%. Such a high volume of imports cannot be consumed within the region. A significant share of imported items are processed and/or assembled in the region and then sold in the other regions of Russia. A great part of the local companies' output (up to 80%) is supplied to the mainland Russia. More specifically, the volume of produce supplied there in 2001 was worth a total of RUR 19 bn, in 2002 - 23.2 bn., and in 2003 - 33.6 bn (Chart 11).

**Chart 11 - Trade flows of the Kaliningrad region (in USD millions)**

| | *1999* | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|---|
| Exports of goods | 322 | 475 | 455 | 471 | 574 |
| Imports of goods | 811 | 875 | 1,047 | 1,610 | 2,142 |
| Turnover | 1,133 | 1,350 | 1,502 | 2,081 | 2,716 |
| Exports of Kaliningrad goods to Russia | -- | 424 | 619 | 759 | 1,118 |

Source: Kaliningrad Oblkomstat (2004)

The Kaliningrad region 'exported' USD 1,118 million-worth of goods produced in the region under SEZ legal provisions to mainland Russia in 2003 (47.3% more than in 2002). Companies in machine building, and food and wood processing industries in particular capitalized on this regime, which is reflected in the structure of the Kaliningrad imports.

Kaliningrad became a virtual gateway for foreign goods to the mainland Russia, the real markets for them. What a foreign company needs in order to comply with the tax exemptions linked to added value of the products under the SEZ regime here is to establish an assembly line located in Kaliningrad. Once its product has been recognized as being manufactured in Kaliningrad, it can be exported to other Russian regions without duties. In doing so companies like Telebalt or BMW lower their market entry cost. On the other side, locally produced goods cannot compete at the European markets yet. That is why the trade flows with mainland Russia grew faster than foreign trade over the period of 1999-2003.

The region takes an intermediate position in Russian-EU trade: Kaliningrad exports predominantly raw materials and goods with low value-added and imports more processed goods (like typical developing country vis-à-vis more developed economies). In relation to the Russian mainland, the region plays the role of a trade partner possessing a comparative advantage in industrial production[17]. However, this advantage is based on the incentives under the SEZ regime and not on the endowments or innovation.

*Insert I. Case study: OAO Avtotor*.

One of the success stories of the SEZ is OAO Avtotor. The company was established in 1994 with the aim of creating a car assembly plant in the region. Now the company has two car assembly facilities in Kaliningrad, where it assembles BMW vehicles and KIA passenger cars, minivans, and trucks. Since opening Avtotor, it has assembled over 19,000 cars at both plants. The production plan for 2003 is 10,000 Kia cars. By the year 2004 this volume has increased by 2-2.5 times. Avtotor also plans to start assembling BMW's X5 car model (which are currently made only in the U.S.), as well as Kia trucks and buses. In February 2001, Avtotor became the first Russian manufacturer to be awarded with the TUV Management Service international certificate for its introduction of a quality control system in accordance with DIN EN ISO 9002 standards. Avtotor's priority is localization of spare parts production in the Kaliningrad Region and Russia. For instance, the assembly of BMW seats has been started, along with 30 other spare parts, which are being purchased from Russian and Belarus manufacturers. A new business direction for Avtotor (as well for many other Kaliningrad companies) is agribusiness. Avtotor owns agricultural land in the region and is interested in applying modern technologies, equipment, and processes.

[17] Vinokurov Y.evgeniy, Economic Prospects…, p 6

*4) Conclusions.* The structure of the regional economy is evolving depending on the policies and economic situation both in Russia and in Kaliningrad region. Among positive outcomes of the last decade is the fact that Kaliningrad has accomplished its economic restructuring and went through period of adjustment to the needs of the market economy. Openness of the regional economy and its sensitivity to external factors should be seen as an achievement. However, the regional economy remains extremely fragile. Economic vulnerability is due to the long period of transition, small economic scale and capacity as well as instability of the regulatory framework.

Like other free economic zones, Kaliningrad was expected to develop exports and sell goods to the nearby European markets. However, the region turned to the opposite direction of expanding imports on a mass scale. For already a decade it is importing consumer goods and reselling them with very small added value to the remote Russian markets. Meanwhile, Kaliningrad's tax-free deliveries to Russia now three times exceed its exports[18]. As a result, Kaliningrad generates an enormous foreign trade deficit. Given that Kaliningrad is attracting a small portion of FDI, this import expansion can be risky in the long run.

The current economic policies (SEZ regime in first place) towards the region do not appear to stimulate created prosperity. For the time being they do provide incentives for economic activities that led to growth of output. However, in the long-run they might have adversary effect on the region's competitiveness. The viable economic model for the region needs to induce orientation towards created wealth and innovation as opposed to speculative or inherited wealth based on a zona franca - type of regime. Therefore, the only growth model that would guarantee sustainable development of the region should be based on the region's competitive advantage, innovation and exports instead of import substitution.

