

***E*ast European *S*tudies**

No. 4



Institute of World Economics RCERS
Hungarian Academy of Sciences

Eurasian Challenges

**Partnerships with Russia and
Other Issues of the Post-Soviet Area**



2012



Research Centre for Economic and Regional Studies
of the Hungarian Academy of Sciences,
Institute of World Economics

EAST EUROPEAN STUDIES NO. 4

**EURASIAN CHALLENGES
PARTNERSHIPS WITH RUSSIA AND OTHER
ISSUES OF THE POST~SOVIET AREA**

Edited by

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Budapest, 2013

The publication was supported by the
Hungarian Scientific Research Fund (OTKA)
Project No. K105914

ISBN 978-963-301-592-6

ISSN 2063-9465

Copy editor: Nóra Kolláth

Page setting: Paksai Béláné

Cover design: András Székely-Doby, Gábor Túry

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FOREWORD

Similarly to the previous numbers of the East European Studies series this volume provides the reader with an opportunity to have a closer insight into researches having been conducted recently on some post-Soviet issues in the Institute of World Economics, which, due to the restructuring process within the Hungarian Academy of Sciences (HAS), now constitutes part of the Research Centre for Economic and Regional Studies of the HAS. As a tradition, the volume contains studies based on researches in our domestic or foreign partner institutions as well. Among the authors one can find both experienced researchers and junior research fellows since we find it very important to give an opportunity to young analysts to publish their first research results.

Our themes vary widely. Four of the studies deal with relationships of individual countries with Russia; it is for this reason that we chose the title of the first block: “Russia as a partner.” In this part of the volume the reader may find analyses on the bilateral relationships of different EU-members (such as Italy and six Central-East European states) and post-Soviet (for example the three Caucasian) countries from political, security or economic approaches. A study on the Ukrainian choice related to the country’s integration direction fits into this group of studies well. In the second part of the book, we publish two challenging studies that are a little set apart from this set of themes. The first deals with the understanding and practice of Public-Private Partnership in Ukraine, which is a key issue in present-day Ukrainian economy. The last article is a real curiosity, since it analyses the problem of the Aral Sea not in the widely used ecological point of view but from an economic approach.

The first study written by *Volodymyr Sidenko* analyses a very timely topic of the past few years. Ukraine, located between the European Union and Russia, has been invited to join both the European Single Market through the Deep and Comprehensive Free Trade Agreement concluded with the EU and the recently launched Russia-led Eurasian Community and its core element, the Customs Union. At the time being it seems that these two integration directions are mutually exclusive, so Ukraine is under pressure to make a very difficult decision. The study gives the pros and cons for both ways concluding that any of the two choices causes

enormous harm to the other relation and to Ukraine itself. As a solution for Ukraine the author suggests the model of a Pan-European Economic Space, an institutional formation consisting of national and regional economic systems that are mutually compatible. An alternative model to this is a Pan-European Economic Space with two independent but interconnected centres (the European Union and the post-Soviet integration), a model the author calls a bipolar Europe model. A third solution is the concept of the 'multipolar big Europe' with a big number of regional and subregional unions participating in it.

The second study written by *Annamária Kiss* deals with relations between Russia and the three South Caucasian countries. Owing to potential political instability, insecurity, economic uncertainty and ethnic conflicts caused by a mutual mistrust of these nations (which are mutually correlated), the South Caucasus can be regarded as one of the world's most vulnerable and unstable regions. Russia, as a most prominent actor in the region, can play an operative role in finding solutions. Naturally, these three bilateral relationships are of a different character, varying from a close partnership (Armenia) to a very hostile relationship (Georgia). The intent of the article is to present the main contradictions and features of the relations with Russia in the fields of security and economy.

Marco Siddi's article focuses on the Italian-Russian relationship embracing both the political and economic fields. Italy is one of Russia's key economic partners in Europe while being among its most significant and influential 'friends' within the EU in a political sense as well. A long period of good political relations, which have not been affected by cabinet changes either in Rome or Moscow, has contributed to the consolidation of the partnership. The author argues that the hugely positive trend in economic relations based on very intensive energy relations and a close co-operation in other sectors is likely to continue. The study gives important details on Italian-Russian trade, investment and energy links highlighting most recent developments.

The last study of the first block written by *Zsuzsa Ludvig* investigates trade relations between six Central East European (CEE) countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia) and Russia focusing on the impact of economic crises on these links, with special regard to CEE export performances. The author argues that CEE-Russian bilateral trade links have been long specific due to historical and economic reasons resulting as a rule in deeper declines in trade volumes under economic crises compared to other, mostly more advanced economic partners of Russia. Moreover, besides common characteristics, individual CEE-Russian bilateral trade developments showed some specific features during the past two decades as well. However, these differentiations in trade links both among them and in a comparison to the economically more developed partners of Russia have been recently diminishing due to the growing presence and dominance of transnational companies in CEE exports.

The fifth article deals with the more and more timely and fashionable theme of Public-Private Partnership (PPP), namely in Ukraine. PPP has become a popular and useful means of implementing public investment projects around the world. Governments have been using PPPs to realise huge investment projects like highways, power plants, hospitals and other fixed assets. The paper written by *Ievgen Cherevykov* provides a survey on PPP practice and implementation in Ukraine considering PPP as a socio-economic institution. The study highlights Ukrainian peculiarities and shortcomings focusing on the institutional background.

Finally, the volume ends with a very interesting but at the same time enjoyable study written by *Alpár Szőke* on the catastrophe of the Aral Sea. As a novelty the focus of Alpár Szőke's article is given to the economic impacts of the environmental change in the Northern Aral region in Kazakhstan. The author argues that the Aral Sea region, and the Northern Aral Sea in particular is a perfect example that shows how negative externalities and mismanaged natural resources resulting in environmental catastrophe can turn a prosperous region into an infamous area hit by both an economic and a social crisis. After providing a brief overview of the drying out process and its practical economic consequences based on statistics the study presents not only the measures already taken in order to save the lake but their already visible results on the local economic and social life as well.

The authors hope that they could provide the reader with interesting and valuable studies and could contribute to the understanding of some challenging issues, all of them related somehow to the colourful post-Soviet region. We offer this volume to both the academic, educational circles and the administrative sphere interested in post-Soviet studies.

Articles were finalised in late 2012.

Zsuzsa Ludvig
editor

RUSSIA AS A PARTNER

UKRAINE'S REGIONAL INTEGRATION POLICIES: THE EU VERSUS THE EURASIAN COMMUNITY

Volodymyr Sidenko

Introduction

The problem of Ukraine's multivector integration policy has become notorious both within Ukraine and outside it, both in professional political and academic circles and in the broader public. Despite the evident political losses for Ukraine arising from the permanent conflict between the Western and Eastern integration vectors, this problem has proved to be amazingly persistent. Thus, it would be a gross mistake to attribute its existence to the mere political preferences of any factually ruling political groups and their lack of desire to make a decisive choice. Evidently, the roots of the problem go very deep, branching extensively, and the most important task is to reveal them entirely in order to see clearly the essence of the phenomenon and find applicable measures to tackle it.

1) The alternating course of Ukraine's integration: a retrospective view

From the very beginning of Ukraine's independence and for the most part of the 1990's, the above-mentioned problem was concealed by the evident preference of Ukraine to the relations with Russia and other post-Soviet states within the Commonwealth of Independent States (CIS). On the one hand, there were frustrating results in the attempts to reintegrate the post-Soviet space on new market principles caused not only by the domination of national state building motivations in a number of new states, but also by the lack of mature market institutions needed for this sort of integration. But on the other side, there was no real alternative at that time, as the process of the institutionalisation of relations with the European Community was at its initial stage. The latter is proved by the fact that the Partnership and Cooperation Agreement (PCA) between the European Communities and their Member States, of the one part, and Ukraine, on the other hand, was enacted only in March 1998. Thus we can say that prior to 1998 Ukraine was a country pursuing a policy with a rather restrained regional integration component. In fact, it was more active globally, focusing its efforts on obtaining access to the WTO and getting the support needed for macroeconomic stabilisation from global financial institutions.

The real change in Ukraine's integration policy came closer to the turn of the millennium and it was primarily based on the following two major factors. Firstly, it became evident that the policy of reintegration of the post-Soviet space had definitely acquired the shape of a hub-and-spoke model, where the hub was represented by Russia. Apart from economic considerations in Ukrainian business circles fearing the domination of Russian capital,¹ it caused much wider and more serious concerns in Ukraine with

¹ The potential danger of such arrangements in purely economic terms was revealed, in particular, in a World Bank study (Schiff and Winters, 2003, 15–16, 78), where the authors stated that this model enables the hub country to reap the bulk of potential benefits arising from integration.

regard to the compatibility of such an integration model with the country's national sovereignty. Russia and its allies showed by that time the explicit desire to rapidly proceed with an ambitious Eurasian integration project which excluded (at least temporarily) such hesitating partners like Ukraine.

Secondly, Ukraine, by the end of 1990's, was approaching the termination of the prolonged systemic transformation crisis and thus encountered new objectives of qualitative change in its development. This new post-crisis period saw the emergence of long-term strategy programmes aimed at creating an internationally competitive economy and achieving European standards of life; these tasks required an entirely new quality of public institutions. It is self-evident that under these new strategic objectives Ukraine's policy of regional co-operation shifted from the formerly dominating task of 'the civilised divorce' in the post-Soviet space to the idea of targeting high-ranking development through following the beacon of European integration. The new opportunities created this way by the PCA led to the adoption of the Strategy of Ukraine's Integration into the European Union² in mid-1998, followed by the Programme of Ukraine's Integration into the EU,³ and culminating in the official adoption of the country's new development strategy in 2002 unambiguously titled 'The European Choice'.⁴

All in all, it seemed that Ukraine had definitely turned towards the West and adopted the model of European integration coupled with the strategic partnership with Russia and the free trade relations in the entire CIS space. But it was a premature conclusion, as already in February 2003 the Ukrainian president principally agreed to enter, together with Russia, Belarus and Kazakhstan, into a new regional integration project called 'The Common Economic Zone' (CEZ).⁵ This principal decision was legally finalised with the signing on September 19, 2003 of the framework

² *Ibid.*, (1998).

³ *Ibid.*, (2000).

⁴ *Ibid.*, (2002).

⁵ This is the term officially used by the WTO in its notification procedures registered in the Regional Trade Agreements database, though in some publications it was named "Common Economic Space" or "Single Economic Space".

agreement on CEZ which was ratified by the Ukrainian parliament on April 20, 2004.⁶

The conflict created by this agreement was evident, but it was not implied in the alleged violation of the Ukrainian Constitution. Though the reservation made during the ratification said that Ukraine was to take part in the formation of the CES within the limits set by its Constitution, it did not mention any specific article. Unofficially, it was made clear that the problem rested with the principle of supranationality laid down in the CEZ Commission acting as a single regulating agency. But it remained unclear how the country could be integrated, with such an approach, into the EU where the same principle of supranationality is even more explicit. Nevertheless, the conflict of two integrations evidently existed and it was rooted in the functional impossibility to implement the Eurointegration course of the country under conditions when substantial regulatory competences had been transferred to the common regulatory body of the CEZ.

This conflict was, for the time being, resolved purely by political instruments. The election of the new president Victor Yushchenko, who was more open-minded toward the West, politically suspended the implementation of the project on the part of Ukraine. However, Ukraine did not denounce the framework agreement; it merely restrained from signing the package of new draft agreements implementing the framework agreement. It put the country into a somewhat ambiguous position: *officially* it is still a participant of the CEZ⁷ but *actually* does not participate. It looked like the country closed the doors before the CEZ project *but not very tightly*, so that *it could reopen it, should it be necessary*.

There is a wide-spread perception, both in Ukraine and in the EU, that the period of the triumph of the 'Orange Revolution' (from January 2005 until August 2006 when V. Yanukovich was appointed prime minister) was the most favourable period for the country's rapid integration into the EU (similar to the way passed earlier by East and Central European countries) and that this opportunity was not used to its full potential and thus was actually lost. But despite the popularity of this view, it does not look persuasive.

⁶ CES (2004).

⁷ Ukraine officially notified its participation in the CEZ while entering the WTO (WTO Regional Trade Agreements Database).

It is true that during the period of the presidency of V. Yushchenko Ukraine and the EU proceeded on a higher level of their interaction that was primarily associated with the transition to the European Neighbourhood Policy (ENP) and later (in 2009) to the policy of the EU Eastern Partnership (EaP). The guiding principles of the ENP and especially of the EaP provide for Ukraine the far-reaching strategic perspective of an actual integration into the single market of the EU and an active participation in different European policies and thus in the activities of a number of the EU institutions. This approach gave priority to real interaction in a permanently expanding integration field over implementation of a virtual larger integration project. This sort of integration policy is fully consistent with the functionalist way of thinking of the EU that proved to be rather efficient during the long period of European integration since the 1950's, and especially it proved its relevance for the initial stages of the European integration process. Nevertheless, in the case of Ukraine it failed to receive an adequate internal political and public support. Very indicative of this restrained attitude was the official position implying that Ukraine treats the EaP only as a *supplementary* instrument that enables the acceleration of Ukraine's integration into the EU and that Ukraine would support this policy as long as it does not substitute the prospect of the EU membership and the further enlargement of the EU.^{8,9}

It was quite clear that Ukraine expected from the EU the above-mentioned 'larger integration project' and not the policy of small, even though multiple real steps. Ukraine did not want to wait for long-term prospects; its officially declared foreign policy objective was to follow a quick integration progress. And this official platform, supported by many political activists, academic researchers and experts who are open-minded to the West, demanded a new agreement with the EU, which would be similar to the European agreements concluded in the 1990's with the future EU members from Central and Eastern Europe. Interestingly, this escalation of integration expectations on the part of Ukraine happened on the

⁸ It is noteworthy that later the Ukrainian government made its official position regarding EaP somewhat more flexible, as it no longer links its support of this policy to the prospect of EU membership; however, it stresses the auxiliary role of EaP to the format of bilateral relations with the EU (Government of Ukraine 2012).

⁹ Government of Ukraine (2009).

background of quite serious problems with the implementation of the bilateral ENP Action Plans in some crucial areas, i.e. pertaining to the quality of existing regulatory environment, rules of competition, independence of the judicial system, *etc.*

The era of Viktor Yushchenko actually revealed the country's dualism with regard to European integration which one can notice in the exacerbated contradictions between the virtual European integration expectations and the country's socioeconomic reality. This dualism reached its extreme point with the advent of the global financial and economic crisis in 2008, which showed the vulnerability of the existing Ukrainian economic model, whose systemic characteristics are non-competitive and hostile to innovation but rent-seeking economic behaviour of the big business coupled with ever-growing foreign indebtedness needed to support internal demand. As a matter of fact, the rule of President Yushchenko was the period of *extensive pro-European diplomatic activity but of a rather controversial policy of internal social and economic transformations*. The European integration course of that period, not backed with proper change in the internal institutional environment of the country, turned to be very *shallow* and to a great extent *formal* and *declarative*.

The widening split between escalating pro-European expectations and declarations, on the one hand, and the reality of a stagnating approach to the European social and economic standards, on the other hand, has created a serious challenge for the future of Ukraine's relations with the EU. In spite of this, the parties embarked on the path leading to a new far-reaching agreement implying political association and economic integration, including the creation of a deep and comprehensive free trade area (DCFTA). The initial idea of this step was, supposedly, that it might stimulate the needed internal change within Ukraine (the way it really did for the new EU entrants in the 1990's and the early 2000's) and thus create additional basis for the further expansion of the integration process. But this idea did not work because of the following three potent factors.

Firstly, the internal development of Ukraine under the new president (Viktor Yanukovych), despite some partial economic achievements in raising the rates of economic growth and infrastructure development, has been diverting from the EU standards in a number of areas embracing both the functioning market mechanism (growing violation of ownership rights, including

raider attacks at profitable private entities, abuse of dominating monopolistic position at different market sectors, oppressive taxation of small and medium-sized businesses) and the public sphere (especially mismanagement of public finances, politically biased court decisions and the surge of corrupted practices in the judicial branch on the whole, attempts to curb democratic procedures and the freedom of the media, *etc.*). In some important aspects (first of all, political democracy and the freedom of the press) there was an evident reversal from the trends inherent in the Yushchenko era.

Secondly, the European Union, facing a most severe financial tension in a number of Eurozone members, has come to a dilemma: whether to continue a risky course of further enlargement or concentrate on internal stabilisation and deepening of integration within its present frontiers. In any case, its unwillingness to accept new problematic members is beyond doubt. The EU seems to pursue the policy of keeping Ukraine within the range of its political and economic influence but without giving any binding commitments as to a possible membership.

Thirdly, since 2010 the efforts of Russia to pull Ukraine into the Eurasian integration communities, contrary to the EU restrained policies, have seriously intensified, based on huge financial resources derived from Russian energy exports and the strengthened Russian transnational corporations seeking a new field for their expansion.

All in all, these three factors have brought Ukraine's integration policy to a position of a stalemate, when former *multivector* (as a matter of fact, *alternate vector*) integration policy has actually transformed into a '*vectorless*' one.

2) Economic dilemmas of Ukraine's integration policy

Since 2010, Ukraine has been showing signs of a rising pragmatism in its integration policy which is characterised by an evident prevalence of its economic aspects over other considerations: '*value*', not '*values*' have come to the forefront. This change reflects the dominating philosophy of Ukrainian big businesses that

now rule the country. At first, this transformation looked more favourable for an eastward integration. But very soon this view proved erroneous because of the intrinsic economic nationalism of the new Ukrainian government. It became aware that regional integration, whatever its model might be, is fraught with not only potential gains but certain losses and risks as well.

Thus, in the course of negotiations with the EU on the future DCFTA, Ukraine faced serious impediments originating from the overtly protectionist stand of the EU in the agrarian sector, its refusal to grant Ukraine a more or less free access to the European single agrarian market in the fields which are mostly interesting to Ukrainian exporters. Practically all key items of Ukrainian agrarian and foodstuff exports (except sunflower seeds and rape-seed needed for bio energy) were practically excluded from the free trade regime, as free trade was granted for them only within minor tariff quotas set at the level sometimes less than 0.1 per cent of the annual value of sales in the EU internal market.¹⁰ Outside these quotas, the EU has extremely high (actually prohibitive) import tariffs for many agrarian products and foodstuffs: the tariff peaks for animal products soar to 191 per cent, dairy products to 172 per cent, fruit, vegetables and plants to 119 per cent, grain, cereals, and preparations to 118 per cent, sugars and confectionary to 106 per cent. In the aggregate, the simple average applied agrarian tariff rate under most favoured nation regime equalled in 2010 12.8 per cent in the EU, while in Ukraine only 9.8 per cent.¹¹

DCFTA with such parameters limits growth prospects for the agrarian sector of the Ukrainian economy and actually blocks the process of its penetration of and consolidation on the EU market. Moreover, it may, in fact foster undesirable structural side effects such as the spontaneous structural adjustment of agricultural production in Ukraine aimed at the substitution of foodstuff production with the output of raw material for European bio fuel capacities, causing the progressive degradation of Ukrainian land and ensuing the radical decrease of land productivity in the long run.

¹⁰ Calculations made by the researchers of the Institute for Economics and Forecasting of the National Academy of Sciences of Ukraine, including the author in the course of negotiations.

¹¹ WTO (2011).

At the same time, the full opening of the EU market of industrial products has a rather limited potential impact on Ukraine, because the simple average import tariff rate for non-agricultural products in the EU, according to the WTO data valid for 2010, was only 4 per cent, compared to 3.8 per cent in Ukraine.¹² Ukraine faces the problem of overcoming the structural barrier on its way to the European markets of industrial goods with higher value added and technology-intensive goods. It requires prolonged periods of adaptation during which sizeable investments, not only into physical but also human capital, are to be made. Access of Ukrainian exporters to high-tech European markets is now blocked not by the existing import tariffs but by the incompatibility with the European standards and technical regulations, low level of involvement into the formation of the transnational production value chains and industrial co-operation, underdeveloped networks of permanent commercial presence at priority segments of the European single market.

Of course, the very process of European integration has certain positive impact on internal development due to the new, more demanding institutional standards of the EU. But as the present-day practical experience of some EU member states proves, they cannot prevent failures in economic policy. It is also important to take into account that the expected effect in terms of institutional development can be attained only in the long run, while considerable adaptation expenses may prevail in the short- and medium-term. Regarding the existing scale of the 'institutional lag' in the case of Ukraine, it is clear that the amount of state budget resources needed to tackle these problems may exceed the limited capacity of the Ukrainian public finance by far.

This problem may even exacerbate, provided Ukraine's entering the DCFTA with the EU is to cause a negative response on the part of the Customs Union (CU) of Russia, Belarus and Kazakhstan. In fact, the newly enacted (in 2012) multilateral free trade agreement of the CIS states has a reservation which enables the above-mentioned partner states to initiate a revision of the list of exclusions from the free trade regime should the DCFTA cause a substantial inflow of imports to the customs territory of the CU. Should this happen, the net trade effect for Ukraine might be not positive but rather negative in the short- and medium-term per-

¹² *Ibid.*, (2011).

spective, as exports, under such conditions, would suffer considerable losses. Apart from this, some negative side effects might follow for Ukraine in other areas as well, *i.e.* in the field of investment flows, international labour migration, co-operation in science and technology, transit transportation services, *etc.*

Under the existence of the above-mentioned limitations arising from the Eurointegration course, the Eurasian alternative seems to offer a number of ready solutions. The most powerful among them is the Russian offer to substantially revise the price formation for Russian natural gas supplies and suspension of export duties for Russian oil and petroleum products. According to some estimates presented by the government officials the gas formula revision might result in a USD 4.5 billion yearly gain for Ukraine, and the oil export duty suspension in another USD 3.5 billion in surplus per year.¹³

These preferences might be augmented with more active development, under unified Eurasian market regimes, of scientific and production co-operation creating a potentially substantial economy of scale effects. Apart from this, Ukraine might benefit from the access to Russian development programmes that are rather abundantly backed by financial resources, not only directly but through regional development institutions (*i.e.* the Centre for High Technologies of the Eurasian Economic Community – EurAsEC) as well. Last but not least is the factor of the possible decreasing of the threat arising from the Russian projects of constructing bypass gas transportation routes.

But, on the other hand, the Eurasian alternative is not free from severe challenges to the Ukrainian economy. The risks are linked not only to the real threat of a failure of the entire system of agreements that have been reached so far with the EU and the inevitable regress in their mutual relations (including the regime of access to EU programmes and financial resources). Ukraine, under that alternative option, would surely fall into unilateral dependence on the actual level and rate of modernisation in the Eurasian member states.

One might predict the pending erosion of price preferences on Russian energy supplies produced by the shift of their extracting

¹³ Muntijan (2011). One should take into account that these figures are based on present-day price and cost situations.

base to distant regions, with much more difficult natural conditions and therefore much higher costs.

But for Ukrainian big business the most serious concern is associated with a possible side effect of the participation in the Eurasian integration communities: the integration of capital markets within it might easily boost inflows of Russian capital to seize control in certain areas which are of strategic interest to Ukrainian business, including aircraft construction, pharmaceutical production and other R&D-intensive industries, the energy sector, ship-building, communication, computer and engineering services. Ukrainian business community has an evidently mixed attitude to this question: a want of extra investments from Russia versus the fear of Russian investors.

As the above analysis shows, *both alternatives – the EU and the Eurasian – need to find a balanced approach in terms of potential gains and losses or risks*. Though this overall balance *taken strategically* seems to be more in favour of the EU integration, it is a major question how to reach these strategic gains if they are associated with considerable medium-term expenses.

It is beyond doubt that Ukraine could benefit most from such a regional integration arrangement, which would combine the benefits offered by the two options and simultaneously offset the risks hidden in both of them. That is why the Ukrainian government seeks the expansion of the field of available opportunities. There are several directions along which this search is being performed.

Firstly, Ukraine tries to *expand the network of free trade agreements beyond the dilemma of the EU versus Eurasia*. Thus, it has a valid FTA with Macedonia since 2001, and one within the GUAM (Georgia, Ukraine, Azerbaijan, and Moldova) since 2003. Of great potential importance is the June 1, 2012 enactment of the FTA with the European Free Trade Association (EFTA) that had been signed in June 2010. By its contents, the latter is a DCFTA, in many aspects similar to the contents of the agreed DCFTA with the EU. Apart from this, Ukraine conducts negotiations or consultations on FTA with a number of other countries, including Canada, Israel, Morocco, Syria, Singapore, and Turkey. By implementing this 'diversification policy' Ukraine tries to expand its field of freedom and facilitate manoeuvre in its relations with its strategic partners – the EU and Russia.

Secondly, Ukraine is trying *to involve China* in its strategic economic relations, so that a *counterpart to any dominating partner* should be present. China is acquiring a growing part as Ukraine's foreign source of finance. During 2012, Ukraine received two large loans from China totalling more than USD 6.6 billion (USD 3.656 billion for the programme of substitution of natural gas with Ukrainian coal, and USD 3 billion for the implementation of development projects in agriculture).¹⁴ And in June 2012 a 3-year swap deal for USD 2.36 billion was signed between the central banks of the two countries. And at the end of August 2012, the Ukrainian President declared Ukraine's interest in acquiring an observer status in the Shanghai Co-operation Organisation (SCO), in order to take part in the ongoing integration processes within this organisation. Moreover, in September 2012 the President of Ukraine¹⁵ added the Asia-Pacific Economic Co-operation (APEC) to the list of priorities in regional co-operation.

Thirdly, Ukraine tries to push through its own vision of *co-operation with Eurasian economic structures* which is based on the concept of the so-called '*3+1*' formula. For this reason, a Working Group on the matters of development of Ukraine's interaction with the Customs Union of Belarus, Kazakhstan, and Russian Federation was set up by the President of Ukraine in June 2011.¹⁶ Its main task was to work up a strategic paper on this matter based on the '*3+1*' concept. The Working Group proposed a strategic vision of this interaction based on sectoral and project approaches rather than institutional adaptation. This platform, if adopted by all the partners, could provide for *far-going cooperation within the Eurasian common economic space, but without participation in supranational institutional structures*. Unfortunately, this approach was not accepted by the Russian Federation. Nevertheless, it cannot be dismissed as a subject for future negotiations, should political and ideological approaches modify.

Despite all the significance of the above-mentioned institutional and political solutions, the most promising one may be connected to the idea of a formation embracing both the EU and the Eurasian community. However, a wider pan-European eco-

¹⁴ However, these were so-called "tied loans" that is with Ukrainian obligations of using Chinese supplies, services and technologies.

¹⁵ President of Ukraine (2012).

¹⁶ *Ibid.*, (2011).

conomic space may be regarded only in the *strategic* perspective, and is not looking viable under the present geopolitical competition of Russia and the EU over the spheres of political domination.

Thus, Ukraine's regional integration policy has come to a crossroads. On the one hand, it almost finalised the process of shaping a DCFTA with the EU. But this process, being an integral part of an association agreement, has rather vague prospects for its official enactment and implementation under the present circumstances of political development in Ukraine. But even if it comes into force, its real effectiveness would be rather questionable, taking into account the massive distortions in the general market environment in Ukraine, mostly because of a huge divide between Ukraine and the EU in the quality of their institutions.

On the other hand, the turn towards the Eurasian Community that at first sight, might look easier from an institutional point of view, is also questionable because it is seriously restrained by Ukrainian fears of being dominated by Russia, with its utterly pragmatic and far from excessively co-operative attitude towards its partner countries.

And involvement of third parties like China is also a risky affair, taking into account China's ability to conquer foreign markets, not to mention dependencies arising out of indebtedness. At that, Russia might be envious of Ukraine's flirtation not only with the EU but with China as well, its rather problematic global ally and competitor.

3) Pan-European Economic Space as a possible solution for Ukraine

The *Pan-European Economic Space (PEES)* may be imagined as an institutional formation consisting of national and regional (or subregional) economic systems that are mutually *compatible* though *not identical* and whose development is co-ordinated via a permanent process of economic policy interaction at various levels in the presence of a relatively high level of liberalisation for the interflow of economic factors.

The basic components of PEES, being a very extensive economic space, may comprise of the following:

- * Co-ordination (harmonisation) of the local (regional) regimes of liberalisation for the flows of goods, services, investments, labour and knowledge – with a possible shaping of a single agreement on these issues valid for all PEES participants.
- * Harmonisation of trade policy measures (in addition to the existing WTO norms) as well as of investment, innovation, labour market, and macroeconomic stabilisation policies.
- * Closing the most evident divergences in institutional parameters relating to the development of business, and implementation of an agreed programme to minimise transaction costs in mutual relations.
- * Implementation of common measures aimed at large infrastructure projects of Pan-European significance, including transcontinental transport, communications and ecology control systems.
- * Support for shaping and functioning of large common projects for the development of international production chains, mainly in high-tech areas, that require the pooling of resources to share the risks associated with high costs.

The initial stage of PEES development, which is to set up the necessary basic prerequisites, is to be characterised, first of all, with mutual adaptation and formation of a network of formalised relations between various regional and subregional organisations and economic unions – to embrace and institutionally link the EU, CIS, EAEC, GUAM, SCO, the Black Sea Economic Cooperation (BSEC) – to determine principles, areas and instruments of co-operation in the solution of common problems.

At this initial stage, it would be extremely important to determine correctly a set of major transnational priority projects, which would be, on the one hand, large-scale in order to create a substantial long-term link of interests, and on the other hand, operable enough to be implemented within acceptable terms and without excessive financial burden.

Should the initial stage prove successful, a more multifarious stage of PEES might follow. It would be associated with the formation of Pan-European institutions regulating transnational economic activities, including the creation of a Pan-European Free Trade Area (or, possibly, Euro-Asian Free Trade Area), and the

gradual (and possibly with certain restrictions) liberalisation of capital and labour movement. Regarding the latter, it might initially be the abolition of the existing visa regimes, and later the introduction of a mechanism to regulate migration and employment. Substantial progress would be needed during this stage to create a format for closer economic policy co-ordination, especially regarding global anti-crisis policy.

If the above-mentioned stage of PEEC formation proved to be successful, it might launch a new stage to finalise the process. It would cover the most sensible areas of interaction that require prolonged preparatory periods. One could imagine here a completion of the process of full liberalisation of capital movement (perhaps with certain minimal exclusions, if needed) as well as the far-reaching liberalisation of labour movement. Among other institutional measures, one could imagine an unfolding of the network of Pan-European organisations needed for the common regulation of key areas of transnational interaction, *i.e.* in key power generation technologies of the future, ecology and transnational communications. One cannot exclude an adoption of a common framework pan-European agreement on trade and economic issues.

Of course, the above-mentioned outline has now a rather speculative character. To a great extent, the real content of the process of establishing a broad pan-European economic structure would be dependent on the model employed. And one could imagine different alternative models through which the PEES may progress.

The EU seems to follow the political ideology which is based on the well-known principle of '*concentric circles*', or its various modifications. The latter, going back to the ideas of Jacques Delors, the former President of the European Commission, formulated as far back as 1990,¹⁷ regards the EU and primarily its 'core' member states as a centre around which the whole structure is to be built. The peculiarity of this model is that it predicts the weakening of interaction as the distance from the core grows, but it preserves its homogeneity due to basic principles emanating from the 'core'. The contemporary ENP may, on the whole, fit well into the concept of this ideology, as it calls for the formation of a belt

¹⁷ A more recent version of this idea was presented by former French Prime Minister Balladur (2005).

of the EU Eastern neighbour countries with their active involvement, but not as member states, into European processes.

However, ENP and EaP proceed from the principle reading that granting certain opportunities to the neighbours (partners) is linked to the level of progress in the adaptation of the EU regulations within the country. It results in different relations with the EU, which cannot but complicate the formation of a broad common space. Under these conditions, the more a neighbour (partner) country advances on its way towards the EU the more it puts at risk its co-operation with post-Soviet regional unions, and thus causes counteraction on their part. Apart from that, any formation of a broad economic space based on the principle of unilateral expansion on the side of the EU is doomed to produce asymmetric regional structures and, sooner or later, will face the barrier of limited resources causing damped influence of the EU in this process.

An alternative model for the formation of the PEEC might look like balanced reciprocal movement towards a common space, with two independent but interconnected centres (*bipolar Europe model*). This model takes into account Russia's self-identification as an Eurasian power which is independent in relation to the EU and does not obligatory follow in the wake of European legislation. Nevertheless, if the four common spaces of the EU and Russia are to be successfully implemented, it would considerably approach the solution of many basic problems associated with the PEEC formation. However, the model of a bipolar Europe also fails to reflect the entire reality of the post-Soviet space, namely its complicated and highly differentiated structure. Therefore, taken in its pure form, it might not be sufficient for efficient formation of a common pan-European economic space.

Under the condition when a number of regional and subregional unions (organisations) have already spread across the post-Soviet space, one cannot ignore their more or less active part in the process of PEEC formation. Thus, the model of a growing interaction between multiple European regional and subregional spaces (*multiregional big Europe*) seems to be more viable. This would require a full manifestation of the principle of openness on their part to other countries in Big Europe and their ability to coordinate their activities in order to achieve better synergies. The problematic aspect of this model is rooted in the difficulty of securing the sufficient integrity of the thus created common space.

To overcome this difficulty, or at least diminish it, a more co-operative approach would be needed on the part of key participants, namely the EU and Russia.

That is why the most realistic way to shape the PEEC is to use a sort of *an eclectic approach* based on a certain pragmatic combination of the three above-mentioned models, with various pan-European institutions set up so as to make the process more or less cohesive.

It is also very important to see a wider perspective for the proposed PEEC, which may well evolve into a *broad Euro-Asian economic space (BEAES)* spreading from the Atlantic to the Pacific. It would be possible if the SCO were to be involved in the process. The SCO has already proclaimed, in its latest summits, its future role as a transcontinental bridge between Europe and Asia. There are certain signs that the EU is also searching for new approaches aimed at achieving synergy between the now segmented actions of the EU in three areas of relations – with Russia, EaP member countries and Central Asian countries, with the latter playing the role of a strategic bridge between Europe and China.¹⁸

For Ukraine, the PEEC model would represent a way out of its deficient ‘multivector’ policy – through substituting the present geopolitical dilemma of ‘*West vs. East*’ with the formula ‘*both West and East*’. And the country might play an active role in the formation of the proposed PEEC as an essential link connecting the EU and the Eurasian space. But to implement this role, it must be successfully developing in terms of economy and social sphere, thinking strategically and being consistent in its policy.

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¹⁸ Emerson *et al.*, (2009).

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RUSSIA AND THE SOUTH CAUCASUS: MANAGING CONTRADICTIONS

Annamária Kiss

1) Overview – The post-Soviet South Caucasus

Following the collapse of the Soviet Union, the world community experienced the realignment that has never been before. The three republics in the South Caucasus – Armenia, Azerbaijan and Georgia – declared their freedom as a breakaway from the “Kremlin’s imperium.” The whole region was in turmoil. Hopes of ordinary people for a better and restful life immediately evaporated. The incongruence between their expectations and reality that was coming about in the wake of independence was large enough to swap the concept of a “bright future” for a “bright past”.¹ Their striving for independence and national liberation was not what they were looking for... Inexperienced and insular politicians and ruling elites had totally neglected civil society-making, social modernisation, and they were unable to use internal resources for the benefit of their nation and secure regional environment during the years of transition. In the brief period of 1918–1921 of their independence they already had a chance to build viable states, which ultimately failed, but have not disappeared without a trace. Notwithstanding, three years seems to be

¹ Markedonov (2007).

too short for shaping the national awakening into a stable, sound state, but that was enough to be a reference point for two countries in the region. The previous constitutions of Georgia and Azerbaijan were renewed in the first half of the 1990's; ostensibly in order to demonstrate a deeply rooted democratic instinct and a struggle against oppression.

After the break-up, the huge discrepancy between state borders and nationality borders could not be glossed over anymore; the republics had to face the tremendous reality of never-ending wars and national animosity.² As the consequence of ethnical clashes and armed conflicts a drastic decline in living standards was seen in the eyes of the South Caucasian nations as an outcome of democracy targeted reforms.³ The Soviet past proved to be nicer, better and more convenient; thus, its traditions had been embedded not only in memories and thoughts of the elder generation of the Caucasians, but in the behaviour of the ruling political elite. To date, authoritarian political culture persists in public opinion as in practice. Additionally, Transcaucasian republics' adherence to medieval values as tradition and hierarchy is the evident legacy of the past. The "shadow" economy in Soviet times worked well, the organised corruption flourished and merged with the political system. Kinship played an important – if not the most important – role in social traditions, lucrative clan bosses did not hide their clout over politicians under the bushel.

In the history of the South Caucasus two factors played major roles in both periods of independence: the strong-handed leader and clan consciousness. Although, twenty years had passed after the disintegration of the Soviet Union, the region barely experienced peaceful transitions of power from the government to the opposition. In contrast to uncertainty, leaders represented continuum, stability and some kind of "timelessness." It is deeply rooted in the social tradition that people in the Caucasus consider their leader to be a person who makes decisions for them, pacifies politics and guarantees socio-economic stability and national security vis-à-vis the anarchy and chaos of the transition years. Nonetheless, there is an important difference that distinguishes the first independence of 1918 from the second one in 1991: their sovereignty was internationally acknowledged in 1991. However, the

² Hintba (2011).

³ De Waal (2010).

recognition was not satisfactory for state building since people were inexperienced in decision-making and democratically formed institutions were brittle, if they existed at all.⁴ Political, social and economic dangers together with the legacy of the Soviet past had to compete with the new trends of international relations, and particularly with the process of globalisation.

In 1991 the change was fundamental also for Russia: the empire became a post-Imperium.⁵ At the end of the 20th century Russian policy tried to find answers for – apparently evident – questions such as “What is Russia?” and “Who is Russian?” Territorial integrity tightly interlinked with the problem of Russian national identity and its self-identification as an empire (even if the Russian term ‘*imperia*’ now transformed into ‘*velikaya derzhava*’) resulted in that political discourse has shifted from “socialistic realism to geopolitical surrealism,” as Aleksandr Rondeli found out.⁶ The fall was unexpected, Russia had not have a strategy concerning how to deal with its ex-member states as completely independent entities.

Russia’s aspirations to spread its interest in the South Caucasus countries hold many contradictions. One of them is the term “near abroad” constructed in the early 1990’s as a base of a new political rule established for ex-Soviet states. The core problem was that the ‘atlantist group’ of politicians of these years at the same time admitted the primacy of international law and the subordination of “near abroad” to the Russian Federation.⁷ Today it is more about how one can distinguish legitimate interests of the Russian state in the former Soviet republics from illegitimate and monopolistic, particularly when it is undoubtedly no longer only “Russia’s” sphere of influence. James Nixey – the Head of the Russia and Eurasia Programme at the Royal Institute of International Affairs – in his latest paper emphasised one of the most prominent contradictions in Russian-South Caucasian relations. He argues that Russian influence in the cultural and economic sphere is higher in those countries where there are no significant resources and obvious security interests as in Armenia (and Kyrgyzstan in

⁴ Nuriyev (2007).

⁵ Trenin (2011).

⁶ Rondeli (2002).

⁷ Russel (1995).

Central Asia).⁸ Another contradiction can be found in the Russian mediation in the Nagorno-Karabakh conflict: the question of whether Russia is interested in a resolution at all. Moreover, Mamuka Tsereteli⁹ bears out that diminished Russian influence in Georgia after the 2008 war appears to be ostensible as Russian state companies still own remarkable energy infrastructure in the country (through Inter RAO UES),¹⁰ while they have continued to acquire a notable share in the Georgian telecommunication, banking and mining sector.¹¹ Remittances regularly sent home from Russia by Armenian and Azeri migrant workers contain a notable share in their country's GDP. Contradictions have emerged because Russia could not evoke any of its past experiences, due to the fact that it has never had any independent neighbours. All through the early 1990's uncertainty determined the Russian security discourse, and the primary task was to hold the Russian Federation together.

Owing to a potential political instability, insecurity, economic uncertainty and ethnic conflicts caused by the mutual mistrust of these nations (which are mutually correlated), the South Caucasus can be regarded as one of the world's most vulnerable and unstable regions. The level of security, the success in peace resolution and conformity to global economy will determine the future of the South Caucasian countries. The republics should continue to deal with two major issues: strengthening regional security and bolstering economic veer. Russia, as the most prominent actor in the region, can play an operative role.

The intent of this paper is to present the main contradictions of the relationship between Russia and the three South Caucasian countries in the fields of security and economy, in order to understand its limitations. It aims to show the complexity and uncer-

⁸ Nixey (2012).

⁹ Mamuka Tsereteli is a Director of the Centre for Black Sea-Caspian Studies at School of International Service at American University and also the Executive Director of the America-Georgia Business Council. He previously served as an Economic Counsellor at the Embassy of Georgia in Washington, covering relationships with US agencies, international financial institutions and the private sector.

¹⁰ The RAO UES – the Unified Energy System of Russia – is one of the largest and most important entities in the Russian electricity industry. The Inter RAO is a subsidiary of RAO UES, its most shareholders are Russian state-owned entities.

¹¹ Tsereteli (2009).

tainty of these ties while tries to find out how, if at all, Russian influence has been transformed from unilateral dependence to interdependence. There is no question of Russian influence waning or not, as it is enough to mention the fact that the Russian language is becoming more and more unpopular among the younger generation of these countries, books in Russian are simply not borrowed from the libraries, *etc.*¹² There is an uncertainty of whether Russia becomes a responsible or a reluctant stakeholder in the region. Even if it is hard to measure the economic and political influence, since investments are always hidden to some extent, the question is still important: with the empire gone, how long does its influence remain? If in one field the influence is waning, will it necessarily spill over into another in the case of Russia?

2) Political and security challenges

Security deficit has emerged in the region in recent years.¹³ After the Russian–Georgian war in August 2008 it became clear that the West (and first of all the United States of America) is reluctant to defend its interests and to invest in the region as Russia, Turkey and China in recent years have been doing so. After more than 20 years the Nagorno-Karabakh conflict is still causing a headache for regional powers; there is a regulation, but not a solution and tensions seriously blow up from time to time. Energy security and pipeline politics are on the table of everyday discussions, similarly to the presence of Russian peacekeeping forces. It concerns not only the territories of non-recognised entities, but usually raises the question of the need of a Russian military presence in the region. Although the impartiality of Russian peacekeeping operations in Abkhazia and South Ossetia is doubtful, there are many examples of Russia giving up its position. For instance, after long negotiations Moscow has demonstrated that it can give up its struggle for military presence in the post-Soviet space by withdrawing from the Azeri Gabala radar station if terms are not satis-

¹² De Waal (2010)

¹³ Boonstra-Melvin (2011).

factory for the country; however, at the same time this step would not necessarily harm bilateral relations with Azerbaijan.¹⁴ A comprehensive, well-targeted and deliberative policy of the European Union in co-operation with the concerned regional powers could shift the situation from a stalemate but not in the foreseeable future. Especially, considering that without Russian approval any arrangement has Buckley's chance to succeed. Western powers and Russia should understand that the same denouement cannot be reached in different countries with different traditions and roots; since ambitions do not necessarily meet conditions. By doing so, they get one step closer to overcoming the deadlock of mutual misunderstanding.