### III. BUSINESS ENVIRONMENT AND COMPETITIVENESS

*1) Business climate in Russia*. Macroeconomic factors like the surplus budget, growth of GDP and investment, predictability of exchange rate development and the reasonably low inflation rate have all improved the investment environment. The role of external factors such as energy prices and devaluation is decreasing and the growth is more based on increased consumption and investment. The World Bank is continuing to praise the economic growth in Russia, which has improved steadily since the 1998 financial crisis[19]. In 2002, both the United States and the EU recognized Russia as a market economy. Russia's sovereign credit rating has also improved.

Favourable economic dynamics and political stabilization have enabled Russian policy makers to achieve some progress in changing of the business environment. The Russian Government has made rather consistent efforts to improve the investment climate both for Russian and foreign investors. Federal legislation regulating creation of new businesses and the general business environment has been improved enormously over the last five years[20]. Tax reform included the introduction of a unified regressive scale of social tax at a lower level, a revolutionary reduction of income tax to 13%, the decision to abolish turnover based taxes, the abolition of VAT in intra-CIS trade and reduction of the profit tax rate to 24%.

However, a number of obstacles remain in the Russian system that concern would-be investors. There are difficulties associated with enforcing contracts in Russia, one facet of the broader challenge the country faces in entrenching respect for the rule of law. Other factors include low respect for personal rights, a poorly functioning court system, and corruption.

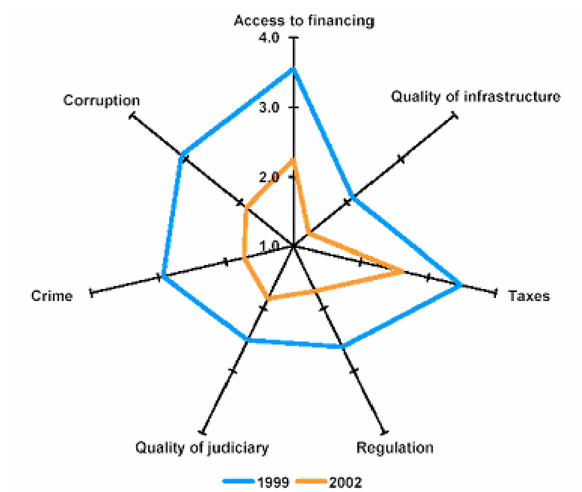
[18] Smorodinskaya N, Kaliningrad Region: Towards Sustainable Development. Date: 2003-05-10 (The article was presented at the 5th Baltic Development Forum Summit in Riga, 5-7 October, 2003. Session: Developing a Joint Strategy for Kaliningrad.)

[19] See for example June 2004 economic report of the World Bank: ttp://www.worldbank.org.ru/ECA/Russia.nsf/ ECADocByUnid/0CF40EF2E501A275C3256CD1002B7D90/$FILE/RER8-June2004(Eng).pdf; Economist Intelligence Unit, September 2004

[20] This view is shared by majority of Russian experts and foreign investors. European Business Club and Verband der Deutschen Wirtschaft in der Russischen Foederation (See for example: http://www.ebc.ru/publications/docs/investmentclimate.pdf)

Russian banking system is suffering under strong influence of several state owned banks that dominate the scene not allowing for more competition and therefore further development of the banking sector. Interest rates remain high which - together with the political uncertainty - makes for difficulties for Russian companies to obtain long external finance. Another key element of the existing infrastructure is Russia's capital market that remains weak and private equity and venture capital industry rather underdeveloped (Chart 12).

**Chart 12 - Operational environment in Russia**




Source: EBRD/World Bank Business Environment and Enterprise Performance Survey 2002[21]

Due to the above deficiencies Russia's performance in attracting investment is rather modest. Contrary to some other transition economies that have managed to attract considerable portion of foreign investment during the 1990s (Poland, Check Republic or China) and despite its recent stabilization, Russia is lagging behind, with the stock of foreign investments standing at $57 billion at the end of 2003. The country is still far from being a true favorite of foreign investors: In 2003 Russia accounted for only 1 percent of global FDI flows and for just 0.4 percent of FDI stock[22].

[21] The seven axes represent the different dimensions of the investment climate. The values range from 1-4 with 1 indicating no obstacles to business growth and operation and 4 indicating major obstacles. The extremity of each axis represents a score of 4, indicating a less favorable investment climate. A fuller circle indicates a more challenging business

[22] Economist Intelligence Unit, 2004

*2) Regional specifics.* Kaliningrad economy does reflect all the above regulatory factors to full extent. In addition, the regional business environment is determined by the free customs zone regime[23]. The rules in effect today have been adopted in the 1996 Federal Law on Special Economic Zone in Kaliningrad (SEZ). The SEZ, remaining an integral part of the Russian state and customs territory has a special customs regime, which comes down to:

- Exemption of all goods produced in the SEZ and exported to foreign countries or to the main part of Russia from all customs duties but customs fees and non-application to such goods of economic policy measures (non-tariff state regulations);
- Exemption of goods imported from foreign countries into the SEZ from all customs duties except customs fees and non-application to certain types of such goods of economic policy measures (quantitative regulation of foreign economic activities);
- Non-exemption of goods imported into the SEZ later to be exported to the main part of Russia (except goods processed in the territory of the SEZ) from any of the import customs duties and application to certain types of such goods of economic policy measures (non-tariff state regulation of foreign economic activities);
- Exemption from all customs duties (both import and export) of such goods as are imported into the SEZ from foreign countries and then exported to foreign counties .

A product is deemed produced in the SEZ if the amount of value added as a result of its processing is at least 30 percent (at least 15 percent for electronics and hi-tech household appliances) and the category of the product (in the customs classification) is changed as a result of such processing. The procedure for certification of goods' origination in the SEZ has been set jointly by the Kaliningrad Region Administration and the State Customs Committee of the Russian Federation (Insert II).

[23] Establishment of a free economic zone in Kaliningrad was announced back in 1991. On June 3, 1991, the Chairman of the USSR Supreme Soviet issued a Decree on the Economic and Legal Status of the Free Economic Zone in the Kaliningrad Region

*Insert II. The Kaliningrad SEZ (SEZ)*[24]

The Kaliningrad SEZ is very specific and unlike most other SEZs throughout the world. The contents of the Law on the Kaliningrad SEZ were reduced to those of a free customs zone, but one of a somewhat unusual nature. As is typical in a free customs zone, there are no import taxes in Kaliningrad. However, goods deemed to be of local manufacture and exported to the Russian Federation will be exempt from customs duties. Custom privileges constitute the core of the SEZ regime. All other preferences, including the ones for investments, are just mentioned in the Law of SEZ and not included in other federal law. Hence, they do not function in practice. One of the peculiarities of the Kaliningrad SEZ is the imposition of regional import quotas. Beginning in 1998, about 35 categories of goods are subjected to import quotas. The quotas, which are regularly auctioned, give the right to import goods duty-free. Imports above the quota limits enter Russian customs territory subject to the normal customs procedures. This restriction of the SEZ regime was initially introduced with the aim of protecting some local industries, with agriculture being the main concern.

The existing customs privileges gave impetus to entrepreneurial activities in the region and to foreign economic activities in particular. They created an incentive to use cheaper imports for their processing in order to enter Russian markets. On the other hand, the SEZ regime suppressed, i.e., agriculture that has hard time competing which cheaper imports[25].

*3) Infrastructure.* Kaliningrad's *administrative and technical infrastructure* remains underdeveloped and most of its elements are deteriorating further. The Kaliningrad Region is logistically favorably located near northern economic centers of the European Union. There are 23 border-crossing points in the region located at sea, airline, railroad and motorways. This stimulates shuttle trade and movement of goods between the region and neighboring countries. However, the ports and other transportation junctures haven't been modernized for decades and can hardly compete with modern and dynamic ports in the neighboring Lithuania

[24] Vinokurov Y., Economic Prospects for Kaliningrad. Between EU Enlargement and Russia's Integration into the World Economy. CEPS Working Document No. 201/June 2004, p 3

and Poland. At the same time the amount of cars owned by the population has been growing. As of 1 January 2001 there were 241 cars per 1000 people. The ranked 2nd in Russia according to that index.

Kaliningrad airport Khrabrovo has regular lines in 15 directions to 22 Russian and CIS cities. The local air company, Kaliningrad Air Enterprise, is teetering on the verge of insolvency. Only two or three of its 12 passenger aircraft are still in service, and it is not clear if even this number can be maintained. As for international flights, so Kaliningrad is entirely dependent on the commercial considerations of foreign airlines for its international linkages to its main trade and investment partners in the West, including the Baltic States and Poland. At present, this means that there are no air services to these latter locations.

Telecommunications remains a weak sector. As elsewhere in Russia, mobile telephone companies are investing in Kaliningrad. However, federal and regional authorities need to encourage developing telecommunications infrastructure, while an appropriate regulatory framework needs to be established to permit and encourage private investment in the sector.

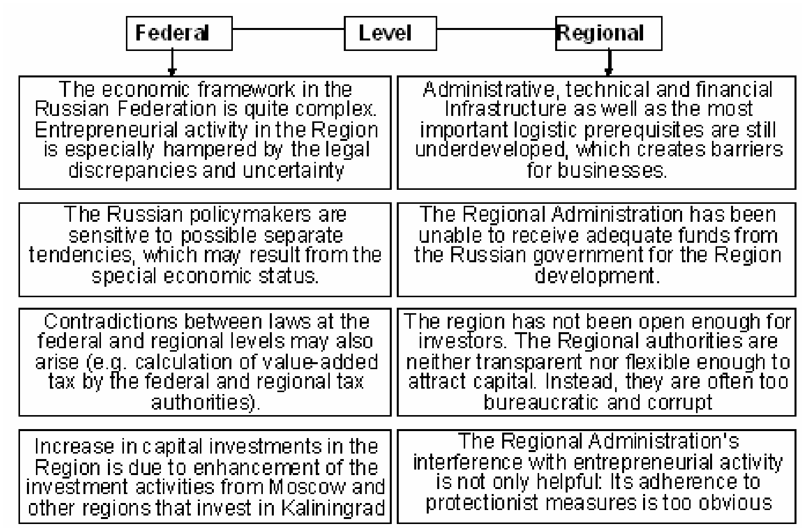
Access to external finance remains low due to weak capital markets and high legal risks, although this is an all-Russian decease. Many Russian banks have opened branches in this strategic region. Approximately 30 branches are located in the city of Kaliningrad, as well around 20 local banks. However, interest rates on commercial loans in the region are higher than in Moscow and St. Petersburg.