The three republics located at the crossroads of three regional powers (Russia, Turkey, Iran) had no alternative but to deal with major changes not only concerning foreign policy, but urgent internal problems¹⁵ too. Suppressed, indigenous tensions between nations and nationalities blew up immediately after the break-up. Four (Armenian–Azeri, Georgian–Ossetian, Georgian–Abkhaz, Georgian civil war) out of eight military conflicts in the post-Soviet space took place in the Caucasus. Furthermore, three out of four “frozen conflicts” existed on its territory (Nagorno–Karabakh, South Ossetian, Abkhaz), the fact that demonstrates well why it still can be named as a crisis prone region. In the early 1990's grievous wars escalated between Georgia and South Ossetia (1991–1992) and between Georgia and Abkhazia (1992–1993), while the struggle over Nagorno–Karabakh between Armenia and Azerbaijan continued for several years with the aim of changing or maintaining the status quo. At the same time, supporting separatist movements in the South and stifling them in the North Caucasus (Chechen wars in 1994–1996 and 1999–2000)

¹⁴ Markedonov, Sergei. Gabala ne rassorit. 16.12.2010. Accessible: <http://www.ekhokavkaza.com/content/article/24799824.html>

¹⁵ In Georgia first a coup d'état took place – against the authoritarian style of Zviad Gamsakhurdia's leadership – in January 1992, and for three months the country was ruled by rebels. Georgian internal policy split into two, in 1993 a civil war broke out. In Azerbaijan three presidents (Ayaz Mutalibov, Ebilfaz Elchibey, Heydar Aliyev) followed each other in a rather short period of time, since the independence until June 1993. Yerevan was engaged in open conflict over Nagorno-Karabakh, and the change in political course towards the settlement with Baku led to Levon-Ter Petrosyan's resignation. It seems that in all three countries the stability of the state and the popularity of their leaders were dependent on the development of ethno-political conflicts.

was a tremendous contradiction of Russian foreign as well as domestic policy. One cannot disregard the disruptive potential of the North Caucasus, which is strongly interlinked with its South, forming what is known as “the Big Caucasus.”¹⁶ This means that whatever happens in the North, has a direct effect on the South. Intentions to unite the South Caucasus in political terms have never existed¹⁷, thus sub-regional co-operation dealing with security questions is inefficient. Obstacles such as a brittle government and authoritarian leadership, the absence of solutions to the conflicts, clan-oriented thinking, postponed or inefficient economic reforms, the problem of refugees and IDPs¹⁸ are all familiar to Armenia, Azerbaijan and Georgia.¹⁹

2.1. Non-recognised entities

The “predictably unpredictable” situations – to use Thomas de Waal’s term – gave birth to a post-Soviet peculiarity called the “frozen conflict.”²⁰ These protracted conflicts arose in newly independent states after the beginning of the post-Soviet era, where the directly involved parties were not satisfied by the status quo. The resolution is delayed, the escalation of the conflict is limited, but there is a high probability of a renewed war. The more these secessionist states or entities seek to be widely recognised by the international community, the most likely the revisionist approach would run into a bloody, lasting armed conflict.

The existence of non-recognized or partially recognized states in the Caucasus should compel one to think about its consequences, since each of its collisions could easily spill over from an intra-state conflict into a disruptive, long-term and omnipresent

¹⁶ Quoted by Sergei Markedonov. In: Mankoff (2012).

¹⁷ Apart from a short-lived Transcaucasian Federation in 1918.

¹⁸ Internally displaced persons are persons who have been forced to leave their homes as a result of or in order to avoid the effects of armed conflicts or serious human rights violations. Definition given by United Nations in Guiding Principles on Internal Displacement (1998). Accessible: <http://www.idpguidingprinciples.org/>

¹⁹ Merlin (2011).

²⁰ De Waal (2012).

danger for the whole region. “Frozen conflicts” can easily turn into an open armed conflict, as it happened in the case of Abkhazia and South Ossetia. It goes without saying that the so-called “five-day war” turned to boil not without antecedents. As mentioned already, between 1991 and 1993 Georgians fought a war against Abkhaz and South Ossetian secession (and at the same time a civil war), then the Georgian revisionist claims intensified again in 1998 and 2001 towards Abkhazia and in 2004 towards South Ossetia. Contradictions of territorial sovereignty and the right of a nation for self-identification can be found in the core principles of the respected United Nations, as Markedonov argues.²¹ The requirement of self-identification on ethnic grounds is becoming more pronounced in recent years, and it concerns also smaller nationalities (as Abkhaz or Ossetians) and titular nations such as Georgians, Armenians and Azerbaijanis.

Russia – as the main guarantor of relative peace during the Soviet era – does not seem to be as successful as it has imagined in securing the three republics under a Russian-led security umbrella such as the Collective Security Treaty Organization (CSTO).²² The three republics are going on they separate ways, for instance, Armenia is a member state in CSTO whilst Georgia and Azerbaijan are not (but the last two are members in GUAM).²³ Geographic location spurred each country to balance its external relations or simply countervail Russian presence with the help of other countries; thus, seeking membership in regional and international (not only military) organisations became a primary goal. The reason of joining them was the strong expectation of economic and political benefits, notably a support in territorial disputes.²⁴

²¹ Markedonov (2012).

²² Sammut–Paul (2011).

²³ GUAM is an acronym for the organisation of Georgia, Ukraine, Azerbaijan and Moldova.

²⁴ Bishku (2011).

2.2. The “five day war” and the Russian–Georgian relations

In the late 1980’s the context of a secessionist idea was rather ideological, afterwards it acquired a legislative overtone about status. Antagonism turned into armed conflict between January 1991 and June 1992. Tskhinvali, the South Ossetian capital was stormed by Georgians many times during the conflict and the proximity with North Ossetia had a direct impact on Russian security by giving way to tens of thousand refugees to its territory, whose presence caused a serious headache for the government. With the signing of the Dagomyss (Sochi) agreement in June 1992 the conflict was “frozen” until May 2004. At that time, Georgian president Mikhail Saakashvili announced the possibility of renouncing the ceasefire agreement, and shortly after shootings and attacks occurred.²⁵

In August of 2008 – when probably almost the whole world’s attention focused on the Olympic games – two “frozen conflicts” not only resurfaced but boiled over after two decades of mutual misunderstanding and enmity. The five-day war significantly differed from previous armed conflicts. Russia participated in military actions, the West and a CIS country (Ukraine) was actively involved as well, and this time the war stepped out from the regional framework and became truly global. The five-day war stemmed not only from the hostile relationship between Georgians and Ossetians; it was more the unavoidable consequence of the tense Russian–Georgian relationship.²⁶ Russian–Georgian relations worsened significantly during 2006, when Tbilisi detained four Russian officials on spying charges and made a political scandal out of it. The Russian response was a ban on Georgia’s top export products of wine and Borjomi mineral water in 2006 and the cutting out of road, rail, air and sea links between the two countries were unequivocal signs of isolation and preludes of the war in 2008. After the Revolution of Roses, in the presidential elections the main promise of current president Saakashvili was to

²⁵ Markedonov (2008).

²⁶ Sharashenidze (2012).

restore Georgia's territorial integrity, instead of increasing social welfare by decreasing unemployment. Russian backing of Aslan Abashidze's "personal little kingdom" inside Georgia (and the presence of Russian troops in Batumi) impeded the centralising Georgian government's dream about a "united Georgia" coming true. Abkhazia and South Ossetia have also restrained the unity. Hostility already surfaced during the second Chechen war when the Russian government blamed Georgia for being a transit country for supplies entering Chechnya.

The brief war had long-term effects. It became obvious that settlements ensuring the status quo do not work anymore. Moreover, Georgia was forced to give up its project of a "united Georgia" while its top foreign policy priority (NATO membership) since the Revolution of Roses was removed from the agenda. Following the August 2008 war the Georgian government has had to manage the housing of an estimated 22,000 new internally displaced persons (IDPs) who were not able to return to their homes, according to the data of the Internal Displacement Monitoring Centre.²⁷ This problem dates back to the 1990's. The political solution of the problem required a large amount of money due to the need for a long-term housing solution of an estimated 270,000 IDPs.²⁸ Russia recognised that its project of CIS does not work smoothly; moreover, the CSTO is weak and premature owing to a lack of collectivity among its member states and the lack of clarity regarding joint reactions.²⁹ The five-day war (as well as the Nagorno-Karabakh conflict) illustrates well the different reactions of the organisation's member states, since Ukraine had a pro-Georgian rhetoric, and Moldova was cautious in choosing a side.³⁰ Russian clout both in military and economic terms became widespread over Abkhazia and South Ossetia. Russia was back in the region as an ultimate guarantor of peace as in the Soviet times. However, it served as more of a "helping hand" in destroying security that had not been stable even in those years. Over and

²⁷ Internal Displacement Monitoring Centre, figures in Georgia (19 March 2012) [http://www.internal-displacement.org/idmc/website/countries.nsf/\(httpEnvelopes\)/C38CFB59E6593F79C12579C6006DCACC?OpenDocument#19.2.1](http://www.internal-displacement.org/idmc/website/countries.nsf/(httpEnvelopes)/C38CFB59E6593F79C12579C6006DCACC?OpenDocument#19.2.1)

²⁸ *Ibid.*

²⁹ Tolipov (2009).

³⁰ Markedonov (2008).

above, Russia may have the illusion that military strength is a primary source of influence in the region.³¹

There are several lessons to learn both for the European Union and the United States from the conflict of August 2008 and their role as reliable stakeholders. Their influence was only limited in conflict resolution, in spite of the fact that this is the core task of the OSCE. There was not a common strategy or united position established. This can be attributed to the fact that the US had a strong pro-Georgian policy under George W. Bush, who called the country “a beacon of democracy”, while President Obama, elected in 2008, rarely discussed publicly the Russian predominance over partially recognised states, probably in order to avoid angering Russian government.

For Russia, the August 2008 conflict was of course in the one hand about teaching Georgia a lesson, but in the other about the West more generally. Moscow demonstrated that it would not lag behind the events anymore and will step ahead when its vital interests – as the stability in the North Caucasus – are at stake. The two countries going on their separate ways, so even if economic ties could be recovered, the shadow of disapproval will remain.³²

2.3. The Nagorno–Karabakh conflict

The disputed territory of Nagorno-Karabakh remains the “last frozen conflict” in the South Caucasus which has the potential to explode as a volcano. Preludes of this conflict go back almost 100 years and are deeply rooted in the self-identification of both nations, especially in the Armenian remembrance of the Genocide in 1915. Under the Soviet rule Nagorno-Karabakh was established as an autonomous entity within the Azerbaijan SSR in 1923, notwithstanding it had an Armenian majority population. However, this brought the tensions to the surface in 1988, and the bloody war lasted six years. Thousands died and were wounded, hundreds of civilians are missing and around 800,000 Azerbaijanis from Armenia and Nagorno-Karabakh and 250-300,000 Arme-

³¹ *Ibid.*

³² Lukyanov (2012).

nians from Azerbaijan and the Armenian border territories were forced to flee their homes. Besides indirect consequences, cross-border shootings remain an everyday problem.

Armenia – suffering from the long-lasting blockade by Azerbaijan and Turkey – has a powerful friendly country to rely on: Russia. Besides providing economic assistance Russia renewed its military presence in August 2010 on Gyumri base until 2044; Armenia is the main partner of Russia in CSTO. These facts of dependence undermine the Russian role of an honest broker. Even the bright picture of the United States as an impartial mediator is challenged. One has to keep in mind that Section 907 of the Freedom Support Act bans any kind of economic and military support from the United States to Azerbaijan except in certain fields of non-proliferation and disarmament. Since the 1994 ceasefire agreement Russia – despite of its commitment to Armenia – has played a leading role in negotiations within the framework of the so-called Minsk Group co-chaired by the United States and France. There was a glint of hope for future normalisation through the more active mediation of Russia and personally of Dmitri Medvedev between 2009 and 2011. At this peak of negotiations 9 trilateral summits were held. Nonetheless, the main negotiation platform, the OSCE seems to fail on presenting visible results; it had not been able to help effectively build up the regional stability leading to a durable peace. The main reasons of the failure of the OSCE are to be found in internal disagreements over presence and in the lack of a political will to reshape the current geopolitical space.

As regional conflicts intensified, military spending sharply increased especially in Azerbaijan and Georgia. The military budget of Georgia not only sharply increased first in 2005 (from 117 million USD in 2004 to 310 in 2005) but almost doubled in the next year. Azerbaijani military spending in 2006 exceeded the amount of 1000 million USD, and in 2012 already reached the amount of 2,794 million USD. Moreover, this spending on the military is by far the largest in the region and is even larger than Armenia's entire national budget.³³

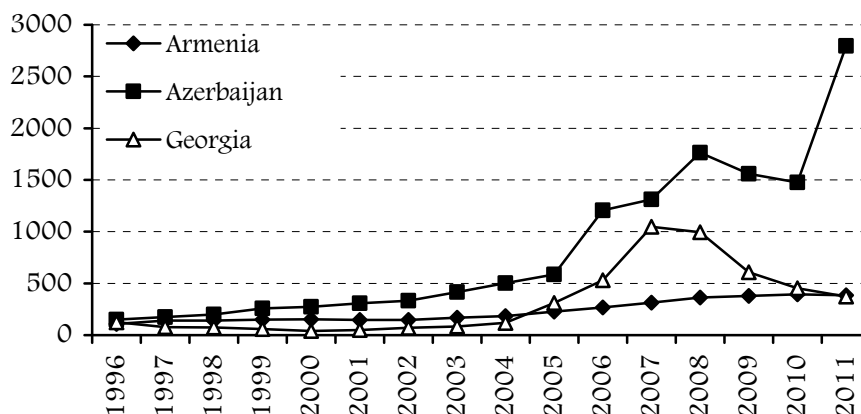
Yerevan finds threatening the high level of Baku's defence spending.³⁴ According to several reports on crisis watch, tensions

³³ SIPRI Military Expenditure Database.

³⁴ Nixey (2010).

have recently escalated; shooting across the so-called line of contact between Nagorno-Karabakh and Azerbaijan took place in early June 2012. The possibility that tensions will rise further is particularly high. The perspective to reopen the Khankendi airport (near the capital city of Nagorno-Karabakh, Stepanakert) only aggravated their uneasy relationship.³⁵ An OSCE representative warned against the use of force, but the threat of shooting down civilian (Armenian) airplanes was constantly voiced by Azerbaijan.³⁶

Figure 1
Military spending of South Caucasian states, 1992–2011
(USD million)



Source: SIPRI military expenditure database.

2.4. The Safarov case

The consequences of the Ramil Safarov case – the Hungarian government's decision to transfer the Azerbaijani murderer of an Armenian soldier to his homeland – are far-reaching and may trigger the escalation. It not simply harmed Hungarian-Armenian relations, but affected Hungary's international position as well. Strengthening economic ties with Azerbaijan – as, for instance, the Hungarian–Azerbaijani Intergovernmental Commission and

³⁵Valiyev (2012).

³⁶ <http://news.am/eng/news/130071.html>

the Hungarian Economic Centre established in Baku indicate – is one of the top foreign-policy priorities within the context of the government’s so called “Eastern Wind doctrine.” It is obvious that a sovereign country can act as its national interests require. Nonetheless, experts critical of the Orbán’s administration, such as Dariusz Kałan in the Polish Institute of International Affairs, argue that the reason of the extradition was a “friendly gesture” from the government, which sequentially rejects conditions for a new IMF loan while offering to the Azeri government the purchase of Hungarian public bonds within a short time period. Kałan suggests that Budapest subordinated its foreign policy goals to short or medium-term economic benefits.³⁷ Others argue that the extradition was based on the 1983 Convention of the Council of Europe and Azerbaijan violated international law when it unilaterally, without the consent of its Hungarian counterpart, pardoned Safarov.³⁸ Whether the letter that the Hungarian Ministry of Public Administration and Justice received from the Azeri Ministry of Justice contained no clear guarantees that Safarov would remain in prison – as Péter Balázs stated³⁹ – or Budapest simply hoped for the best and was misled, remains unclear for the public.⁴⁰ The fact is that Baku already rejected to buy Hungarian public bonds, in addition to the criticism of the Hungarian government by the United States. The risk of increasing tension in Nagorno-Karabakh concerns all the responsible stakeholders of the region, mostly the two most important members of the OSCE Minsk Group, the U.S. and Russia. Hungary’s action, whether it was conscious or unconscious of the outcome, became another step back from the rapprochement between Armenians and Azerbaijanis.

One can say that containment policy and delimitation is untenable, even though Armenians and Azerbaijanis are both intransigent in their position on Nagorno-Karabakh. What matters most is that their idea of a “resolution” is completely different. For Yerevan it means to play the “time card” with the aim of gaining full

³⁷ Kałan (2012).

³⁸ Törő (2012).

³⁹ <https://cens.ceu.hu/news/2012-09-04/peter-balazs-about-the-extradition-of-ramil-safarov-in-aty> and the written letter received from the Azeri Ministry: <http://mno.hu/belfold/itt-a-bizonyitek-hazudtak-az-azeriek-1102783>

⁴⁰ http://hvg.hu/itthon/20120905_Nemeth_tisztaban_voltunk_vele_hogy_Safaro

recognition for the entity, whereas Baku strongly demonstrates that it has the confidence and readiness to recover its sovereignty over the disputed area. However, intimidation remains intimidation. In all likelihood Azerbaijan does not want to launch a full-scale war tomorrow, it will be too dumb a step to take. Baku knows that besides its military capacity the absence of strategically important resources – such as an informational and lobby campaign – are arguments for avoiding getting stuck in a long war.⁴¹ The potential reconstruction of a railroad – what could help Armenia loosen its grip on the blockade – from Georgia through Abkhazia has prompted Azerbaijan to immediately protest against it.⁴² Neither Azerbaijan, nor Armenia is willing to relinquish the “politics of hatred” in the foreseeable future. This fact became abundantly clear in the light of recent events. There is neither war, nor peace.

Every question in the Big Caucasus becomes harshly political and the sides grab every opportunity to come up with their “national egoism”⁴³ to blackmail or threaten the other side. These steps can easily tilt the situation from a stalemate, but unlikely in the right direction. The existence of a negotiation process itself is a guarantee for peace. It keeps both sides in dialogue and Minsk Group maintains the status quo within the framework of the OSCE.⁴⁴ Nevertheless, the stability of the South Caucasus depends on the level of trust and willingness of the opposing parties, not only of regional stakeholders.

2.5. Peripheral instability as a threat: the North Caucasus

The northern side of the Caucasus – seven republics that are in majority Muslim⁴⁵ – pose a direct security threat to the Russian Federation. On its far southern territory Russia should deal with acute problems in the North Caucasus such as political crises, bad

⁴¹ <http://www.regnum.ru/news/polit/1593251.html>

⁴² <http://www.vestikavkaza.ru/analytics/Abkhaziya-snova-zheleznaya-doroga.html>

⁴³ <http://www.ekhokavkaza.com/content/article/24774140.html>

⁴⁴ Guidetti (2011).

⁴⁵ The seven republics from West to East: Adygea, Karachay-Circassia, Kabardino-Balkaria, North Ossetia, Ingushetia, Chechnya, Dagestan.

governance, a large degree of corruption and armed resistance groups (abductions, ill-treatment, homicides, hostage-takings, etc.). The marginalised problem of Islamist mobilisation based on the brittle structures in the neighbouring republics became interconnected within the republics and spread throughout the region. The increasing number of terror attacks is significant, but so far this is not the only factor causing the diffusion of violence in the region.⁴⁶

Many Russians feel a kind of mistrust and even xenophobic attitudes are growing towards Caucasian people; they are scared of the increasing number of terror attacks in Moscow.⁴⁷ The association “Caucasus-Islam-Terrorism” is far-reaching within the Russian population, some experts worry that it exacerbates the alienation of the North Caucasus from the Federation.⁴⁸ Most (in total 68 per cent) of the Russian population is afraid of a terror attack and even if 39 per cent think that secret services can “more or less protect” them from a terror attack, 35 per cent of them think they “rather cannot.”⁴⁹ 60 per cent of the respondents answered in 2012 that the situation in the North Caucasus was tense and would not change in the years ahead.⁵⁰ Chechnya receives a large amount of money from the federal budget as 74 per cent of the North Caucasian republics’ budget is coming from federal resources.⁵¹ The relative peace and stability of Ramzan Kadyrov’s Chechnya has its price: a tremendous scale of corruption and violation.

Suspiciousness and fear of Russians spread into the xenophobic movement of “Stop Feeding the Caucasus!” (*“Hvatit kormit Kavkaz!”*) in September 2011, and it questioned the existence of the North Caucasian republics within the Russian Federation. This is well indicated by an opinion poll where 28 per cent of those questioned whether they support the slogan or not answered

⁴⁶ Halbach (2010).

⁴⁷ Such attacks as the bombing of the *Nevsky Express* train in November 2009, the suicide bombing of the Moscow subway in March 2010 or the January 2011 bombing in the arrival hall of Moscow’s busiest airport, Domodedovo.

⁴⁸ Dzutsev (2010).

⁴⁹ Opinion poll of the Levada Center, March 2012. <http://www.levada.ru/30-03-2012/rossiyane-o-svoikh-opasenyakh-po-povodu-terroristicheskikh-aktov-i-situatsii-na-severnom>

⁵⁰ *Ibid.*

⁵¹ Kolosov (2010).

“definitely yes” and 34 per cent “rather yes”.⁵² For more than 20 years the vital interests of Moscow have not changed: to keep together the Federation and not let the “separatist disease” infect other republics and spread throughout Russia. To let the North Caucasus go on its own way will not reduce the migration or stop the allocation of federal aid. On the contrary, the country would pay much higher bills for the chaos. Consequently, it cannot be questioned whether Russia should or should not keep the North Caucasus within the Federation. It is not a question of choice, but of necessity.⁵³

Moscow’s counter-terrorist campaign against the Caucasus Emirate (or Emarat Kavkaz) and personally Doku Umarov⁵⁴ is uncompromising. The separatist, radical Islamist terrorist organisation committed many terror attacks against Russian civilians and threatens the existence of the Russian Federation. The Russian Federation itself facilitated the spread of violence and extremism from Chechnya into all regions of the North Caucasus with its cruel actions in the two Chechen wars. The ideological base of the Emarat Kavkaz was transformed from a Chechen separatist movement to a radical Salafit⁵⁵ movement. Its strategic goal is to fight against everybody who declares war against Islam and Muslims and the notion of establishing an Islamic state based on Sharia law in the North Caucasus.⁵⁶ Moreover, in July 2011 the organisation was added to the list of formations associated with al-Qaeda by the United Nations Security Council Al-Qaeda and Taliban Sanctions Committee.⁵⁷ Therefore, it is not surprising that the Russian government grabs every opportunity to declare its

⁵² <http://www.levada.ru/15-12-2011/rossiyane-ob-obstanovke-na-severnom-kavkaze-natsionalizme-politike-i-finansirovanii-regio>

⁵³ Markedonov (2011).