*4) Regulatory environment*. The main factors that adversely affect the region's investment attractiveness have been the instability of the *regulatory environment*: The lack of a clear government policy towards the Kaliningrad Region (taking into account its unique position as a Russian enclave in the EU), instability of the federal and local legislation, and instability of transit terms. As can be seen from the above, there are some significant

[25] Zhukov et al., P. 32

impediments to growth of the foreign investments both Russia- wide and specific for Kaliningrad. Most of them are of regulatory nature. Property rights are not sufficiently protected. Judicial system remains subject to complaints by most of the foreign investors. Lack of financing and political pressure as well as corruption in the judiciary are factors damaging image of the Russian legal system in the eyes of the investors.

**Chart 13 - Infrastructural and regulatory constrains**




To put the regulatory framework concrete terms, what follows is a list of challenges and problems that a typical large or medium-sized industrial enterprise in Kaliningrad faces, as summarized in the Strategy of social and economic development of Kaliningrad Oblast as the region of cooperation up to the year 2010[26]:

- high deterioration of the key assets (70-80%), deficiency in finance for their renewal, as well as for application of modern technologies and development of new production
- incomplete production capacity resulted in the malfunction of the production cycle, production deterioration, and growth of costs
- high tariffs for transporting energy, raw materials, and spare parts to the region and integrated products - from the region

[26] Available on the website of the Regional Administration: www.gov.kaliningrad.ru

- complicated (in time and costs) procedures of the customs clearance of production when shipped to other Russian regions
- instability of the federal tax and tariff legislation, and the SEZ regime in the Kaliningrad Region.

*5) Skill base and institutions for collaboration.* Kaliningrad's economic infrastructure includes an educated workforce offering the comparative advantage of wage rates lower than Poland or Lithuania. Kaliningrad region, being part of Russia offers decent secondary and technical education. The biggest universities include Kaliningrad State University, Kaliningrad Technical University and Baltic Maritime Academy. All of them are average institutions in Russian standards. Among specializations that have been intentionally developed during the Soviet era were fisheries and military education. Both branches have become less important during the last decade though.

However, contrary to a widespread belief, Kaliningrad lacks cheap and disciplined workforce. Actual cost of local labour isn't cheap for it includes a high shadow component. Official cost, although being 2-2.5 times lower than in the neighbouring Lithuania and about 3-3.5 times lower than in Poland, is yet not as low as to compensate for other shortcomings of the local investment conditions, such as long distance from the mainland Russia's outlets[27].

Kaliningrad's economic recovery was followed by some increase in labor productivity, which rose at a higher annual rate than in the Russian economy as a whole. However, in spite of the high rate of growth, the level of labor productivity in Kaliningrad is still quite inferior to average Russian indicators both in the economy as a whole, and in its major sectors[28]. Due to the present structure of production and employment in Kaliningrad, the region, unlike its neighbors, cannot expect any spontaneous and massive workforce flow

[27] Smorodinskaya N, Zhukov S., The Kaliningrad Enclave in Europe: Swimming against the Tide. Diagnostics of the State and Potential of Economic Development. EastWest Institute 2003, P. 102

from less efficient to more efficient sectors. For instance, Poland and Lithuania's primary sectors (agriculture in particular) have redundant workforce and capital resources that can be channeled into more efficient sectors in the sphere of services. In comparison, not only are such resources minimal in Kaliningrad (the number of those officially employed in agriculture and industry in the region is nominally close to advanced market systems) but also, the tertiary sector has already accumulated about two-thirds of the total workforce.

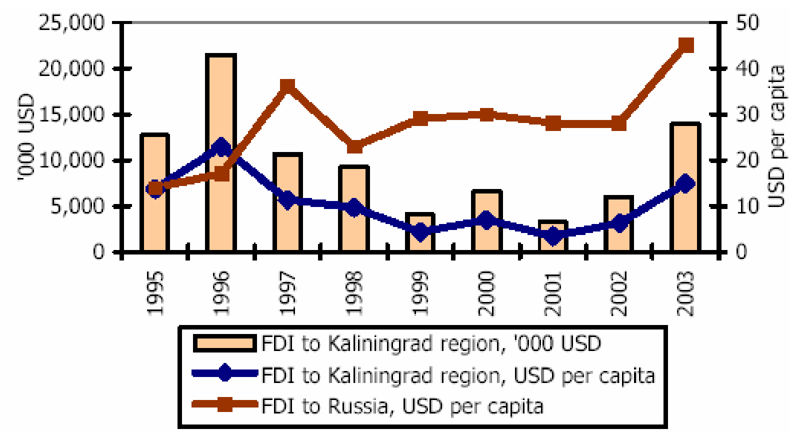
*Institutions for collaboration* are rather weak but are developing fast. On the federal level the most important is the so called "Shuvalov Group". It is an expert task force in the Putin's Administration comprising both regional and federal policy makers and experts. It offers a unique opportunity for dialog between the region and the federal centre. Also the Office of Special Representative of the President of the Russian Federation in the North West District was established to achieve better implementation and coordination of federal policies in the North Western District. On the regional level there are various institutions including Chambers of Commerce and Industrial Associations. One of the most active organizations is the Chamber of Commerce of Hamburg that has had its representation in Kaliningrad Region since 1994.

Emerging think tanks are increasingly influencing regional policy making. As opposed to the rather weak regional universities these several institutions became strong voice in the Kaliningrad debate. Among them are Kaliningrad Regional Development Agency (implementing technical assistance and other development projects funded by European and other organizations) and EastWest Institute (dealing with exclave problems). Both organizations are delivering decent research and discussion papers on the key questions of Kaliningrad policy making.

[28] Smorodinskaya N, Zhukov S., Op. cit., P. 71

*6) Dynamics of the foreign investment inflow.* The most prominent investments of the early 1990s include a joint enterprise set up by France Telecom to develop a telephone network in Kaliningrad, the purchase of the Avtogen plant (manufacturing industrial gases) in 1992 by the Swedish company AGA AB, the purchase of an equity stake in Baltkran (a crane making company) by the German company Noell and the establishment of many joint enterprises in the food sector by Polish companies. By 1995, the number of enterprises benefiting from foreign investment exceeded 800, making Kaliningrad one of the leading regions in Russia.

**Chart 14 - Foreign direct investment in Kaliningrad**




Source: Kaliningrad Oblkomstat (2004)

The initial optimism of foreign investors was soon replaced by pessimism and disappointment[29]. The legal regime of the SEZ turned out to be unstable and the Russian Government attempted to abolish the SEZ in the Kaliningrad region. The economic situation in Russia characterized by high inflation, a decrease in the population’s income. The high unemployment rate and violations of the law and of business ethics were also factors in discouraging investment from foreign companies. The financial crisis of 1998 and the de facto

[29] Dewar S., Economic Development in Kaliningrad. Russian regional perspectives on foreign and security policy. IISS, London 2003. P 23

default of the Regional Administration on Dresdner Bank loan reduced FDI to an absolute minimum[30].

A new wave of FDI has begun since 2001. It seems that the main reason for this growth has been the general improvement of the economic situation in Russia and in the Kaliningrad region in particular, not to mention the attention that the region has attracted from the Federal authorities and the mass media. Foreign investment has been growing steadily over the last four years, demonstrating that foreign investors are increasingly interested in the region. The value of foreign investment to the Kaliningrad region has reached USD 56.2 million in 2003 (a growth of 18%). The net foreign investment inflow (gross inflow minus investment outflow such as repaid loans and credits, etc.) was USD 19.8 million, and the total FDI stock was USD 105.8 million at the beginning of 2004. Although there was a significant increase in the inflow of FDI (by 2.4 times), the amount is very low even for a small economy like Kaliningrad.

**Chart 15 - Foreign investment in USD millions**

| | *1999* | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|---|
| Total foreign investment | 18.3 | 19.1 | 24.6 | 47.7 | 56.2 |
| *Of which* | | | | | |
| Direct investments | 4.1 | 6.6 | 3.2 | 5.9 | 14.0 |
| Other investments – trade credits and loans | 14.2 | 12.5 | 21.3 | 41.8 | 42.2 |

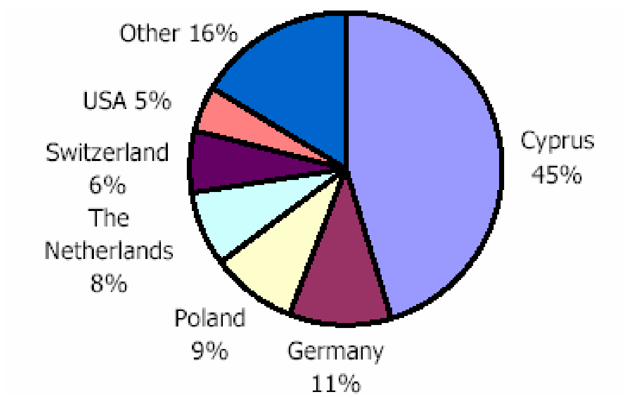
Source: Kaliningrad Oblkomstat (2004)

While evaluating the investment dynamics over the last five years it is important to bear in mind its structure and the source of funding. Foreign direct investment comprises only one third of the investment flow (Chart 15). The rest is made up by loans and trade credits which demonstrates the low level of commitment of investors to the region. Distribution of

[30] Turku School of Economics and Business Administration - Kaliningrad Regional Development Agency,

foreign investment by investing counties and by sectors is very uneven as well. In 2003 more than half of all foreign investment (60%) went to trading activities (retail and business), and Cyprus was the main investor (45% of the total).