⁵⁴ It is a self-proclaimed virtual state entity, which was officially announced in 2007 as partially a successor to the Chechen Republic of Ichkeria. The leader of Chechen rebels and the current president is Dokka Umarov. As an Islamic state required by Sharia law, it rejects democracy as a system of governing and bans every rebel to co-operate with Western countries or negotiate with the Russian government. Umarov said that his movement had bases “from Azerbaijan to Abkhazia.”

<http://www.kavkazcenter.com/eng/content/2007/11/30/9148.shtml>

⁵⁵ The Salafit movement is similar to the Wahhabi.

⁵⁶ Jihad in Russia (2012).

⁵⁷ <http://www.un.org/sc/committees/1267/NSQE1311E.shtml>

tough measures in fighting against terrorism. It also emphasizes its own success, especially in a decade when Russia shall be a host country of many international events, among which the most important is the 2014 Winter Olympic Games in Sochi. In October 2012 Russian President Vladimir Putin held a meeting and stressed the importance of continuing the effective collaboration of federal security services with local departments of counter-terrorist organisations.⁵⁸ They have an undisputed reason to be prepared.⁵⁹ For the Russian counter-terrorist authorities and the Kremlin itself this worldwide event, the 2014 Winter Olympic Games will be a litmus test. In addition to conducting a high quality event, it is more important to guarantee its safety. As a matter of fact, it is not enough to prevent a terrorist attack during the Olympics, the Russian government should convince the international community that there is no reason for any fear. Half-empty hotels can cause great harm on Russia's prestige as well.

3) Economic challenges

In terms of economic potential the three South Caucasian countries did not have the same chances to develop their own economy after the collapse of the Soviet Union. Armenia lacks Georgia's big agricultural potential as well as the large hydrocarbon reserves of Azerbaijan. Since 1993 its borders with Turkey and Azerbaijan have remained closed. Moreover, these countries' economic structures were subordinated to Soviet needs. Thus, immediately after gaining their independence they have faced a sharp economic decline and recognised the essential need for searching for new trade partners to accelerate the diversification of their national economies.

This part of the study seeks to conceptualise how Russian influence can be detected in the economy of these three countries. Af-

⁵⁸ <http://kremlin.ru/news/16658>

⁵⁹ The Federal Security Service (FSB) in May 2012 found a significant amount of weapon caches in Abkhazia. Probably they wanted to be used in terror attacks in Sochi planned by Dokka Umarov. <http://www.interfax.ru/society/txt.asp?id=244998>

ter describing their general economic situation, it examines, where it is possible, Russian positions among the top trading partners. Secondly, it analyzes the flow of foreign direct investments and credits and Russian shares within them. As a third field, the amount and significance of remittances sent home by South Caucasian workers from Russia will be studied. Forth, we try to show how each country controls its energy industry, the significant shares Russian companies have in the gas and oil business or in hydroelectric- and/or thermo plants. Next, each country's case study will picture the means and the effects of recent world economic crisis. Finally, we will conclude the strength and tendencies of Russian presence in the particular South Caucasian economy.

3.1. Armenia

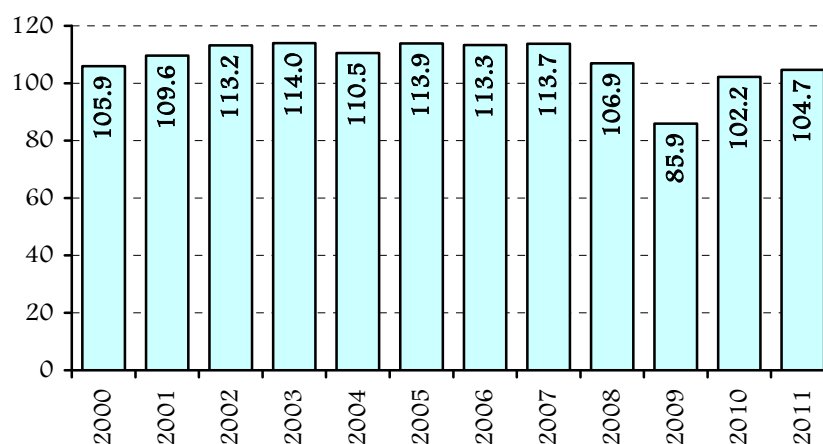
The Nagorno-Karabakh conflict with Azerbaijan has had a direct impact on Armenian economy. A land-locked country with embargo on its economy and post-independence transformation problems of the 1990's had limited routes to choose from. Even though an agreement was signed in October 2009 by Ankara and Yerevan to establish bilateral diplomatic ties, nothing has changed.⁶⁰ The blockade has necessarily made the country more dependent on Russia (and on Iran at its Southern borders) and traditionally good relations have been transformed into strong economic ties, more precisely into a unilateral dependence on Russian commercial support. The Russian airline company owns 70 per cent of the Armenian Armavia airlines, and the Russian Vneshtorgbank has the same percentage of shares in the Armenian Saving Banks. The Russian Railways owns the South Caucasian Railway as its subsidiary and it has been running the Armenian Railway from 2008 onwards.⁶¹ Investments in the Armenian telecommunication system through the presence of Beeline are also notable.⁶²

⁶⁰ Bishku (2011).

⁶¹ http://www.ukzhd.am/ru_about_company.html

⁶² *Soft Power?* (2010).

Figure 2
Armenian real GDP growth rates 2000–2011
(per cent)



Source: National Statistical Service of Armenia; <http://www.armstat.am>

Armenia experienced a double-digit economic growth in the past years until the global economic crisis hit the country. The real GDP dropped by 14.15 per cent in 2009. It was one of the deepest declines worldwide, with the nadir of decline in July 2009 at 18.5 per cent, mostly generated by the decrease in the construction industry.⁶³ The nominal GDP decreased in all of the three South Caucasian states, but not as sharply – by 30 per cent – as in Armenia. Although Yerevan, just as Baku, devaluated its currency, the costs of previous interventions were high for the Central Bank of Armenia.⁶⁴

Yerevan's main export partner is the EU27 with a share of 54 per cent in 2010, while Russia has 13.3 per cent and Germany 15.8 per cent in Armenia's exports.⁶⁵ The European Union ranks first as import partner closely followed by Russia with its 22.6 and

⁶³Khachatryan–Mikaelian (2011).

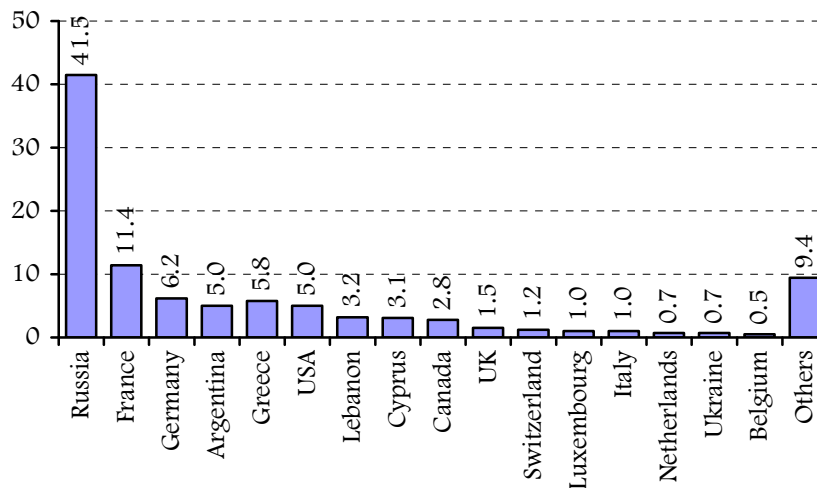
⁶⁴Despite the notable Russian loan, the IMF remained Armenia's major creditor. Statistical Bulletin of the Central Bank of Armenia (2009).

http://www.cba.am/Storage/EN/publications/statistics/monetary_stat_manual/vichtex_09_eng.pdf

⁶⁵ Khachatryan–Mikaelian (2011).

Turkey with 11 per cent shares. The trend seems to be obvious: Russian economic influence measured in trade figures moderately dwindled whilst the European Union stepped to the front as a trading partner.⁶⁶

Figure 3
Share of major countries of origin
in cumulative FDI in Armenia in 2010
(per cent)



Source: Armenian Economic Association; <http://www.aea.am/econdata.html>

The level of foreign direct investments (FDI) often correlates with the trends of the GDP. So in Armenia, there was a significant fall in the amount of FDI in 2008 and 2009 as well and it continued to slowly decrease even in 2010 and 2011.⁶⁷ The government does not have an easy job attracting foreign direct investment to Armenia as the high transport tariffs and cargoes – the direct side effects of the blockade – often discourage potential investors.⁶⁸ Besides significant amounts of Russian FDI, the Russian Federation ensured a 500 million USD loan for the Armenian government. In

⁶⁶ *Ibid.*

⁶⁷ Khachatryan (2011).

⁶⁸ *Ibid.*

bilateral means Russia remains Armenia's main creditor concerning its external public debt stock.⁶⁹

Table 1
Yearly foreign direct investments in Armenia by countries of origin
(USD million)

	Pre-2003	2003	2004	2005	2006	2007	2008	2009	2010
Russia	191	68	52	13	154	340	735	385	195
France	67	9	28	20	16	19	84	197	147
Greece	134	10	43	49	35	0	0	0	0
Germany	1	2	39	97	48	67	25	19	22
US	95	11	12	17	38	31	24	13	6
Argentina	0	4	24	11	34	18	88	48	30
Lebanon	4	2	3	12	1	83	19	14	11
Cyprus	21	5	3	10	16	12	64	7	12
Canada	111	11	3	1	18	0	0	0	0
UK	53	6	2	2	3	7	1	0	4
Switzerland	21	7	0	7	0	2	4	9	11
Luxembourg	29	1	2	1	3	4	7	22	5
Italy	13	0	0	0	1	0	0	33	5
Ukraine	0	0	0	4	4	5	0	0	0
Netherlands	5	2	2	4	1	2	5	5	4
Belgium	7	0	5	5	1	1	4	1	2
Above together	752	138	218	253	373	591	1060	733	454
Total FDI	876	218	235	304	437	675	1118	752	483

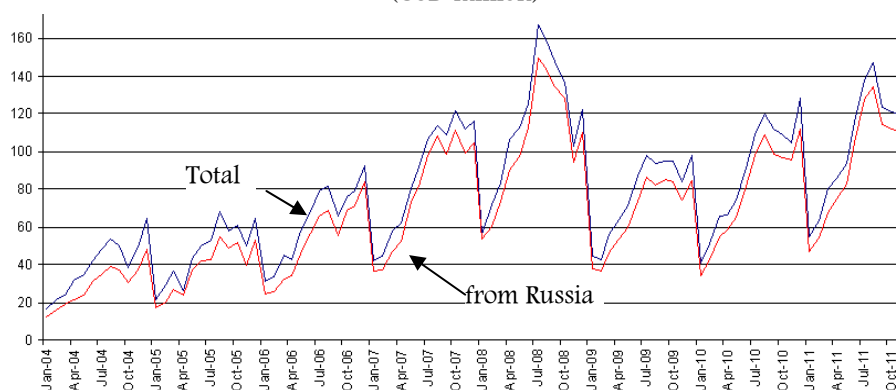
Source: Armenian Economic Association; <http://www.aea.am/econdata.html>

In 2010 Russia remained the largest foreign direct investor in the country, followed by France. Large French investments in the telecommunication system seem to continue in the near future.⁷⁰

⁶⁹ Joint IMF/World Bank Debt Sustainability Analysis on Armenia (November 28, 2011). Accessible: <http://www.imf.org/external/pubs/ft/dsa/pdf/dsacr11366.pdf>

⁷⁰ France Telecom-Orange has invested a sum of 250 million EUR into its Orange Armenia subsidiary since its foundation in 2009. <http://www.telegeography.com/products/commsupdate/articles/2012/01/26/oranges-armenian-investment-tops-eur250m-plans-new-services-for-2012/>

Figure 4
Net non-commercial money transfers of individuals
through commercial banks in 2004–2011
(USD million)



Source: The Armenian Economist, 2012.

Remittances play a key role in Armenian economy.⁷¹ The share of remittances in the GDP was 12.6 per cent in Armenia, the highest among the South Caucasian countries in 2011.⁷² The nadir of the non-commercial money transfers of individuals was in 2009. However, in 2010 the amount of money transfers had risen, and almost reached their pre-crisis level.⁷³ Remittances, undoubtedly, come to a great extent from Russia. Russian share reached 83 per cent in all remittances in 2012 while money transfers coming from the USA – where there is a significant number of Armenians – was only 5.3 per cent.⁷⁴

Between 1998 and 2008 many companies were privatised, especially in the energy sphere. In 2005 with the aim of repaying external debts the government privatised the electricity distribu-

⁷¹ The Armenian Minister of Economy declared the reality of high amount of remittances as more of a challenge than a fostering factor for Armenian economy: <http://www.kavkaz-uzel.ru/articles/170745/>

⁷² It was 7.7 per cent in Georgia and 3 per cent in Azerbaijan according to 2011 data. Annual Remittances Data of the World Bank, inflows: <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/Q,,contentMDK:22759429~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html>

⁷³ <http://www.cba.am/EN/SitePages/statexternalsector.aspx>

⁷⁴ <http://www.regnum.ru/news/1573269.html>

tion system which was bought by Russia's RAO-UES. In April 2010 the Yerevan Thermal Plant, also with Russian participation, was completed and has been activated.⁷⁵ The Russian state-owned company, Inter RAO UES is the sole electricity supplier; through Armenian Electric Networks it has 950,000 suppliers in the country, and also disposes over the Razdansk Thermo Power Plant.⁷⁶

The economic crisis hit Armenia strongly; the poverty rate increased to 38.8 per cent in 2008 and it has not changed spectacularly since then.⁷⁷ Unemployment is particularly high in the South Caucasus. The data can vary widely, for instance, for the year 2011 the percentage was 5.9 according to the CIA World Factbook⁷⁸ and 18.4 according to the National Statistical Service of Armenia.⁷⁹ Russia provided a helping hand to Armenia by granting a preferential loan of 500 million USD.⁸⁰

Summarising Russian economic influence in Armenia, we could undoubtedly ascertain that Russia has a great amount of share in almost every field of Armenian economy from import-export activities, remittances, energy supplies to credits. Although there are some examples for significant European involvement, such as strong trade links and investments in Armenia and the prospects for increasing investments through European Unions' DCFTA (Deep and Comprehensive Free Trade Agreement) are good, Russia will determine the economic path of Armenia in the foreseeable future.

3.2. Georgia

In late 2008 the Georgian government had to face a dual crisis of an economic downturn and the deterioration of investor confi-

⁷⁵ The CIA World Factbook <https://www.cia.gov/library/publications/the-world-factbook/geos/am.html>

⁷⁶ <http://www.interrao.ru/activity/foreignact/>

⁷⁷ <http://www.worldbank.org/en/country/armenia/overview>

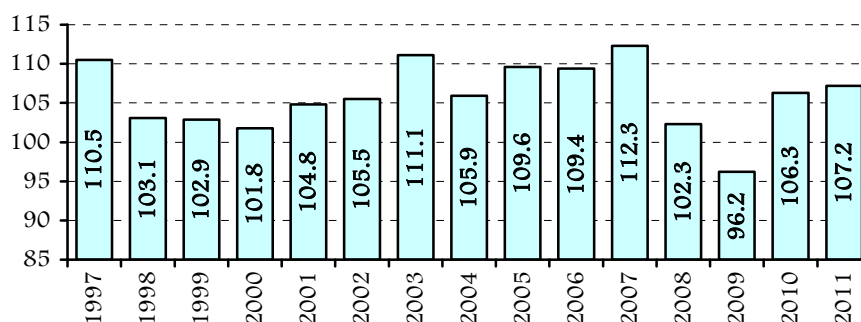
⁷⁸ <https://www.cia.gov/library/publications/the-world-factbook/geos/am.html>

⁷⁹ <http://www.armstat.am/ru/?nid=126&id=08010&submit=%D0%9F%D0%BE%D0%B8%D1%81%D0%BA>

⁸⁰ Nixey (2012).

dence – mainly due to the August “five-day war” – that resulted in the sharp decline of the county’s GDP and FDI figures. Agriculture remains an important sector in Georgian economy as more than 55 per cent of its population works in this sphere giving almost the fourth of the country’s exports.⁸¹ However, its share in the GDP has seriously declined since the 1990’s reaching only 8.8 per cent in 2011, in contrast to the 60 per cent share of the service sector.⁸²

Figure 5
Real GDP growth rates in Georgia, 1997–2011
(per cent)



Source: National Statistics Office of Georgia;
http://geostat.ge/index.php?action=page&p_id=119&lang=eng

Imbalances could be witnessed in the banking sphere as well, since many Georgian banks received loans from American banks, bolstering an immediate spread of the crisis to Georgia, and forcing the country to roughly devalue its national currency, the lari.⁸³

After a record high foreign capital inflow in 2007 – which was mainly attributed to the successful fiscal and institutional reforms and fight against high-level corruption of the Saakashvili government with the aim of constructing a business-friendly climate

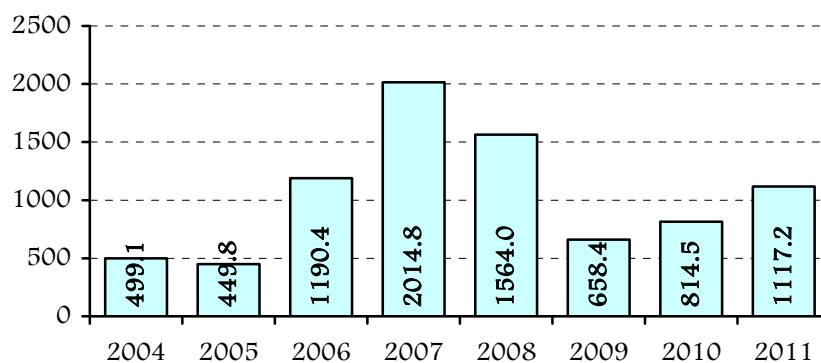
⁸¹ <http://www.worldbank.org/en/country/georgia/overview>

⁸² The tendency of decline of the agriculture share of total GDP:
http://devdata.worldbank.org/AAG/geo_aag.pdf
<http://www.gfmag.com/gdp-data-country-reports/269-georgia-gdp-country-report.html#axzz2EjTUVUJF>

⁸³ Khachatryan – Mikaelian (2011).

in the country – the FDI in Georgia has gradually been declining in the past years and reached its record low level in 2009 since 2006 (*Figure 6*). In 2007 the Czech Republic, the Netherlands (engaged in energy and financial sector investment), Britain, Cyprus and Turkey were the main sources of FDI inflow.⁸⁴ In 2010 the Netherlands became the top investor with its 143.3 million USD investments, followed by the United States and Russia with its significant investments in Georgia’s transport and communication system.⁸⁵

Figure 6
Yearly FDI flows to Georgia, 2004–2012
(USD million)



Source: National Statistics Office of Georgia;
http://geostat.ge/index.php?action=page&p_id=140&lang=eng

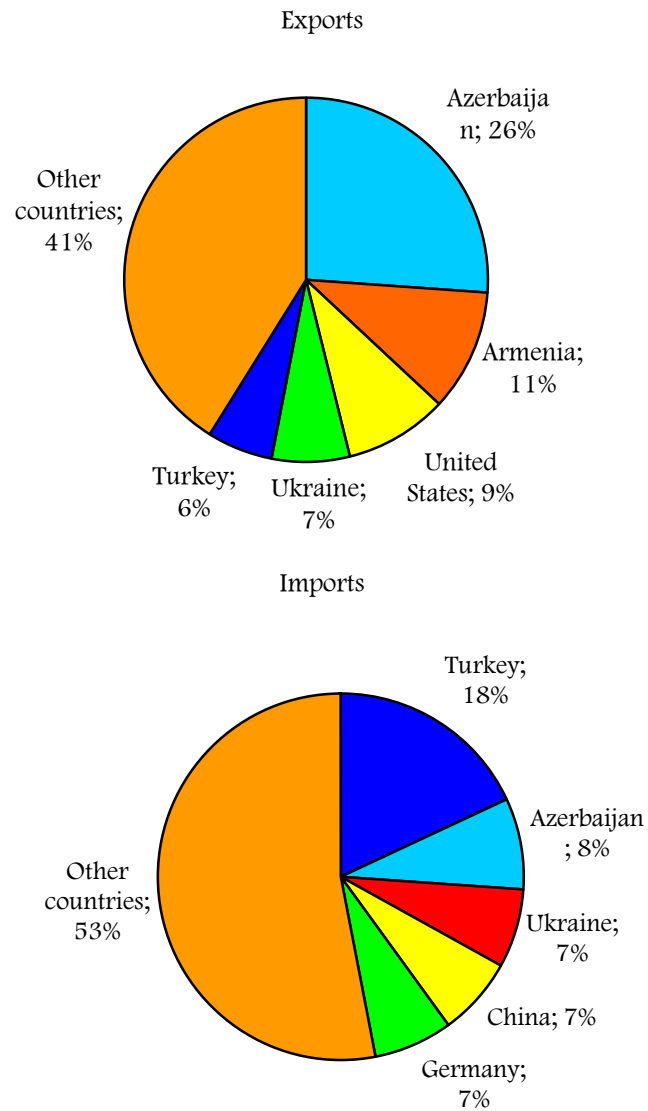
Russia is not represented among the top export and import partners due to the Russian economic sanctions introduced in 2006 on Georgian economy. In 2011 Georgia’s direct neighbours represented the top three export partners, led by Azerbaijan and followed by Turkey and Armenia. The list of top export partners can be continued with Kazakhstan, Ukraine and the United States, while Russia is far behind them and its share even in Georgian imports is not significant.⁸⁶ In 2012 the order seems to remain the same, as *Figure 7* illustrates below. China and Germany are also among major import sources.