**Chart 16 - Foreign investment by investing countries in 2003**




Source: Kaliningrad Oblkomstat (2004)

Besides the fact that most Russian large businesses conduct their foreign investment activities through off-shore jurisdictions, the timing of the second wave of investment inflow to the region is symptomatic as well: it coincides with the economic growth in mailand Russia. It is, therefore, safe to assume that almost half of the FDI that has been attracted to the region in 2003 has Russian origins and comes from the mainland via Cuprus[31]. Russian businesses operating in Kaliningrad are especially active in construction sector, energy production and retail as well as food production.

*7) Conclusions.* Geopolitical situation and relatively cheap labor force have been promising Kaliningrad the future of the Hong Kong on the Baltic Sea. However and despite the favorable prerequisites under the status of the SEZ, the Region has is lagging behind other

Kaliningrad Province in 2003, May 2004, Biannual monitoring review. P. 5

[31] Elina Pelto, Peeter Vahtra, karl Liuhto. Cyp-Rus investment flows to Central and Eastern Europe. – Russia's Direct and Indirect Investment via Cyprus to CEE. Electronic Publications of pan-AEuropean Institute, 2/2003 (www.tukkk.fi/pei)

regions of the Russian Federation where the investment climate made a better progress (Moscow, Moscow region, St. Pete or Nizhniy Novgorod).

Business environment in the region is influenced by two main factors. Firstly, being part of the Russian Federation, Kaliningrad economy is subject to federal regulations and all-Russian economic and development policies. In spite of the progress that has been made in reforming regulatory framework, business environment is not very conducive to would-be investors. The rewards of sound macro- and microeconomic policies will depend greatly on progress in the legal environment for their implementation. Accordingly, the development of all pillars of Russia's investment climate must be addressed simultaneously. The quality of the infrastructure has received a great deal of attention, while the most substantial improvements are found in access to financing and corruption. Property rights protection and taxes remain an area of great concern.

Secondly, the SEZ regime creates additional conditions - both favorable and constraining - for the business environment in the region. Establishing of the SEZ in Kaliningrad has led to increase in business activities including foreign investments in the region. About 10 years after the introduction of an SEZ, the data is finally indicating that Kaliningrad is attracting strategic investment, mainly of Russian origin, lured by its position as a gateway to Russian, Baltic and wider European markets. The region retains an enormous potential for growth in investments. Some of the large foreign investors have already been successful. Notwithstanding some drawbacks, the SEZ mechanism contributed to the rapid and significant structural transformation of the regional economy. In the result, there has formed roughly a mobile economic model. It is oriented on the openness based on foreign economic activity.

However, the regional authorities have not paid enough attention to promotion of the region so that Kaliningrad is attracting a tiny portion of FDI even as compared to other

Russian regions. Despite relatively cheap labor force and favorable location the Kaliningrad region is nevertheless lagging behind Russia and its neighbors (Poland and Lithuania) in terms of the level of FDI. The FDI stock per capita in the Kaliningrad region was 44 dollars at the beginning of 2003, whereas in Lithuania it was 1,230 dollars[32].

**Chart 17 - FDI per capita in Kaliningrad as compared to Russia**

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|---|
| Russia | 14 | 17 | 36 | 23 | 29 | 30 | 27 | 17 |
| Kaliningrad Region | 13 | 23 | 11 | 10 | 4 | 7 | 3 | 6 |

Source: EastWest Institute (Usanov et al.)

The high risks of doing business in the region have created a situation whereby most foreign investment currently comes in the form of trade and other credits. FDI per capita has been less than national average throughout the second half of the 1990s and remains at very low level. At the same time, social and economic problems confronted by the region, witness insufficient sustainability of the regional economy and social situation compared to the results achieved. Business environment in the region including administrative infrastructure and regulatory framework has not proven to be conducive to foreign investments.

[32] Turku School of Economics and Business Administration - Kaliningrad Regional Development Agency, Kaliningrad Province in 2003, May 2004, Biannual monitoring review. P. 75

## IV. POLICY CHALLENGES AND RECOMMENDATIONS

*1) Strategic issues* for the region development are:

**Sustainability of economic growth in the region**. Economic growth in Kaliningrad remains fragile. The boost to the economy was during the last four years was given mostly by the import substitution model. However, companies involved in such manufacturing for imports to Russia and assembly enterprises are structured in the way allowing them close up immediately and leave the region in case if environment changes. There are only few companies with a vision for the region. Kaliningrad economy is taking advantage of the model that does not appear to attract strategic long term investment. Therefore to secure a healthy and sustainable economic growth will be the main task for regional authorities for the net five to ten years.