⁸⁴ Edilashvili (2011).

⁸⁵ *Ibid.*

⁸⁶ <https://www.cia.gov/library/publications/the-world-factbook/geos/gg.html>

Figure 7
Share of the top partners of Georgia in total imports and exports,
January–October 2012
(per cent)



Source: National Statistics Office of Georgia;
http://geostat.ge/index.php?action=page&p_id=137&lang=eng

Remittances from abroad play a significant role in Georgian economy as well, owing to the fact that the amount of money transfers increased almost by a fifth and constituted 6 per cent of the country's GDP in 2011 based on official Georgian statistics. 200,000 Georgians work in Russia – out of the 250–300,000 people (according to several sources it can be 1 million as well) who work abroad. A notable 65 per cent of all remittances come from Russia. What matters most, remittance flow was barely reduced during the economic crisis and immediately recovered in the post-crisis period.⁸⁷

Table 2
Remittances to Georgia, 2003–2010
(USD millions)

	2003	2004	2005	2006	2007	2008	2009	2010
Inward remittance flows ^a	236	303	346	485	695	732	714	824
of which								
Workers' remittances	64	64	94	153	245	305	317	-
Compensation of employees	168	236	247	315	406	419	391	-
Migrants' transfers	3	3	5	17	45	8	5	-

a) For comparison: net FDI inflows USD 1.6 bn, net ODA received USD 0.9 bn, total international reserves USD 1,5 bn, exports of goods and services USD 3.7 bn in 2008.

Source: World Bank database; www.worldbank.org

Prior to the 2008 five-day war Georgia had a serious presage to a grave break with Russia after 2006, as it has been mentioned already. Admittedly, the Russia-Georgia 2008 war has caused a long-lasting setback on Georgian economy directly and indirectly. The country successfully reshaped its energy supplies by renovating its hydropower plants and increasing its natural gas imports coming from Azerbaijan – instead of Russia – through the Baku-Tbilisi-Erzurum gas pipeline and oil imports via the alternative

⁸⁷ The Role of Remittances in Georgian Economy (2011).

route of Baku-Tbilisi-Ceyhan oil pipeline.⁸⁸ Although the physical damage of the pipelines in the five-day war was not significant, the war undermined Georgia's reliability as a responsible, well-functioning energy-transit state and has questioned the future pathways of the European energy system even if for a relatively short period of time. The mistrust seems to have diminished. However, contrary to what one would expect, investments of Russian state-owned RAO UES in the Georgian electricity system are still significant, nothing has changed since the open conflict. Tsereteli rightly emphasises that the signing of a memorandum of joint management over the Enguri Hydroelectric Power Plant (HPP) in December 2008 had seriously diminished the chances for the Georgian government to diversify its electricity supplies.⁸⁹ The main problem is that even if the Georgian officials argue that the Enguri HPP is in their hands, the fact that the electricity production plant is located in Abkhaz territory (therefore, controlled by Russian authorities) undermines statements like this.⁹⁰ This is supported by the fact that Inter RAO UES also has management rights on Khrami HPP-1 and Krami HPP-2, both located in Southern Georgia and operating even now.⁹¹ Furthermore, the Tbilisi Electricity Distribution Company (Telasi) was sold to the same Russian company in 2003, so Russia owns and operates a company which supplies electricity to the Georgian capital and has 466,895 suppliers throughout the country.⁹² This demonstrates the high level of unilateral energy dependency on Russia.

The 2008-2009 financial crisis led to an increase of budget deficit and government debt coupled with a decline of exports, foreign investments and the current account balance in Georgia, too. Decline in remittance flow was not notable, while the rapid deterioration of the exchange rate jeopardised macroeconomic stability.⁹³

⁸⁸ Even though according to the World Bank only 12 per cent of its hydro-power potential has been utilised to date.

⁸⁹ Tsereteli (2009).

⁹⁰ <http://dfwatch.net/enguri-hydro-power-station-is-still-on-georgian-hands-49699>

⁹¹ <http://www.georgianews.ge/business/147-khrami-2-back-to-operation-after-12-years.html>

⁹² <http://www.interrao.ru/activity/foreignact/>

⁹³ Rahmanov-Valiyev (2011).

All in all, Russian influence in Georgia has diminished considerably since the fall of the Soviet Union, but by contrast it has increased to a high extent in Abkhazia and South Ossetia. Georgia no longer imports Russian energy for domestic use, however, Russia still has important investments in the Georgian energy sphere even though after 2008 some contracts were delayed. Hostility in political relations has its impacts on the economy, even though it has never been an excluding reason for investment interactions.

3.3. Azerbaijan

Russia's influence and penetration in the economy of Azerbaijan cannot be felt as much as in the other two countries of the South Caucasus because of its relatively low degree of dependency in energy sphere since the BTC was opened in 2003 and began exporting in mid-2006.

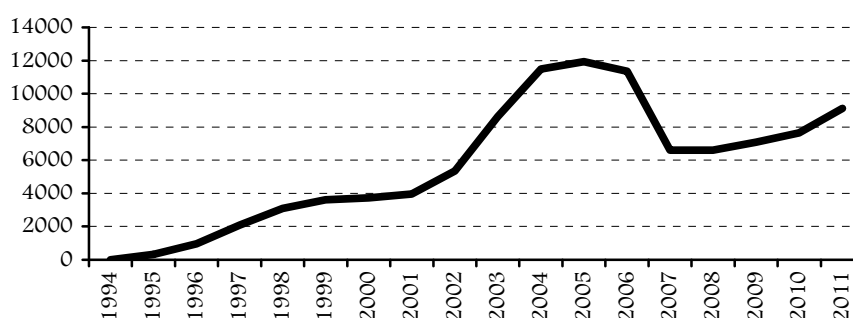
Table 3
Main trade partners of Azerbaijan in 2010
(USD million)

	Turnover	%	Import	%	Export	%	Trade balance
Italy	7 215.5	25.8	118.3	1.8	7 097.2	33.3	6 979.0
France	1 992.6	7.1	136.1	2.1	1 856.5	8.7	1 720.4
Russia	1 918.5	6.9	1 145.0	17.3	773.5	3.6	-371.4
Israel	1 804.2	6.5	59.4	0.9	1 744.8	8.2	1 685.5
USA	1 744.8	6.2	206.3	3.1	1 538.6	7.2	1 332.3
Ukraine	1 354.1	4.8	465.5	7.1	888.6	4.2	423.2
Turkey	942.2	3.4	771.3	11.7	170.9	0.8	-600.4
China	926.0	3.3	587.2	8.9	338.8	1.6	-248.3
Croatia	789.1	2.8	1.9	0	787.2	3.7	785.3
Indonesia	788.5	2.8	6.4	0.1	782.2	3.7	775.8
Total above	19 474.9	69.6	3 496.6	53	15 977.9	75	12 481.3
Total	27 924.1	100	6 599.3	100	21 324.8	100	14 725.4

Source: State Statistical Committee of Azerbaijan; <http://www.azstat.org>

Azerbaijan's high hydrocarbon reserves were the main reason for the significant inflows of foreign investments during the 1990's, which contributed to the country becoming the largest recipient of FDI in the South Caucasus region. Furthermore, Azerbaijan's FDI per capita was twice larger compared to the CIS and Central European average through 2010.⁹⁴ According to UN Conference on Trade and Development data, foreign direct investments to Azerbaijan sharply declined in 2007 and hardly recovered in recent years (*Figure 8*). About 88 per cent of the total FDI went to the oil industry, while the fact that non-oil FDI inflow showed a rough decline in the past decade is also important.⁹⁵ As it is seen in *Table 4*, Russia is not among the top countries of Azerbaijan's non-oil FDI sources.

Figure 8
Yearly foreign direct investments to Azerbaijan, 2000–2011
(USD million)



Source: UN Conference on Trade and Development (UNCTAD), WIR 2010

Baku's potential of natural gas production is huge and after the start-up of the Shah Deniz gas-oil field the country became a net gas exporter in 2007. The share of the Russian company, Lukoil in the consortium is not substantial, but with the Russian government doubling its gas imports from 1.5 to 3 billion cubic meters starting from 2013 Russia will become the second biggest gas importer of Azerbaijan after Turkey.⁹⁶ Oil exports to Russia via Baku-Novorossiysk are also complicated because of an ongoing dispute over transportation tariffs between SOCAR and Transneft.

⁹⁴ Hübner (2011).

⁹⁵ *Ibid.*

⁹⁶ <http://www.gazprom.com/press/news/2012/january/article128158/>

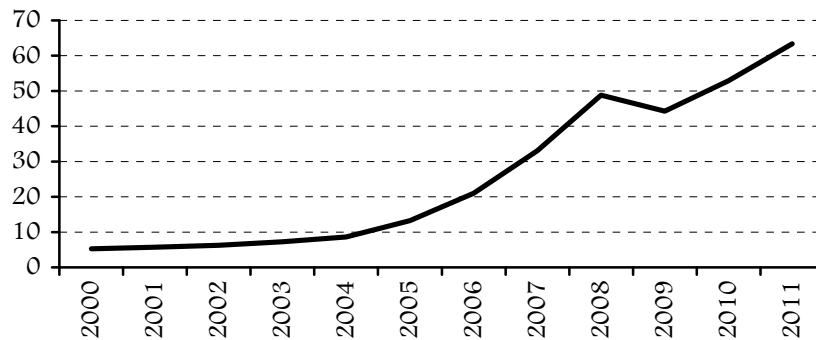
According to the Energy Information Administration approximately 45,000 barrels/day were transferred through this pipeline in 2010.⁹⁷

Table 4
Yearly non-oil FDI and accumulated FDI in Azerbaijan
by major countries of origin, 1993–2010
(USD million)

	2005	2006	2007	2008	2009	2010	1993-2010 (%)
Turkey	96.2	136.6	109.2	60.8	76.8	81.1	29
USA	24.8	70.0	78.0	108.8	117.6	124.2	18
UK	39.5	39.1	80.0	146.4	160.0	169.0	16
Germany	21.5	17.4	22.9	48.2	38.8	41.0	5
UAE	5.7	18.3	12.3	38.5	43.2	45.6	4
Other countries	28

Source: Caucasus Analytical Digest

Figure 9
Real GDP in Azerbaijan, 2000–2011
(USD billion)

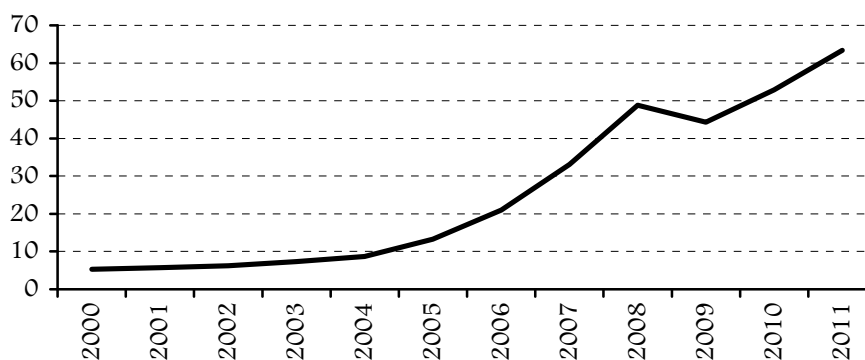


Source: State Statistical Committee of Azerbaijan, <http://www.azstat.org>

As a consequence of the downfall of oil prices in 2009 tax receipts also decreased. Therefore, as it can be seen in *Figure 10*, the State Oil Fund of Azerbaijan (SOFAZ) increased its contributions to the state budget in recent years in order to accelerate economic growth.

⁹⁷ Energy Information Administration Country Analysis Brief (2012) 3.

Figure 10
SOFAZ transfer as a percentage
of state budget revenues, 2003–2011
(per cent)



Source: State Oil Fund of Azerbaijan, www.oilfund.az (Annual Report, 2011)

Given the facts that Azerbaijan's potential is essential for the international community as an oil and gas exporter country and the era of high economic growth of 2006–2008 seems to be over, the Azeri government should bolster non-oil economic development and diversification of its economy to avert its rough consequences.⁹⁸

Among the top 10 trade partners of Azerbaijan Russia ranked third in 2010; it was the main source (with a 17.3 per cent share) of imports, and a relatively low (3.6 per cent) share in exports according to the State Statistical Committee of the Republic of Azerbaijan.⁹⁹

A strong recovery in remittances after 2009 occurred in Azerbaijan, but there is a meaningful discrepancy between official figures of the State Statistic Committee of Azerbaijan and the Central Bank of Russia as a Centre for Economic and Social Development (CESD) survey found out. According to CESD experts, the amount of remittances is no less than 2 billion USD per year. More than

⁹⁸ In order to read a comprehensive, deep analysis of Azerbaijan's energy sector and problems of its reliance on energy exports see: Szigetvári Tamás: Azerbajdzsán gazdasága és az energiaszektor (Kelet-Európa Tanulmányok 4. szám, 2008. MTA Világ gazdasági Kutatóintézet)

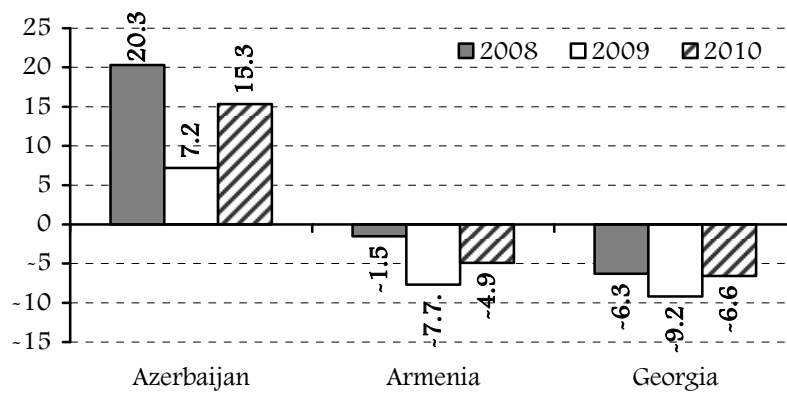
<http://www.fakprojekt.hu/docs/Szigetvari%20-%20Azerbajdzsan.pdf>

⁹⁹ <http://www.azstat.org/publications/azfigures/2011/en/018.shtml>

80 per cent of total remittances come from Russia.¹⁰⁰ This seems to be confirmed by the EBRD reports on remittances, stating that the overwhelming majority of non-commercial money transfers was accomplished from Russia in 2006.¹⁰¹

Azerbaijan has managed the recent global crisis much better than Georgia and Armenia due to high oil revenues. However, although the country had successfully avoided a budget deficit, the high growth of external debt, the serious fluctuation in the current account balance, the sustainability of the positive trends is challenged by the fluctuation of oil prices and the forced extraction at the same time.¹⁰² The Azerbaijani budget was in surplus in spite of the worldwide recession, while its government debt also increased similarly to Armenia and Georgia in 2009.¹⁰³

Figure 11
General government fiscal balance in South Caucasian countries
(per cent of GDP)



Source: Rahmanov-Valiyev (2011).

¹⁰⁰ Remittance From Russia to Azerbaijan Increased (Centre for Economic and Social Development, 22 May, 2012) Available: <http://cesd.az/new/2012/05/remittance-from-russian-to-azerbaijan-increased/>

¹⁰¹ European bank for Reconstruction and Development: Survey on Remittance Flows (last updated 22 June, 2010) <http://www.ebrd.com/pages/about/where/etc/survey.shtml>

¹⁰² Rahmanov-Valiyev (2011).

¹⁰³ *Ibid.*

As opposed to Soviet times, Russia has little direct control in Azeri economy nowadays. Russia is still representing the main source of imports, and remittances sent home from Russia are notable. Nonetheless, Russian-Azeri ties are not as tight as they were two decades ago, Baku takes great advantages from its growing energy export potential. However, Russia will become Azerbaijan's second biggest gas importer from early 2013 onwards.

4) Conclusions

The empire is long gone, but consequences of its fall remain and shape the current Russian policy towards the South Caucasus. Whilst in our globalised world of cross-border interactions when the physical borders are gradually eroded and the supranational, multithreading "networks" covering almost the whole planet are gaining more and more ground, for Russia this seems to be incongruous. Trans-border threats are more likely to emerge on its territory when international crime is rising, migration and illegal arms trafficking flourishes and the spread of radical Islam is accelerated.

It is particularly hard to distinguish valid interests of a nation state from desirable dominance. Russia demonstrates the use of "hard power" and "soft power" at the same time. A good example of the use of the "hard power" was the Russian-Georgian "five-day war" when Moscow made it clear what it was not for but against. Russian "soft power" as a tool of influence is more about shaping identities and increasing economic presence.¹⁰⁴ In the South Caucasus it can be witnessed undoubtedly in Abkhazia and South Ossetia. This kind of power includes the so-called "passportizatsiya," beneficial extensive contracts and agreements with the separatist governments, investments in tourism and the healthcare system, the purchasing of real estates. Cultural promotion is probably its main content; increasing Russian language learning in schools encourages feelings of familiarity. Moscow is ready to give legal assistance to non-recognised states and many Russians

¹⁰⁴ *Soft Power?* (2010).

were sent to work in the administrations of the separatist governments *etc.* Thus, two entities are fully dependent on Russia.

A government sometimes makes bad decisions while following the country's national interests, nonetheless, one should take into consideration that the Kremlin is also able to recognise its own limitations. Russian pullout from the Gabala radar station was not the first sign of Moscow's willingness to give up military presence on the territory of one former Soviet republic that can be a positive trend to continue.

A comprehensive resolution of the South Caucasian economic and security problems rests on the political will of the three affected countries and the main stakeholders. Russia should recognise that ambitions of an empire do not coincide with today's conditions; tactics of the Soviet era towards ex-republics will not fully work when they are internationally recognised, sovereign states. Moscow can play a dominant role in those spheres of these countries, where they are not strong or independent enough as energy in Georgia or almost in every field of the vulnerable Armenian economy and security. A huge dependency on pipeline and land routes still remains, but it is decreasing related to Azerbaijan (and even becomes a benefit of Baku in gas supply). Russian influence is also increasing through the South Caucasian Railway with a potential to build up the infrastructure in the whole region. With the start of the negotiations between the European Union on the one hand, and with Georgia and Armenia on the another, the Deep and Comprehensive Free Trade Agreement (DCFTA) can bring not only liberalisation of trade but it also contains long-term objectives of harmonising trade-related legislation to meet EU standards. But this process is very slow. Although Russia needs to accept a more limited role, it also launched its projects on post-Soviet reintegration, affecting perhaps most of Armenia from among the three countries. The effectiveness and outcome of both initiatives are hard to be evaluated at the moment. The other regional stakeholder, Turkey – having a huge and growing economic potential – can help develop medium-sized businesses in the South Caucasus countries.¹⁰⁵

Direct security threats represent a great concern to a post-Imperium such as the Russian Federation, obviously because it is

¹⁰⁵ De Waal (2012).

afraid of turmoil as it was after the collapse of the Soviet Union. Hence, Moscow is not truly interested in a resolution of the Nagorno-Karabakh conflict. Naturally, a full-scale war would not have any winners, the result could only be a long-lasting upheaval where Russia should take a side and would have to make many financial sacrifices. A mutually acknowledged resolution does not seem to be reachable in the foreseeable future. The struggle to guarantee Abkhazian, South-Ossetian and Armenian security means a lot in the context of fighting against North Caucasian disengagement. To hold the Commonwealth of Independent States (CIS) together or at least most of its ex-members remains the number one foreign policy goal for Russia. In addition, the Collective Security Treaty Organization (CSTO) as a regional security organisation and the forming economic integration with the aim of creating the Eurasian Union could benefit from the remaining ties of the Soviet legacy. These two regional integration groupings are of outstanding importance for the Kremlin.

Economic ties could recover more easily than political ones. They are still very strong due to the legacy of the Soviet past and recent Russian intentions to acquire considerable positions in the three economies. However, the more attractive Western values and conceptions compete with usual and well-established old Russian ones, the South Caucasian countries should choose the most beneficial path in favour of their economic prosperity and political stability.

* * * * *

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ITALY~RUSSIA RELATIONS: POLITICS, ENERGY AND OTHER BUSINESSES

Marco Siddi

Introduction

Italy is one of Russia's key partners in Europe. Although Rome has been part of Western economic and military integration structures since the immediate post-war period, it has always maintained a positive dialogue with Moscow, resulting in numerous economic partnerships and friendly bilateral relations. Within NATO and the European Union, Italy often advocates policies which take into account Russian interests and attempts to include the Kremlin in discussions concerning the main European security issues. In the energy field, Italy is one of the main supporters of co-operation with Russia, as shown by the active involvement of the main national energy company ENI in numerous joint ventures with Gazprom and other Russian partners. Also when the political forces in power in both countries changed, Italian-Russian relations witnessed remarkably little variation in quality and substance. A further improvement in the relationship took place during the Putin era, mostly due to Russia's economic growth and the new opportunities for Italian entrepreneurs to make business in the large and still growing Russian market.

This analysis argues that economic ties constitute the core of the partnership between Rome and Moscow. The mutual interest in economic co-operation and the lack of controversial political or

historical issues greatly facilitates bilateral relations. Cultural co-operation and several civil society initiatives have recently contributed to the increasing interest of many young Italians and Russians in each other's country. For instance, 2011 was the year of Italian language and culture in Russia and the year of Russian language and culture in Italy. In both countries, celebrations for the event were accompanied by a considerable number of cultural and economic initiatives.¹

The quality of Italy-Russia relations has inevitable repercussions in the multilateral forums where the two countries are represented. Italy is the fourth largest economy in the European Union after Germany, France and Britain.² It is also one of the founding members of both the EU and NATO. Russia is the largest economy and a main military actor in the post-Soviet space and is also considered a member of the BRICS, a group of large and fast-growing economies that includes also Brazil, India, China and South Africa. For Moscow, Italy is a very friendly and pro-Russian member of the European Union, which constitutes the world's largest economic bloc and is also by far Russia's main trading partner. For Rome, Russia is the pivot of the Italian economic strategy in the entire post-Soviet space, as well as a key factor in European security matters. The recent development of Russia-led integration structures in the post-Soviet space, most notably the Customs Union and the Eurasian Union, has reiterated Moscow's importance for all external actors that plan to do business in the region. Italy's co-operative approach to Russia is promising in terms of its future involvement in this area, which is one of the world's richest in fossil fuels and natural resources.

1) History and political relations

History does not play a major role in current Russian-Italian relations. This is due to the lack of unresolved controversies from the past and the geographic distance between the two countries which led them to orient themselves towards different areas of

¹ Special issue of *The Moscow Times* (2011).

² World Economic Outlook Database of the International Monetary Fund (2011).

influence throughout the majority of their history. The last military confrontation between Italy and Russia took place during the Second World War when Fascist Italy sent an army to support the Nazi invasion of the Soviet Union. Italy's participation in the aggression did not leave a lasting impact on either Russian or Italian collective memories, except for the waning recollections of veterans who had taken part in the disastrous rout of the Italian Royal Army.³ Unlike many East-Central European countries, Italy does not challenge Russia's foundational narrative of the 'Great Patriotic War', which celebrates Moscow's contribution to the defeat of Nazism and the liberation of Europe.

At the end of the Second World War, Italy did not experience Soviet occupation and was solidly anchored in the Western military and economic camp. Due to its distance from the main scenarios of East-West confrontation, its geopolitical role during the Cold War was not of primary importance. The existence of a strong Italian Communist Party – it was the second political party for number of votes from the 1950's to the early 1990's – constituted a considerable political link to Soviet Russia, notwithstanding the fact that Italian Communist leaders had been gradually distancing themselves from Moscow in the 1970's and 1980's. Furthermore, political differences were not a hindrance for the establishment of friendly relations. Christian Democratic governments in Italy and businessmen such as ENI's founding father Enrico Mattei were eager to seek economic co-operation with the Soviet Union from the 1950's onwards. To mention just two examples, the Italian energy company ENI accessed the Russian market back in 1969, as one of the first Western companies to conclude an energy supply contract with the Soviet Union.⁴ The Italian automobile manufacturer FIAT began its production of cars in the USSR in 1970, when its factory in Togliattigrad delivered the first Zigulis. The FIAT Zigulis would become the symbol of the 'car age' in the USSR.⁵

The political chaos following the collapse of the Soviet Union and the economic slump of the Yeltsin years temporarily hindered

³ The most well-known biographical account of the event is the one authored by Mario Rigoni Stern (2005).

⁴ The 40th anniversary of Russian gas supplies to Italy, Gazprom's official website.

⁵ "Togliatti e l'auto di massa. La Ziguli' invade l'URSS." *La Repubblica*, http://www.repubblica.it/online/auto_prima/fiat100anni/sei/sei.html (accessed on 22 October 2012).

the development of the economic partnership between Moscow and Rome. A swift improvement of political relations and a steady increase of bilateral trade took place with the advent of the Putin era. Political stabilisation and especially the rapid growth of the Russian economy attracted Italian investors. Simultaneously, Putin developed a tight personal relationship with Italian Prime Minister Silvio Berlusconi, who became one of the most ardent advocates of co-operation with Russia within both the European Union and NATO throughout his career in power (2001-2006 and 2008-2011).⁶ In the early 2000's, Italy facilitated Russia's approximation to NATO security structures. At a summit held at Pratica di Mare (near Rome) in May 2002, NATO and Russia established the NATO-Russia Council (NRC). The Council provides a forum for consultation, consensus-building, joint decisions and actions, where individual NATO member states and Russia co-operate as equal partners on a wide spectrum of security issues.⁷

The summit at Pratica di Mare created an atmosphere of co-operation between Russia and NATO, which Italian leaders later labeled as the 'Pratica di Mare spirit'. Berlusconi took special pride in having hosted the event and made the consolidation of good relations between Russia and NATO one of his main foreign policy goals. He renewed his efforts in this respect in the months that followed the August 2008 war between Russia and Georgia, when tensions between NATO and the post-Soviet Russia reached an unprecedented peak. The success of Berlusconi's diplomatic efforts is highly disputed, mostly due to Italy's and his own limited influence within the Atlantic Alliance. However, the fact that he was the only head of government to attend and speak at the NATO-Russia summit at Corfu in June 2009, where a reset of the relationship was discussed, is evidence of his personal commitment to the topic.⁸

Berlusconi's career as Italy's Prime Minister had come to an end in November 2011, when his government was replaced by a cabinet of technocrats headed by former EU Commissioner Mario Monti. Prior to his appointment, Monti had expressed critical views on Italy's bilateral relations with Russia and declared his

⁶ See also N. Arbatova (2011) 13.

⁷ "NATO-Russia Council." NATO website.

⁸ "Vertice NATO a Corfù. Berlusconi media tra i grandi." *Il Tempo* 28 June 2012.

preference for policies agreed upon at EU level.⁹ Nevertheless, once in power he did not alter the substance of the partnership between Rome and Moscow. During his visit to Russia in July 2012, Monti supported ENI's commitment to build the gas pipeline 'South Stream' in a joint venture with Gazprom, a project that met with considerable criticism at EU level. He also supervised the signature of several agreements that should enhance economic partnership in the banking and insurance sectors and in fields such as tourism and the construction industry.¹⁰ In September 2012, Rome and Moscow went as far as organizing a 10-day joint military exercise, a remarkable example of security co-operation between Russia and a NATO member state.¹¹

2) Economic relations

2.1. Trade volumes

Over the last ten years, Italy-Russia trade relations witnessed a remarkable increase, the only exception being a serious contraction at the start of the 2008 financial crisis. In 2002 the total value of bilateral trade had stood at 11,715 million euros; by 2007 it had doubled, and it reached a peak of 26,557 million euros the following year. Due to the crisis, trade decreased by nearly one third in 2009 (down to 18,574 million euros), but started growing again – at an even faster rate than before the crisis – in 2010. Already in 2011 the peak of 2008 was exceeded, with a recorded 27,357 million euros of trade. The data for the first eight months

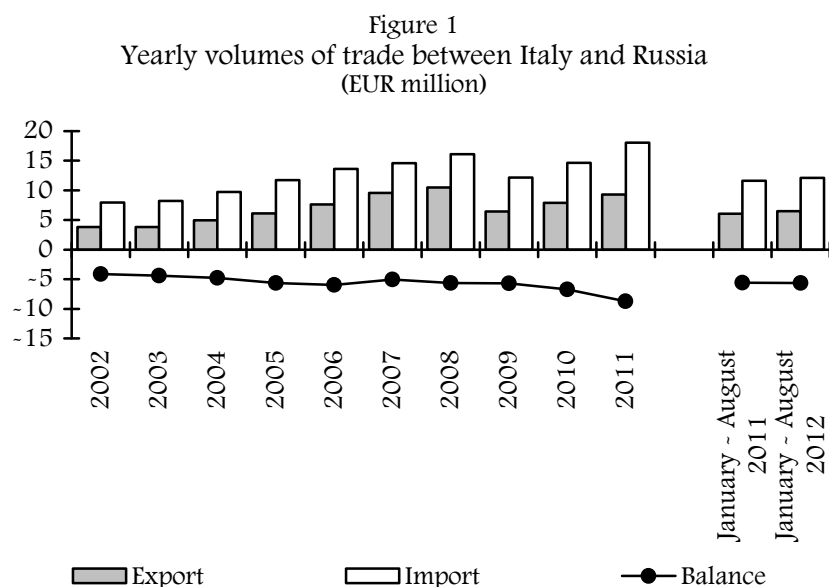
⁹ "Mario Monti – La Russia e il ricatto energetico." Interview with *La Repubblica*, 17 January 2007, available at <http://video.repubblica.it/copertina/mario-monti-la-russia-e-il-ricatto-energetico/6227/8653> (accessed on 22 October 2012).

¹⁰ "In Russia, Monti rafforza la partnership col Cremlino." *Meridiani Relazioni Internazionali* 24 July 2012.

¹¹ Similar maneuvers involving reconnaissance units took place also in 2011 in Russia. "Russia, Italy start joint reconnaissance drills." *ITAR TASS* 12 September 2012.

of 2012 show a further increase of 908 million euros compared with the same period of 2011.¹²

Figure 1 shows the data for Italy-Russia trade, divided into goods exported from Italy to Russia and goods imported into Italy from Russia. The volume of export from Russia to Italy has constantly been much higher than the other way around, and the gap widened at a greater pace in 2010 and 2011. This difference is shown by the continuous line in the graph, which highlights the problem of negative balance of bilateral trade for Italy. In 2011 a peak deficit of 8,727 million euros was reached.



Source: Istituto Commercio Estero (ICE), 2012.

As emerges from the analysis of the 2011 data, this difference is entirely due to the size of Italian energy imports from Russia. Gas and oil imports constitute 41.2 per cent and 28 per cent of total Italian imports from Russia, respectively. A further 13.7 per cent comes from other oil products and another 1.9 per cent from anthracite. All energy and energy-related imports combined account for 84.8 per cent (15,402 million euros) of total Italian imports from Russia. The remaining 15.2 per cent of imports comes mostly from the Russian steel industry (4.4 per cent), metals and

¹² Rapporti economici Italia-Russia (2012) 2.

nuclear fuel (3.5 per cent) and chemical products (3.3 per cent). Between 2010 and 2011 the value of energy-related imports increased: gas imports increased by 39.1 per cent (from 5.3 to 7.4 billion euros), oil imports by 13.7 per cent (from 4.4 to 5 billion euros) and the imports of other oil products by 19 per cent (from 2 to 2.4 billion euros). Imports of chemical products also registered a remarkable 42.4 per cent increase (though the figures were much smaller, from 0.4 to 0.6 billion euros), but imports of steel products and metals/nuclear fuel dropped by 3 per cent and 16 per cent, respectively (from 0.82 to 0.8 billion euros and from 0.65 to 0.55 billion euros).¹³

Italian exports to Russia are more diverse. In 2011, various types of industrial machinery accounted for 26.9 per cent of total exports (2,502 million euros), followed by products of the clothing industry (15.9 per cent, 1,478 million euros), furniture (6.4 per cent, 596 million euros), cars, commercial vehicles and related equipment (5 per cent, 467 million euros), machinery for domestic use (2.4 per cent), other metal products (2.2 per cent) and pharmaceuticals (2 per cent). In the same year, most sectors recorded an increase in the value of exports, with a +68.6 per cent in pharmaceuticals, +24 per cent in industrial machinery, +21.9 per cent in the clothing industry, +17.6 per cent in cars, commercial vehicles and related equipment and +11.1 per cent in exports of furniture.¹⁴

Overall, fossil fuels make up most of the trade from Russia to Italy and recent trends show that their weight is further increasing. Although industrial machinery and manufactured products together account for 42.8 per cent of the total trade, trade from Italy to Russia is more diversified and the different categories are growing at a similar rate. The type of goods traded highlights the complementarity of Italy's and Russia's productive systems: Rome relies heavily on imports of fossil fuels from abroad, whereas Moscow needs Western technology (such as industrial machinery) to modernise its economy.

¹³ *Ibid.* 3. The increase in value of energy-related imports was due mostly to an increase in volume (as opposed to a simple rise of oil and gas prices). The political crises and instability in North Africa during the Arab Spring, an alternative supply region for Italy, explain these variations.

¹⁴ *Ibid.* 3.

2.2. FDI

Italian foreign direct investment (FDI) in Russia increased exponentially during the last decade. In 2004 it was only 57 million euros; by 2010 it had reached 972 million euros. The peak of Italian FDI in Russia was reached in 2008, with 1,183 million euros. Russian FDI in Italy also grew considerably, from a mere 1 million euros in 2004 to 865 million euros in 2008. However, following the beginning of the crisis it dropped to 343 million euros in 2009 and to only 74 million euros in 2010. If we sum up the data for Italian and Russian FDI in the respective partner country for the period between 1992 and 2010, we can observe that Italian FDI in Russia (2,861 million euros) was approximately twice as much as Russian FDI in Italy (1,427 million euros).¹⁵

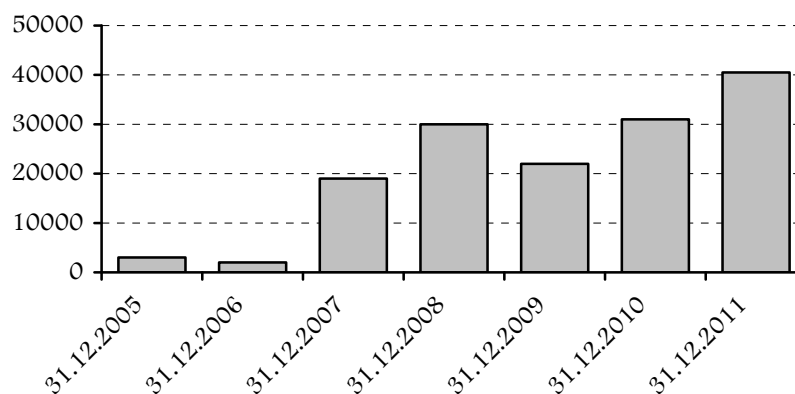
Based on the yearly data of 2011, Italy was the second European Union country (after Germany) in terms of foreign investments in the Russian market, accounting for 4.58 per cent (13.6 billion euros) of total foreign investments in Russia. If all foreign state actors in the Russian market are taken into account, Italy ranked fourth; it was preceded by Germany (15.35 per cent), China (13.9 per cent) and Ukraine (6.57 per cent), but was ahead of countries such as Japan (4.23 per cent), France (3.19 per cent) and the United States (2.96 per cent).¹⁶ As *Figure 2* shows, the size of business (turnover) of Italian firms or firms with Italian investments active in Russia increased drastically between 2006 and 2011, rising from approximately 2 billion euros to 41.4 billion euros. Around 38,000 people are employed in these companies.¹⁷

¹⁵ Data provided by the Italian Ministry for Economic Development (Ministero dello Sviluppo Economico), 1992-2012. The reasons for the greater size of Italian FDI are likely to be linked with the desire of Italian entrepreneurs to open firms in a country where labour is cheaper than in Italy and which offers a large market for Italian goods.

¹⁶ Rapporti economici Italia-Russia (2012) 4.

¹⁷ *Ibid.* 7.

Figure 2
Turnover of Italian companies
and companies with Italian participation in Russia
(EUR million)



Source: Istituto Commercio Estero (ICE) and Politecnico di Milano, 2012.

However, the volume of Italian FDI in Russia is still limited if we consider the potential opportunities offered by the complementarity of the Italian and Russian productive systems. It is likely that Italian FDI in Russia will increase if Moscow carries out legal and judicial reforms in order to improve the business environment and if visa liberalisation between the two countries takes place. Ideally, visa liberalisation with Russia should take place at EU level and eventually lead to the abolition of the visa regime. Meanwhile – as suggested by Italian ambassador to Russia Antonio Zandar di Landi – Italy could use the flexibility allowed by the Schengen treaty and undertake bilateral initiatives, such as granting multiple-entry visas covering a progressively increasing timespan.¹⁸ With regard to Russian involvement in the Italian economy, 65 companies with Russian participation were active in 2011; they employed 16,136 people and had revenues for 14.2 billion euros. The main Russian companies operating in Italy are the aluminum giant RusAl; Severstall, Evraz and Novolipetsk in the steel and metal industry; Lukoil in the energy sector;

¹⁸ *The Moscow Times* (2011), Special Issue 4.

VimpelCom in telecommunications and Russkiy Standard in wine production.¹⁹

2.3. The Russian-Italian energy partnership

In 2011 Italy was the second largest buyer of Russian exports within the EU and the seventh most prominent supplier of foreign goods on the Russian market. Energy co-operation continues to play a leading role. In 2011 Italy imported 24 per cent of its natural gas and 13 per cent of its crude oil consumption from Russia.²⁰ The state-controlled ENEL group, Italy's largest electricity operator and the second biggest utility in Europe in terms of installed capacity, controls 56.4 per cent of Otk-5, a company which manages four power stations in Russia, and 45 per cent of RusEnergosbyt, which operates in the energy-trading field. ENEL also signed a memorandum of understanding with RosAtom, Russia's federal agency for nuclear energy, in order to develop the electric and nuclear power generating system in Russia and East-Central Europe, possibly including participation in the construction of a nuclear power plant in the Kaliningrad enclave.²¹ Together with ENI, ENEL also has shared ownership of SeverEnergia, which operates in the Yamal-Nenets region in western Siberia.²²

In April 2012, ENEL signed a strategic co-operation agreement with Rosneft, which has recently become the biggest oil-producing company in the world, for joint ventures in the exploration of fossil fuel resources in the Black and Barents Seas.²³

¹⁹ Rapporti economici Italia–Russia (2012) 9.

²⁰ M. Comelli (2012) 72.

²¹ “EDF, Enel in talks with Rosatom on nuclear plan.” *Reuters* 23 May 2011 (accessed on 3 November 2012). While ENEL's participation in the construction of the Kaliningrad nuclear plant is still uncertain, the company's website confirms its general co-operation with Rosatom “in the joint development of new plants.” “ENEL's nuclear power activities.” ENEL website, http://www.enel.com/en-GB/group/production/nuclear_power/enel/ (accessed on 3 November 2012).

²² “La Russia dopo la crisi.” (2011) 9.

²³ “Eni: firmato con Rosneft l'Exploration Loan Facility Agreement per le attività congiunte nel Mare di Barents e nel Mar Nero.” ENI website 23 July 2012, http://www.eni.com/it_IT/media/comunicati-stampa/2012/07/2012-07-23-firmato-Rosneft.shtml (accessed on 3 November 2012).

Most importantly, the Italian company ENI has become the main international partner of Gazprom, Russia's state-owned energy giant. In November 2006, during the last Prodi government, ENI and Gazprom signed a strategic agreement that set up a strong, long-term alliance. In particular, they agreed on extending sales of Russian gas to Italy until 2035 and identified major projects that would be jointly owned.²⁴ ENI's strategic plan for the period between 2012 and 2015 stressed co-operation with Russia for the extraction of gas in the Yamal region as one of the key elements of the company's growth strategy.²⁵

The Blue Stream pipeline and the South Stream pipeline projects stand out as examples of the ENI-Gazprom partnership. Blue Stream, connecting Russia and Turkey via an offshore route in the Black Sea, was completed in 2003. ENI played a key role in the project, as its subsidiary SAIPEM built the offshore part of the pipeline (385 kilometers at a maximum depth of 2,150 meters), thereby compensating for Gazprom's lack of capacity in offshore technology. The Italian energy company will also build the offshore part of the South Stream pipeline, an ambitious project that should bring Russian gas to Italy and Austria through the Black Sea and the Balkans by 2015. A second branch of the pipeline reaching Southern Italy via Greece and an offshore route in the Mediterranean were also discussed (*Figure 3*).²⁶

The origins of the South Stream project date back to June 2007 when ENI and Gazprom signed a Memorandum of Understanding to build a pipeline that would ship gas to the European Union and bypass problematic transit countries such as Ukraine. The energy crisis between Russia and Ukraine and the consequent shortage of gas in several South-Eastern European countries in January 2009 confirmed the necessity of an alternative route for energy supplies from Russia. South Stream appears as the 'mirror project' of Nord Stream, which started operating in November 2011 and ships Russian gas to Germany via the Baltic Sea, bypassing Belarus and Poland. According to the current project, the capacity of South Stream would be larger than that of Nord Stream, reaching 63

²⁴ "La Russia dopo la crisi." 14; "Eni and Gazprom sign new agreements." ENI website 16 February 2011, http://eni.com/en_IT/media/press-releases/2011/02/2011-02-16-gazprom.shtml (accessed on 22 October 2012).

²⁵ "Eni announces its 2012-2015 Strategic Plan." ENI website 15 March 2012 (accessed on 22 October 2012).

²⁶ "La Russia dopo la crisi." (2011) 18.

billion cubic meters of gas per year. Gazprom estimates that the proposed pipeline would match Europe's increasing gas demand in the following years, which would be accompanied by a decline in the EU's domestic gas production due to the gradual depletion of North Sea resources.²⁷

Figure 3
The proposed route of the South Stream gas pipeline



Source: south-stream.info

In early March 2012, ENI and Gazprom discussed actions for the expedited implementation of the South Stream project that will start in December 2012.²⁸ Meanwhile, no progress was made in plans for the construction of the Nabucco pipeline, which is supported by the European Union and the United States. The Nabucco project aims at diversifying EU energy imports away from Russia and is seen by many analysts as a competitor to South Stream. It would draw on gas from Azerbaijan and Turkmenistan and reach the European Union via the South Caucasus, Turkey and the Balkans. However, so far the project has remained in the European Commission's drawers, which has also increased the

²⁷ A. Bini (2011) 4.