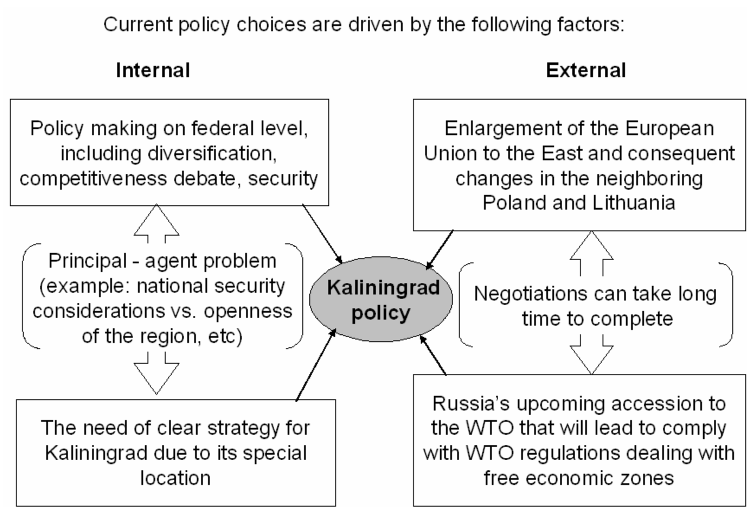
**Integration and survival in European markets**. Deeper integration in Europe as opposed to potential isolation is the only long term solution. The disadvantage of isolation should be turned into the advantage of close cooperation. Pilot region concept that is being put forward by several Russian and European experts must be supported. The concept consists in developing Kaliningrad as a region of cooperation between Europe and Russia. Through consistent common policies Kaliningrad could capitalize on its advantageous conditions and unique location.

*2) Challenges of the policy making in the region.* Among the most difficult challenges for the shaping regional economic policies we would like to emphasize the following ones.

**Geographic isolation** of the territory of the Kaliningrad Region from the territory of mainland Russia creates additional complications and increases the cost of production for the majority of industries. Instability regime of transit carriage through the territory of Lithuania. Given all these adversary effects a deeper integration in Europe offers the only logical response. Regional cooperation can help overcome additional difficulties of isolation.

**Different stakeholders**. It is difficult to find a simple and quick solution to the Kaliningrad problem because of competing interests in the region. Major actors – regional, federal and international - pursue different interests in Kaliningrad, interests that may clash each other from time to time. For example, Kaliningrad authorities want both more freedom in their external relations and, at the same time, more assistance from the federal budget. On the other hand, Moscow is very suspicious about greater Kaliningrad's independence from the center and encourages the local authorities to look more actively sources of finance other than federal funds (private sector, international investors, etc.).

**Chart 18 - Policy making towards Kaliningrad**




**Negative image** of the Kaliningrad Region in the media, both Russian and foreign. During the last decade Kaliningrad has been in the headlines of the news with rather negative message. Public opinion in Russia and abroad is by now convinced that the region is one of the poorest in the are and has huge problems with drugs and crime. The strategy for development of the Region should be aimed at reduction of effects of this negative perception. The region need to work on investment promotion and creation of positive brand in other regions of Russia and abroad.

*3) Policy proposals.* After the dissolution of the Soviet Union the Kaliningrad issue has emerged on the political agenda as an acute and controversial one. Among serious policy proposals that are being debated on both federal and regional level the following should be emphasized:

- *Off-shore zone*. Considerable part of Moscow politicians are proposing to introduce a financial off-shore in Kaliningrad that would be able to compete with other well-known off-shore countries in attracting capital
- *Switching to export orientation*. Abandonment of the existing import substitution model of the economy seems to be currently prevailing policy approach in the Presidential Administration. It includes nullification of all the custom privileges and stimulating export oriented economic growth. This approach is dictated by the fact that customs preferences in Kaliningrad contradict the WTO norms. Besides, the impact of the SEZ on the balance of payment is such that it promotes imports creating conditions for the circumvention of the customs duties and indirectly subsidizing imports from the federal budget due to the exemption from the VAT.
- *Deepening import led model*. Regional authorities and part of the federal elites are favoring sticking to and further promotion of the current economic set-up. They understand that some reform is needed. Therefore, this part of the elite argues that SEZ should be supplemented by a package of tax and investment-related privileges that would stimulate exports.

*4) Recommendations.* In our view only an export oriented economy with several strong and competitive sectors and clear investment promotion approach can make for competitive region that is will sustain growth and successfully integrate in European markets. Therefore the future strategy for Kaliningrad should build on the following pillars:

- *Cluster approach and export orientation*. The region has clear potential to develop several strong clusters. Candidates are pulp and paper industry, furniture and engineering manufacturing, tourism and hospitality sector. Capacity of these sectors need to be stimulated and developed by clear and consistent policies.
- *Regional cooperation*. The regional authorities should support the idea of Kaliningrad being developed as a pilot region of EU-Russia cooperation. Deeper involvement in the Baltic Rim region cooperation should allow Kaliningrad to develop its infrastructure and benefit from the Baltic region institutions for collaboration.
- *Get a strategic investor in the region*. It will be or paramount importance for the region to create a success story. Getting one of the major international companies to invest in the region should become one of the priorities of the current regional Administration. Only examples of successful engagement in the region will send a strong signal to investment community and stimulate further investment inflow.
- *Consistency in policies*. Further expansion of the region’s economy will strongly depend on the continuity and stability of the federal government’s policy towards the region and political consensus between Russia and EU on various issues concerning Kaliningrad.

A new law on the Kaliningrad region is scheduled to be adopted by the end of 2004. The law is causing increased uncertainty for the population and would-be investors. However, the ambition of the federal authorities to make Kaliningrad a showcase for the achievements of the Russian economy requires a favorable investment climate, and this will almost certainly lead to new tax breaks and concessions for investors.