²⁸ "Eni and Gazprom reach agreement on gas supply contracts and discuss actions for the expedited construction of the South Stream gas pipeline." ENI website 1 March 2012, http://www.eni.com/en_IT/media/press-releases/2012/03/2012-03-01-eni-gazprom-contract-south-stream.shtml (accessed on 22 October 2012).

odds for the full implementation of South Stream. As leaked US government cables have revealed, the strategic partnership between ENI and Gazprom has been so successful that Washington was becoming deeply concerned about its impact on Europe's increasing dependence on Russian gas.²⁹ Critics of the South Stream project argue that undermining Nabucco and keeping Europe hostage to Russia's energy policy are its main aims.³⁰

Gazprom and ENI reject this interpretation. According to Paolo Scaroni, chief executive officer of the Italian energy company, marginalising Russia in the European energy market is unrealistic. Hence, it is best to invest resources in joint ventures that strengthen existing energy security structures, as opposed to developing alternative routes of dubious economic viability. For Europe, binding Russian supplies to its own energy market through long-term projects is of essential strategic importance also because emerging powers such as China may become tough competitors for the purchase of available Russian gas. From this perspective, South Stream is functional to vital European interests. To emphasise the European dimension of the project, ENI and Gazprom have successfully involved Électricité de France (EdF) and Wintershall, a subsidiary of the German group BASF, in the joint venture. The two companies will take part in the construction of the offshore section of South Stream. In 2011 each of them purchased 15 per cent of shares in the joint venture from ENI; the Italian company now controls 20 per cent of the shares, whereas Gazprom has retained its initial 50 per cent.³¹

ENI and Gazprom hope that the involvement of a German and a French company would improve South Stream's standing in the European Union, in particular through its recognition as an EU top-priority project. Gazprom is also attempting to have South Stream exempt from the rules of the EU's third energy package in order to retain ownership of the pipeline; the EU has already granted a similar exemption for the Nord Stream pipeline. Furthermore, the joint venture hopes that the recognition of the pipeline as an EU project will contribute to drawing much-needed funds. The cost of building South Stream is estimated at 19-25

²⁹ Wikileaks website, <http://www.wikileaks.ch/cable/2008/04/08ROME451.html#> (accessed on 30 March 2012).

³⁰ Bini (2011) 5.

³¹ *Ibid.* 5.

billion euros and can be compensated only by the buyers' and suppliers' long-term commitment to keeping it operational.³²

According to the advocates of energy co-operation with Russia, the issue of costs shows that Moscow is also taking considerable risks through the implementation of Europe-oriented energy projects.³³ If European companies stepped out of the current projects and refused to buy Russian gas, Moscow would not be able to offset the cost of building the pipelines. Hence, the EU-Russia energy relationship is best described as one of mutual dependence. Bilateral energy deals between Italy and Russia reflect this: Russia is Italy's first gas and second oil supplier. At the same time, the Italian market is very important for Russian energy exports. Gazprom is dependent on the co-operation with ENI for the implementation of its offshore projects and for access to lucrative energy markets such as Libya.³⁴ Furthermore, in order to make projects such as South Stream lucrative, Gazprom needs Italy's and its other European partners' commitment to buy the gas that will be channeled through the pipeline.

2.4. Co-operation in other sectors and recent developments

Russia has an interest in co-operating with Italy in many other sectors too, particularly those that are crucial for its technological modernisation. The economic co-operation of the Cold War years has extended to many other fields, including aeronautics, industrial machinery, telecommunications, credit insurance and recently also to the development of infrastructure for the 2014 Olympic games in Sochi. In the automobile sector, IVECO produces 50 per cent of its armored vehicles in Russia. In December 2010 it was commissioned to produce 2,500 Lince military vehicles on Russian soil and sell a part of these to the Russian army.³⁵ In March 2012, FIAT and the Russian bank Sberbank signed a letter of intent for the creation

³² *Ibid.*, 6–7.

³³ *Ibid.*

³⁴ "Eni, Gazprom Neft Resume Work in Libya, Margelov Says." *Bloomberg* 2 November 2011.

³⁵ "Russia to buy 10 Italian armored vehicles." *RIA Novosti* 3 December 2010.

of a joint venture that will produce cars and light commercial vehicles starting in 2013.³⁶ The Russian transport sector witnessed an increasing involvement of the Italian conglomerate Finmeccanica. In November 2010, Finmeccanica signed a memorandum of understanding for a joint venture with Russian Railways to develop automation, signaling, telecommunication and safety technology for the Russian rail network. Thanks to this joint venture, Finmeccanica may also be able to obtain strategic access to the networks of other post-Soviet and Baltic states – where railways operate in similar extreme climatic conditions – when they decide to upgrade their railroad traffic.³⁷

In addition, from 2007 onwards Finmeccanica has participated in the international marketing of the new Russian regional jet Sukhoi Superjet 100, thanks to the establishment of a Venice-based joint venture between its member company Alenia Aermacchi and the Sukhoi Holding. Also in the field of aeronautics, Finmeccanica paired up with Russia to construct helicopters. In June 2011, Agusta Westland (a company of the Finmeccanica group) signed a joint venture deal with Russian Helicopters for assembling AW139 civil helicopters in Tomilino, near Moscow.³⁸

The co-operation between Italian and Russian businesses has recently expanded to new areas, most notably to the credit insurance sector. In February 2012, the Italian export credit agency SACE, which is controlled entirely by the Italian Ministry of Economy and Finance, won an advisory contract to train the personnel of EXIAR, the Russian agency for export credit and investment insurance. The co-operation between SACE and EXIAR will be strengthened further by a memorandum of understanding that aims at boosting commercial and investment opportunities in their respective national markets and in the Commonwealth of Independent States.³⁹ In July 2012, SACE guaranteed an investment of 276 million euros made by the Russian bank VTB and the Italian banks Cassa Depositi e Prestiti and Intesa San Paolo.⁴⁰

³⁶ “Fiat-Sberbank, c'è l'intesa.” *Russia Oggi* 1 March 2012.

³⁷ “Russian Railways forms JV with Italian Major Finmeccanica.” *BSR Russia* 29 November 2010.

³⁸ “Russian Helicopters, Agusta Westland sign 20 million euro JV deal.” *RIA Novosti* 22 June 2011.

³⁹ “Garanzia italiana sugli investimenti russi.” *Russia Oggi* 17 February 2012.

⁴⁰ “In Russia, Monti rafforza la partnership col Cremlino.” *Meridiani Relazioni Internazionali* 24 July 2012.

New commercial agreements were concluded during Monti's latest trip to Russia, in July 2012. The Italian company Rizzani de Eccher signed a 1 billion euro deal with its Russian counterpart North Caucasus Resorts for the construction of touristic infrastructures in the North Caucasian mountain range.⁴¹ The deal aims both at developing the facilities that will host the 2014 Winter Olympics in Sochi and at stabilising the region (one of the poorest and most volatile in Russia) through the creation of local employment. Also during Monti's last visit to Russia, the Italian company Selex Elsag, Poste Italiane and Russian Post agreed to strengthen their strategic partnership. Furthermore, Gazprombank and Intesa San Paolo planned the establishment of a common fund to support Italian and Russian companies in their respective countries.

Currently, over 500 Italian companies operate on Russian territory. Among the main companies not mentioned so far, Pirelli, Martini & Rossi, Indesit, Parmalat, Ferrero and Candy also feature in the Russian entrepreneurial landscape. Most of these companies are based in the area around Moscow, but some have opened branches also in other parts of the Federation, for example, Parmalat in Yekaterinburg and Candy in Kirov. Easier communications and visa facilitation may contribute to the further expansion of activities in other parts of Russia in the coming years.⁴²

3) Conclusions

Bilateral relations between Russia and Italy have been very friendly for over a decade and are based on a tradition of co-operation that dates back to Cold War times. During Berlusconi's premiership, they were strengthened by the Italian leader's personal friendship with Vladimir Putin and his frequent calls for a closer partnership between the European Union and NATO on one side and Russia on the other. Following Berlusconi's demise, relations have not changed substantially. Monti's trip to Russia last July showed that the new Italian Prime Minister is keen on economic

⁴¹ L. Alexandrova. "Italy to join tourist cluster project in North Caucasus." *ITAR-TASS* 23 July 2012.

⁴² *The Moscow Times*, special issue on 'Year of Italy in Russia', No. 3/17 (May 2011) 8-9.

co-operation with the Kremlin. Despite the crisis, trade between Italy and Russia grew by 25 per cent during 2011, reaching 27.3 billion euros. During the last decade, Italian FDI in Russia increased exponentially, from 57 million euros in 2004 to 972 million euros in 2010.

Energy sales are the most important category in trade exchanges. In 2011 Italy imported 24 per cent of its natural gas and 13 per cent of its crude oil consumption from Russia. Due to the depletion of domestic EU resources, instability in North Africa and the Middle East and the abandonment of nuclear power projects, the share of Italian energy imports from Russia may increase in the coming years. Italian-Russian energy co-operation has been successful since the Cold War period when political tensions in Europe were much higher than today; hence, Italian companies and governments do not shy away from further deals with post-Soviet Russia. Presently, the main Italian and Russian energy companies are involved in strategic joint ventures. The Gazprom-ENI joint ventures for the construction of the Blue Stream and South Stream pipelines constitute the most important examples, particularly if the significance of South Stream for Europe's energy security is taken into account. Furthermore, Rosneft and ENEL have recently signed a strategic co-operation agreement, which suggests that the Italian-Russian energy partnership may soon involve other national energy giants more deeply.

Over the last five years co-operation developed in numerous other sectors too, including the construction and automobile industries, aeronautics and military vehicles. The recent developments in the credit insurance sector, together with Russia's accession to the World Trade Organization (WTO), will probably lead to an increase in Italy-Russia bilateral trade and investments in each other's markets. As a result of Russia's WTO membership in July 2012, important hurdles for the country's external economic relations will be lifted. Italian presence in the Russian market, particularly in the form of small and medium-sized enterprises, would increase further if the Russian legal system became more reliable and if rules on Russian customs duties became more transparent. Furthermore, Italian activities in Russia will receive a boost when the visa and work permits regimes are loosened or abolished. Negotiations with the European Union regarding the abolition of the visa regime are of primary importance for Moscow, but they are proceeding at a slow pace due to the current

bad state of EU–Russia relations.⁴³ Prominent European officials criticised the Russian leadership during the anti-Putin demonstrations in Moscow in the winter at the turn of 2011 and 2012 and the Syrian crisis. In October 2012, the European Parliament's decision to impose sanctions against Russian officials involved in the incarceration and death of Sergei Magnitsky, a lawyer who had been working on a corruption scandal involving high-ranking Russian civil servants, further contributed to the deterioration of relations.⁴⁴ Nevertheless, at the EU level Italy is one of the staunchest supporters of visa liberalisation with Russia. Besides allowing the free movement of entrepreneurs and workers, visa liberalisation would also increase the already growing flow of Russian tourists to Italy.⁴⁵

In 2013 Italy–Russia economic relations will likely continue to develop positively and play an important role in the broader European context. The construction of the South Stream pipeline will drive the debates on the future of European energy security. Although it will not decrease Europe's energy dependence on Russian gas, South Stream will create an alternative supply route that bypasses Ukraine and contributes to shelter EU countries from potential new energy crises between Russia and Ukraine. On a broader level, the post-2009 trends of trade volumes suggest that commercial relations are likely to see a further boost in the coming years. After a short period of serious contraction in 2009, the Russian economy has continued to grow and its market now offers invaluable opportunities for many crisis-ridden Italian companies. Finally, co-operation with Italian companies in a broad range of sectors will help Russian enterprises to become more active in foreign markets and cope with the increased competition that will result from Russia's adoption of WTO trade rules.

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⁴³ “La Russia fa gola alle aziende.” *Russia Oggi* 13 February 2012.

⁴⁴ “European Parliament recommends Magnitsky sanctions.” *RIA Novosti* 23 October 2012.

⁴⁵ In 2010, the Italian general consulate in Moscow alone released 436,000 visas; the figure for 2011 was between 600,000 and 700,000 visas. Russians already make up the largest group of foreigners at the renowned Bocconi Business School in Milan. N. von Twickel. “Italy's ambassador: from the Vatican to Moscow.” *The Moscow Times* (May 2011) 3-4.

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RUSSIA AND THE CENTRAL~EAST EUROPEAN COUNTRIES – IMPACTS OF ECONOMIC CRISES ON THEIR TRADE RELATIONS

Zsuzsa Ludvig

Introduction

Since the early nineties the new international actor called the Russian Federation faced three major economic crises. None of these can be considered a purely ‘Russian crisis’, since all were deeply rooted in the international economic environment. The first was the lasting crisis of transition with its deep decline in economic performance and serious social consequences between 1992 and 1996/1997. This type of crisis was characteristic of all post-Socialist countries. The so-called Russian financial crisis broke in August 1998 due to both internal and external factors and spread rapidly to the real economy. Contrary to the then widespread international expectations, although this crisis was really deep, it was shortly overcome and followed by almost a decade of intensive growth. As a spill-over of the world economic crisis later named as the ‘Great Recession’ Russia faced its third deep economic crisis starting in 2008 and with hitting bottom in 2009. All the three economic crises were accompanied by a dramatic decline in the volume of Russian foreign trade. This study aims at giving a brief overview on the impact of these crises on Russian foreign trade with Central-East European (CEE) countries that all

had their own transition crises during the nineties and were hit hard by the Great Recession as well. Unfortunately, the Russian financial crisis in 1998 also had extremely bad negative impact on trade with the CEE region or some individual economies of the region in comparison with general Russian trends. In this study the CEE region includes the Visegrad countries (Hungary, Poland, the Czech Republic and Slovakia), Romania and Bulgaria. They used to be major economic and trading partners of the Soviet Union and some of them kept their leading position in trading with the Russian Federation in wide CEE even today. The focus is put on the export performance of CEE countries on the Russian market. The article aims at giving some explanations why CEE exports were usually hit more strongly than exports of Russia's other trading partners in general and in some particular cases as well. The EU15 is often taken as a reference country grouping.

For the past two decades Russia has often been seen as a country where business is over-politicised. To put it simply: on a country level this would mean that countries having good political relations with Russia have better chances of developing business contacts with it. As this study will show, the reality is not so simple and CEE countries are peculiar in this respect.

1) Trade impacts of the transition crises of the 1990's

Russian-CEE trade relations of the 1990's were featured by a mutual turning away. Starting with 1990 CEE countries and later Russia turned to the West and tried to strengthen its economic links with its Western partners. In the case of CEE this process can be seen as part of their European integration ambitions and initiatives. Naturally, besides the integration intentions the need of these economies for modernisation was another important motive.

It has been widely discussed whether the break-up of the Socialist economic block and their traditional trading system within the CMEA caused the long-lasting transition crisis of the CEE region or on the opposite, the deep transitional decline led to the

dramatic shrinkage of trade links.¹ All in all one can point to this period as to the era of foreign trade crisis in the post-Socialist world.

It is also worth mentioning that already before the break-up of the Soviet Union and the start of the Russian transition process the geographic structure of Russian foreign trade went through significant changes. During the late 1980's Germany, Japan, Finland, Italy (in 1988 already the USA) were among the major Soviet trade partners just like the former Czechoslovakia, Hungary, Poland, Romania and Yugoslavia from among the Socialist block.² According to Soviet data the share of CMEA member countries both in Soviet exports and imports was around 60 per cent in 1988, while the proportion of so called 'industrially developed capitalist countries' reached a bit more than 20 per cent.³ Compared to these geographical patterns of the late 1980's, CEE countries experienced a really dramatic loss of position at the beginning of the 1990's.

On the other hand, CEE countries' trade partners were changing to a great extent in a similar way. For example the share of developed countries in Hungarian exports and imports in 1988 already exceeded 30 per cent, with the Soviet Union possessing less than 20 per cent from a total of approximately 40 per cent share of all Socialist countries.

CEE export performance was extremely poor in Russia at the very beginning of the nineties with a permanent tendency of decline. CEE products and producers were soon displaced by Western ones on the Russian market. CEE–Russian trade reached its bottom in 1993 with Russian imports from the region shrinking more than by half. Interestingly, the same year Hungary was the first on the list of CEE exporters to Russia exceeding even Poland. The share of the six CEE countries in total Russian imports totalled to 6.1 in 1993 and reached only 6.8 per cent in 1997 in spite of the constant rise of CEE export value between 1993 and 1997. (1996 was the only year when CEE exports declined.) At the same time the share of the European Community (EU15) in Russian imports rose from 31.1 in 1993 to 36.8 in 1997.

¹ Köves–Oblath (1994).

² See, for example, figures of Direction of Trade Statistics (1993).

³ Vnesniye ekonomiceskiye svyazi SSSR v 1988 (1989).

At that time the commodity structure went through some significant changes. *Table 1* shows the commodity pattern of Hungarian exports to Russia during the 1990's. Food and animals represented the most important product group making up around one third of all exports to Russia, followed by the declining, but still significant proportion of machinery. Chemicals (within it primarily medicines) showed the most remarkable growth both regarding their shares and values. Other CEE machinery exports showed a similar trend of reduction, except for the Czech Republic, both as a direct consequence of the end of the co-operation within the CMEA and the penetration of West European firms into the Russian market.

Table 1
The commodity structure of Hungarian exports
to Russia (SITC classification), 1990–1999
(per cent)

SITC		1990*	1995	1997	1999
0	<i>Food and live animals</i>	21.8	38.9	29.3	32.3
1	Beverages and tobacco	2.8	8.2	6.8	1.2
2	Crude materials, inedibles, except fuels	2.9	1.7	0.3	0.7
3	Mineral fuels, lubricants and related materials	0.3	0.4	0.3	1.4
4	Animal and vegetable oils, fats and waxes	0.1	1.9	8.1	7.7
5	<i>Chemicals and related products, n.e.s.</i>	11.4	14.9	20.0	27.5
6	Manufactured goods classified chiefly by material	5.1	2.6	4.0	6.5
7	<i>Machinery and transport equipment</i>	41.8	24.9	24.2	16.4
8	Miscellaneous manufactured articles	13.3	6.5	5.7	6.3
9	Commodities and transactions not classified elsewhere in the SITC	0.5	0.0	0.0	0.0
	Total	100.0	100.0	100.0	100.0

* Figures for the Soviet Union.

Source: based on the Hungarian Central Statistical Office database.

However, Russian exports to the CEE countries were not hit as hard as CEE supplies to Russia due to a very simple reason. These countries continued to import energy from Russia since the already existing infrastructure (pipelines) made this import source

to be the cheapest and most rational choice. Oil and gas imports from Russia secured a certain, not too low level of Russian supplies to the CEE region. (1994 was the worst year regarding Russian exports, when Russian exports decreased by 25 per cent compared to the previous year.)⁴ But the Russian export structure went through a very unfavourable modification; energy exports began to constitute the overwhelming part of all Russian exports. There are two major reasons for this change. Firstly, the physical volume of other products declined dramatically in parallel with the increasing level of imports of CEEs from the West. Secondly, changes in international oil prices also influenced the structure of these exports; the average oil export prices were on the rise between 1994 and 1997. Altogether, the share of the six countries in Russian exports fell to a small extent, from 12.1 per cent measured in 1993 to 11.3 per cent in 1997. In this respect the dramatic turning point was already over, as it had appeared in the early 1990's similarly to the import side.

As a consequence of the dramatic fall of CEE exports to Russia and the relatively modest decline of the value of Russian supplies into CEE countries the growing trade deficit became the most important and problematic feature of CEE–Russian trade. This deficit has often been described as the ‘energy bill’ in the CEE region. It is true that the energy supplies and oil prices have been playing a most significant role in the development of these trade deficits.

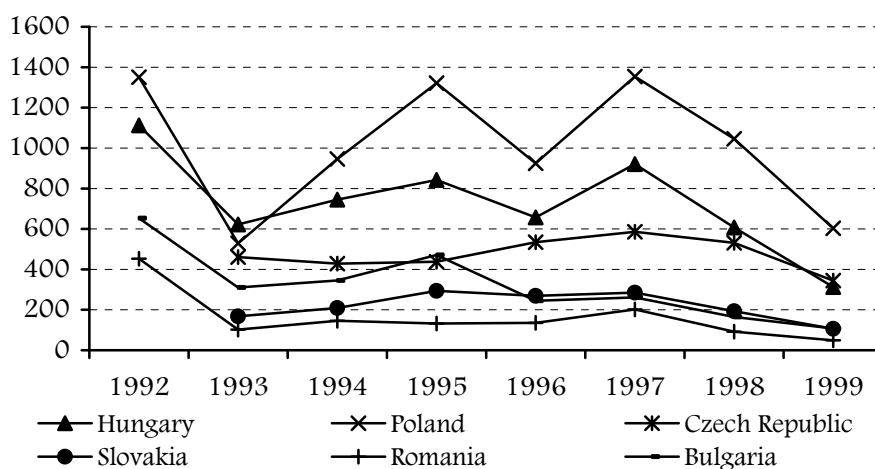
Nevertheless, it is worth making a country-to-country analysis on the CEE export performance in Russia during the 1990's. Poland achieved a spectacular export growth on the Russian market since 1994 while export performances of all the other CEE countries were not that impressive. (*Figure 1*) Poland increased its supplies considerably to Russia year by year until 1997, except for 1996 when several new Russian import regulations were introduced affecting some of the major Polish (and other CEE) export products. Yearly Polish export increases to Russia were above the general Russian trends of import growth. This was the time of the so-called ‘food for gas’ programme of the Bartimpex Group led by an excellent Polish businessman, Aleksandr Gudzowaty.⁵ One could say that Gudzowaty ‘privatised’ the Polish trade with Russia, concluding lots of good business contracts, with many of them using barter techniques. This happened just in an area when bi-

⁴ Ludvig (2011a).

⁵ *Ibid.*

lateral Polish-Russian political links were already burdened. Notwithstanding, in 1997 Russia was the second most important destination for Polish export products.

Figure 1
CEE exports to Russia, 1992–1999
(USD million)



Source: based on Rosstat

Other CEE exports were lagging behind the Polish one, but following a similar trend. A permanent ranking list of the six countries' export performance in Russia between 1994 and 1997 was as follows: Poland, Hungary, Czech Republic, Slovakia, Bulgaria and Romania. At the same time trade relations between the EU15 and Russia were on the rise. EU exports to Russia more than doubled between 1993 and 1997 with an almost similar increase in imports. EU15 turnover with Russia reached its highest figure precisely in 1993, the poorest year in the case of the CEE–Russian trade.

1997 was the peak year in CEE exports to Russia since 1993 with Polish, Hungarian, Czech and Romanian record levels as well, while Slovakian and Bulgarian exports reached their highest value in 1995. This slightly promising trend of increasing CEE exports was suddenly broken by the August 1998 Russian financial crisis.