**SOURCES:**


Birckenbach H.-M., Wellmann C. (eds.) The Kaliningrad Challenge. Options and Recommendations. LIT Verlag, Münster, 2002

Dewar S., Economic Development in Kaliningrad. Russian regional perspectives on foreign and security policy. IISS, London 2003.

Eliseeva I., Burova N. The measurement of the shadow economy in St Petersburg and Kaliningrad, paper presented to RECEP conference "Russia's opening to the world economy and the building of a common European economic space", Moscow 20-21 Sept.

Emerson M. with Tocci N., Vahl M., Whyte N. The Elephant and the Bear. The European Union, Russia, and Their Near Abroads. Brussels, Center for European Policy Studies.

Kaliningrad Regional Development Agency Prospects of Regional Foreign Trade Regime. 1st Quaterly Bulletin. Kaliningrad.

(The) Kiel international ad-hoc group of experts on Kaliningrad Kaliningrad in Focus. Policy recommendations in the perspective of problem-solving. SCHIFF-texte No.67, Oktober.

Lamande V., Vinokurov E. Formation of Kaliningrad Trade Specialization (Formirovaniye torgovoy spezializacii Kaliningradskoy oblasty), in: Voprosy Ekonomiki, No.2, P.53-63.

Lamande V., Samson I., Vinokurov E. Measuring Regional Economic Development in Russia: The Case of the Kaliningrad Oblast. European Urban and Regional Studies 11: 71-80.

Brian O'Reilly, Kaliningrad: A Telecommunications Development Plan (Brussels: Tacis, December 1998).

Samson I. (dir.) The Kaliningrad Economy - at the Edge of EU Enlargement, IMC/UPMF "Promoting Trade and Investment in Kaliningrad Oblast", Economic Survey, Tacis, The European Commission, Brussels.

Samson I., Lamande V. Elisseeva I., Burova N., Fedorov G. A New Look of Kaliningrad Region, GTD UPMF working paper, October.

Samson I., Elisseva I. Kaliningradskaya Oblast: inoy vzglyad [Kaliningrad Oblast: a New Look], Voprosy Ekonomiki, No.2, P.43-53.

Smorodinskaya N. Kaliningrad exclave: prospects of transformation into a Pilot region. East-West Institute.

Smorodinskaya N, Zhukov S., The Kaliningrad Enclave in Europe: Swimming against the Tide. Diagnostics of the State and Potential of Economic Development. EastWest Institute 2003

Usanov et al., Support to Transforming the Kaliningrad Oblast into a Pilot Region of Russian-EU Cooperation. EastWest Institute, 2003

Vinokurov E., Kuzin V. Regional import quotas in SEZ Kaliningrad: Experiences and impact on the regional economy, 1998-2003. AIKE Online Papers, 2004, www.kaliningradexpert.org, in Russian.

V. Zhdanov, O. Kuznetsova, V. Mau, V. Plyukhin, S. Prikhodko, M. J. Wojciechowski and A. Hecht Problems Related to Development of the Kaliningrad Region As an Exclave Territory of the Russian Federation, Institute of Economies in Transition, Moscow 2002

**OFFICIAL DOCUMENTS:**

Commission of the European Communities Report to the Council of Ministers of the EU “EU and Kaliningrad”, Brussels, 17.01.2001, KOM (2001) 26.

Commission of the European Communities. Implementing policy for external trade in the fields of standards and conformity assessment: a tool box of instruments. Brussels, 28.09.2001, SEC(2001) 1570.

Commission of the European Communities Communication from Commission to the Council “The EU and Kaliningrad”, Brussels, 17.01.2001, COM 2001 26 (final).

Commission of the European Communities (2002a) Communication from the Commission to the Council. Kaliningrad: Transit. Brussels, 18.09.2002, COM (2002) 510.

Commission of the European Communities (2003) Communication from the Commission to the Council. Wider Europe - Neighborhood: A New Framework for Relations with our Eastern and Southern Neighbours. Brussels, 11.03.2003, COM (2003) 104.

Economist Intelligence Unit. Country Report. Russia. September 2004. London 2004

Kaliningrad Regional Committee for Statistics (2001) Kaliningrad Oblast in numbers 2001. (Kaliningradskaya Oblast v cifrach 2001). Kaliningrad.

Kaliningrad Regional Committee for Statistics (2002) Kaliningrad Oblast in numbers 2002. (Kaliningradskaya Oblast v cifrach 2002). Kaliningrad.

Kaliningrad Regional Committee for Statistics (2003). Kaliningrad Oblast in numbers. Short statistical collection.

Kaliningrad Regional Committee for Statistics (2004). Kaliningrad Oblast in numbers. Short statistical collection.

North-West Customs Office (2001) (Overall characteristics of external economic activities of Kaliningrad Oblast in 4$^{th}$ quarter of 2001 and for the whole year 2001, in Russian) Customs Bulletin 2001/4.

Strategy of social and economic development of Kaliningrad Oblast as the region of cooperation up to the year 2010. Kaliningrad 2002

Turku School of Economics and Business Administration - Kaliningrad Regional Development Agency, Kaliningrad Province in 2003, May 2004, Biannual monitoring review.