Table 2
EU15 trade with Russia, 1993–2002

	1993	1996	1997	1998	1999	2000	2001	2002
Exports								
Million ECU/EUR)	11476	19093	25539	21170	14726	19916	27961	30465
Russia's share in total (%)	2.7	3.1	3.5	2.9	1.9	2.1	2.8	3.0
Previous year=100	201.0	118.1	133.8	82.8	69.6	135.2	140.4	109.0
Imports								
Million ECU/EUR)	14778	23299	27037	23172	25977	45724	47688	47729
Russia's share in total (%)	3.6	4.0	4.0	3.3	3.3	4.4	4.6	4.8
Previous year=100	172.0	106.7	116.1	86.0	112.1	176.0	104.3	100,1

Source: Eurostat database.

CEE–Russian bilateral political links remained modest and rather muted during this transition period except for the peculiarities of the Meciar era in Slovakia. The Euro-Atlantic integration process was the number one CEE foreign policy priority, and CEE politicians were reluctant to encourage relations with Russia. At the same time Russia lost its interest in the CEE region as well. Poland remained the only important CEE player for Russia due to its special relations with Ukraine and Belarus and owing to the Kaliningrad issue.⁶ But Polish-Russian relations were rather tense over these issues. While it used to be a widely spread opinion that the CEE decline in trade with Russia was closely connected to the loosening political ties, the Polish business success seems to disprove this kind of argumentation. Passivity on part of other CEE business circles should have played a major role.

⁶ Póti (1997).

2) Trade relations between the 1998 and 2008-2009 crises

Although the 1998 Russian crisis had broken out in the financial sphere it soon expanded causing a deep decline in production. Consequently, together with the impact of the financial crisis, it led to the drastic shrinkage in Russian foreign trade performance. All of Russia's trading partners experienced a dramatic drop in their trade with Russia. The average shrinkage of Russian import reached 18 per cent in 1998 and another 31 per cent in 1999 compared to the previous year. Hungarian exports to Russia fell to their third; and Romanian ones to their quarter by 1999 compared to the pre-crisis level of 1997, while the percentage fall of exports for Poland, Slovakia, the Czech Republic and Bulgaria were as follows: 55; 63; 41 and 59 respectively. The EU15 faced a trend similar to the Russian average of 43 per cent fall in their exports in the examined two-year period. The causes of the weakening Russian export performance are well-known: the drop in production, the fall in world oil prices (being at the same time a reason for the financial crisis as well), with the serious consequences of insolvency on the part of Russian companies, the lack of state guarantees, the collapse of the banking system, the dramatic devaluation of the rouble being major causes on the import side. During these circumstances only those trading partners could keep their positions on the Russian market that had strong capitalisation and/or possessed state guarantees. In some cases barter constructions helped in keeping trade contacts or even in breaking into the market. It is not by chance that the USA could increase its share in total Russian imports from 7.6 (in 1997) to 9.4 by 1998 while the EU15 succeeded in keeping their share between 36-37 per cent.

However, Russian economy recovered soon, unexpectedly for most international institutions and economic forecasters. Russian GDP showed an impressive 6.4 percent growth already in 1999, when exports also had a modest increase. Imports continued to decline in 1999 but this was followed by a 12 per cent growth in 2000. Given these facts the most interesting question is the following: how did the crisis affect the different trade partners of

Russia? What changes occurred in the positions of the individual partners, among them of the CEE countries?

Table 3
Time of reaching pre-crisis (1997)
level in CEE exports to Russia

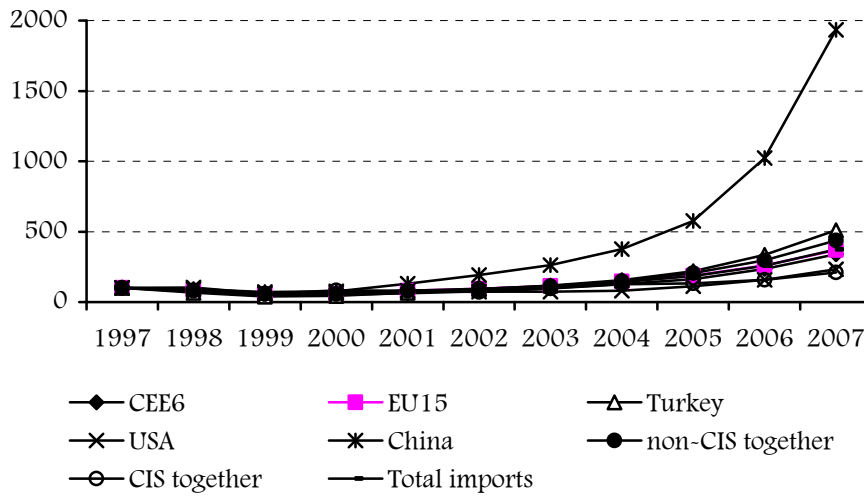
Hungary	2005
Poland	2002–2003
Czech Republic	2002–2003
Slovakia	2003
Romania	2005
Bulgaria	2005–2006
CEE6 together	2003–2004
EU15	2000
Total exports to Russia	2002–2003

Source: based on Rosstat.

According to *Table 3* Russian imports recovered by 2002–2003 meaning that their value in 2002 nearly reached the pre-crisis level of 1997. The USA was the only important partner country that could increase the value of its exports to Russia in a modest way in 1998. The fall in Chinese exports was less (8%) than that of total Russian imports (18%) in 1998 with the EU15 and CIS-countries being slightly under the Russian average.

The CEE export decline was the deepest one from among the examined trade partners of Russia both in 1998 and 1999. Reasons are manifold. (*Figure 2*) Firstly, Central-East European companies simply did not have the capital to finance their activities on the Russian market during the drastically changed circumstances including increased risks of non-payment, while their Western competitors could afford to offer more favourable payment terms to the Russian partners. Secondly, in some cases they did not have the support of the state and without state guarantees they were not able to survive on the market. There was a lack of trust on the part of CEE states and in some cases these states acted too slowly as well. Their Western competitors took the opportunity to acquire new positions or at least keep their old ones. Not surprisingly, EU15 exports recovered already in 2000 while total CEE exports reached their 1997 level only by 2003–2004. It is a lesson to be drawn from the experiences of the crisis that Russian market positions are easily lost while regaining them is extremely difficult. The very low basis is an important explanation why yearly export growth rates for the CEE were a bit higher than the Russian average import dynamism between 2000 and 2003.

Figure 2
Russian imports in country grouping
and major partner comparison
(1997=100)



Source: based on Rosstat.

However, there were big differences among CEE countries export performances on the Russian market after the crisis. Hungary was the last to reach the export level of 1997 from among Visegrad countries, while Poland and the Czech Republic were more successful.⁷ Romania and Bulgaria were also among those lagging behind in this respect. (*Table 3*)

Nevertheless, CEE exports showed an imposing dynamism during the 2000's. While there were explanations according to which improving political relations were in the background of the flourishing export activities (for example in Hungary), this might not be the best conclusion. For instance, this was the era of an impulsive Russian economic boom, which had a positive impact on

⁷ The Hungarian slow recovery can be explained firstly by the fact that the extent of the fall was extremely large, and secondly by structural factors. Hungarian exports had contained a large proportion of food and agricultural products, while the Russian food industry began to develop rapidly after the crisis leaving less room for imports. Thirdly, political hesitation or mistrust hampered the supplies of Hungarian buses, formerly being traditional Hungarian commodities on the Russian market.

all trading partners of Russia. Indeed, almost all partner countries experienced a high dynamism in their trade with Russia, including the results of their exports. (*Figure 2*) This was the case within the CEE region as well, although accompanied with another major factor.

In 2004 eight CEE countries joined the EU. From among them the four Visegrad countries constitute the subject of this analysis. It seems that EU membership brought significant changes in their trade with Russia. Although there were several worries on the Russian side concerning the potentially negative impact of the EU-accession on CEE–Russian trade, the most significant effects in reality were very much different from these concerns. Russian exports to CEE were not really hit by the new trade conditions; however, there were remarkable changes on the Russian import side. Commodity composition of CEE exports to Russia had been radically changing with a growing tendency of the proportion of machinery and transport equipment.

The dynamism of CEE exports to Russia was above the average growth rate of Russian imports in 2006 and 2008, and around the Russian average in 2007. The explanation could be given by the changed attitude on part of the transnational companies with subsidiaries in CEE countries. Although there was a real growth in their export volumes and values (backed by the Russian GDP growth), an important part of the considerable increase seen statistically was caused by their intra-firm agreements. In earlier years a considerable part of the production (like mobile phones, cars, car components, *etc.*) produced in CEE locations of transnational companies was not indicated statistically as CEE (Hungarian, Czech, Slovakian or Polish) export, but as of other, for example, EU origin. After the EU accession of CEE countries this practice has been gradually, in some cases suddenly changed giving an important impetus to CEE exports. A similar tendency can be observed in relation to Romanian and Bulgarian EU accession, leading to a high dynamism of these countries' exports to Russia recently.⁸ This change in transnational company behaviour explains primarily the very positive changes in CEE export compositions in relation to Russia. *Table 4* shows this radical change in

⁸ A short remark on Romanian exports should be made here. In the Romanian case TNCs behaviour changed even 1-2 years before the real date of EU-accession.

Table 4
Commodity structure of Hungarian exports to Russia (SITC classification), 2000–2008
(per cent)

SITC		2000	2001	2002	2003	2004	2005	2006	2007	2008
0	Food and live animals	31.8	31.3	34.0	26.9	20.7	20.6	12.4	7.5	6.8
1	Beverages and tobacco	1.2	0.9	0.9	0.8	0.6	0.5	0.4	0.4	0.3
2	Crude materials, inedible, except fuels	2.0	0.4	0.8	0.4	0.8	0.9	0.3	0.4	0.3
3	Mineral fuels, lubricants and related materials	0.3	0.5	0.0	0.0	0.1	0.6	0.5	0.8	0.4
4	Animal and vegetable oils, fats and waxes	2.8	1.3	1.2	3.0	2.0	0.5	0.1	0.0	0.0
5	Chemicals and related products, n.e.s.	29.9	33.2	31.9	30.4	36.6	40.3	27.7	22.1	21.5
6	Manufactured goods classified chiefly by material	7.4	7.6	10.0	9.4	10.5	10.0	7.6	7.0	7.6
7	Machinery and transport equipment	18.4	17.7	11.2	21.1	18.6	18.0	46.4	58.0	60.0
8	Miscellaneous manufactured articles	6.2	7.1	10.0	8.0	10.1	8.6	4.6	3.7	3.1
9	Commodities and transactions not classified elsewhere in the SITC	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: based on Hungarian Central Statistical Office database.

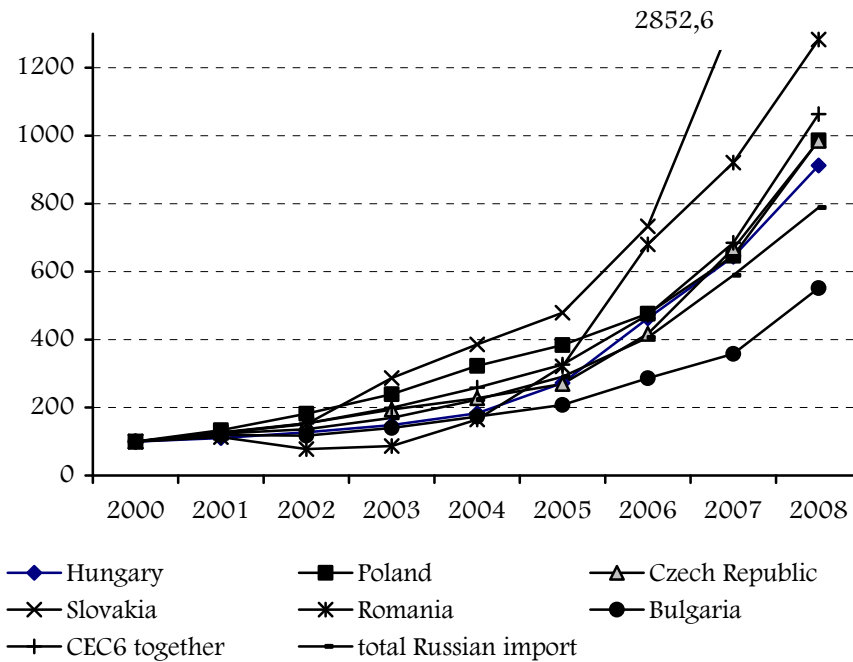
the Hungarian example. This phenomenon highlights another major feature of present-day CEE–Russian trade links. Like CEE exports generally, their exports to Russia are also influenced and generated to a great extent by the production of transnational companies located in individual CEE countries. In the future there interests will decide whether to maintain or not the given level of production or the direction of exports with potentially great fluctuations in the volume of trade with Russia as well.

The 2000's witnessed an improvement in several CEE–Russian bilateral political relations. Although Poland remained a 'cool partner' of Russia, other CEE countries like Hungary or Slovakia took a pragmatic turn and put the aim of improving relations with Russia among their foreign policy priorities.¹ Since this intent coincided with improving trade figures, trade successes on the Russian market were often considered as fruits of improved political relations. Indeed, balanced and friendlier political relations had some positive impact on the economic relations with Russia, but as the significant changes in the commodity structure of the Hungarian example indicate, the biggest modifications and impressive export growth were due to other factors. Moreover, Polish exports reached an almost tenfold increase, well above the average sevenfold CEE export growth despite the rather cool Polish-Russian political relations between 2000 and 2007. The evidently worsened political relationship in 2005-2007 had only a temporary negative impact on Polish export performance in Russia.² Notwithstanding being a 'cool partner' of Russia as well, the Czech Republic has also reached outstanding export successes on the Russian market since 2006. (*Figure 3*)

¹ According to a classification of EU member states by their political-economic relationship towards Russia made in 2009 by the Institute for World Economics of the Hungarian Academy of Sciences, Hungary, Slovakia and Bulgaria belonged to the group of "friendly pragmatists," while Poland, the Czech Republic and Romania were so-called "cool (but pragmatic) partners" of Russia. (Ludvig, 2011b) The ECFR categorisation made in 2007 also put the former three countries into the category of "friendly pragmatists," described Romania and the Czech Republic as "frosty pragmatists," while labelling Poland as a "new cold warrior." Mark-Popescu (2007).

² Russia introduced embargo on the import of Polish meat in 2005 on supposed political grounds. As a response Poland has repeatedly vetoed the launch of negotiations on the new EU–Russian basic agreement for years. Despite the Russian veto on Polish meat, other Polish exports could reach approximately 20 per cent growth during 2005-2006 and a more than 35 per cent increase in 2007. After the end of this Polish-Russian bilateral dispute, in 2008 Polish export dynamism on the Russian market was around the CEE average growth rate.

Figure 3
CEE countries exports to Russia
(2000=100)



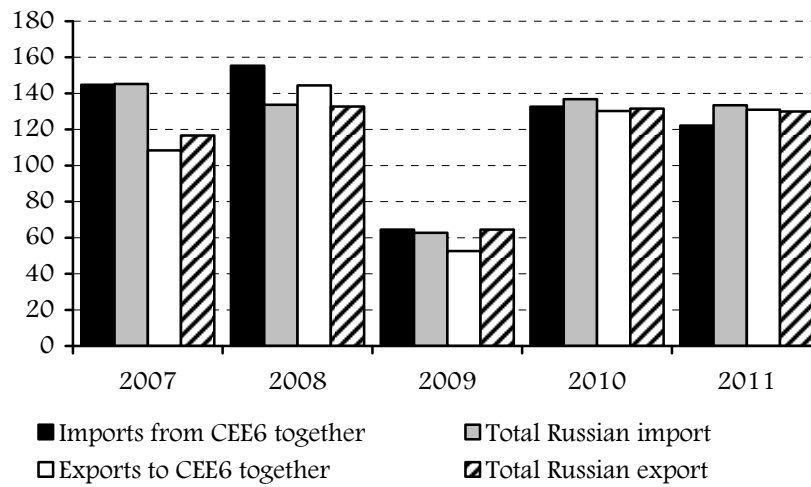
Source: based on Rosstat.

3) Impacts of the 'Great Recession' on CEE–Russian trade

The era of the world economic crisis, recently called the 'Great Recession', was the third period when CEE–Russian trade relations experienced a dramatic fall. The financial crisis had broken out in 2007 in the USA but soon spread to almost all regions of the world and to the real economy. It reached Russia in the second half of 2008 leading to almost immediate decline in Russian foreign trade turnover. However, for the whole year of 2008 Russian foreign trade still had positive dynamics. Moreover, in CEE–Russian trade 2008 was the peak year both regarding export and

import values and with higher yearly growth rates than the average increase of total Russian exports and imports.

Figure 4
Yearly change of Russian exports to
and imports from CEE6, 2007–2011
(per cent)



Source: based on Rosstat.

The year 2009 already witnessed a radical, more than 35 per cent fall both in Russian exports and imports with their rates well exceeding the level a world trade decline (~12 per cent). As it had been usual in CEE–Russian trade for many years, the value of Russian exports was determined mostly by the volume and prices of energy supplies during and after the crisis.³ However, Russian imports from CEE showed a new feature: the extent of the decline caused by the crisis was more or less the same as the average shrinkage of Russian imports. We assume that the major part of the explanation could be given by the dominance of transnational companies in CEE exports to Russia. Owing to them CEE exports to Russia were and still are not really different from other exports, mostly coming from developed economies. Besides, some CEE

³ Perhaps the most significant impact of the crisis on CEE–Russian trade has been the intention on part of the consumers of Russian gas, including CEE countries to modify the old system of gas contracts and gas pricing. The crisis highlighted the advantages of spot markets and spot prices. Several partners of Russia made steps to shift to this kind of pricing.

companies have been growing stronger for the past decade and their internationalisation also provides a better basis for maintaining or even increasing their position on the Russian market. A good example is the Hungarian Gedeon Richter Group in the pharmaceutical industry.⁴

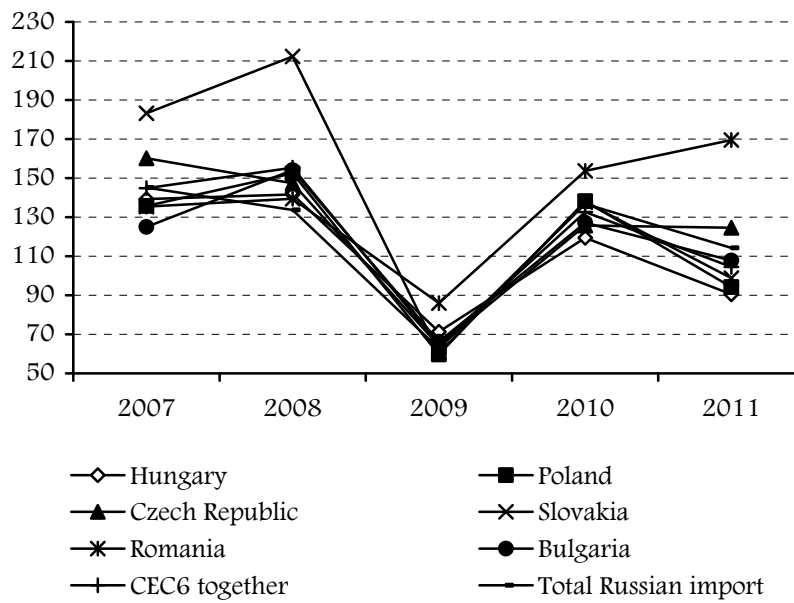
Country-level analysis makes this general picture more colourful. Romanian exports already exceeded their 'pre-crisis' level (of 2008) in 2010. The other new EU member, Bulgaria succeeded in achieving this in 2011, but it was only the Czech Republic that was able to export more in 2011 than in 2008 from among V4 countries. As a consequence the share of V4 countries in Russian imports decreased from 6.5 per cent in 2008 to 5.7 per cent in 2011.⁵ But CEE6 as a country group lagged behind the Russian average in measuring the level of exports in 2011 compared to the export value of 2008. This can be mainly explained by the high basis for them in 2008. According to the newest data, 2012 witnesses export growth again in four CEE countries, with the exception of Hungary and Romania. However, we believe that these fluctuations can be explained more by TNC's behaviour and the general conditions of the Russian market than by CEE-specific reasons.

Based on the Hungarian example the commodity structure did not change to a considerable extent in the past few years. However, as the crisis and the keen competition hit some TNCs, some formerly dynamically increasing CEE exports, including those to Russia, may be at risk. A well-known example is the case of Nokia, a company that in 2012 decided to cut 2300 job places in its Hungarian-located factory, in Komárom and relocate its production to other regions. Most probably this will have an impact both on the value and the commodity pattern of Hungarian exports to Russia in the near future. Nokia earlier made a similar decision regarding its site near Cluj-Napoca in Romania.

⁴ The Richter Group's sales to Russia in 2008 were almost at the 2007 level followed by an impressive growth of 11 per cent in 2009, the worst year of Russian foreign trade in the past few years. Richter sales continued to grow during 2010 and 2011 as well. Exports to Russia amounted to 37 per cent of their total international sales in 2011. (*Gedeon Richter Annual Report, 2011*.)

⁵ V4 share in Russian exports also decreased from 9.2 per cent in 2008 to 8.1 per cent in 2011.

Figure 5
Yearly change of CEE6 exports to Russia, 2007–2011
(per cent)



Source: based on Rosstat.

Table 5
CEE exports compared to 2008, 2008–2012
(per cent)

	2008	2009	2010	2011	January to November 2012/2011
Hungary	100.0	71.3	85.2	90.5	91.7
Poland	100.0	59.7	82.4	94.2	112.3
Czech Republic	100.0	64.1	80.6	124.6	122.9
Slovakia	100.0	60.4	83.1	98.8	124.5
Romania	100.0	86.0	132.2	169.5	98.7
Bulgaria	100.0	66.2	84.1	107.8	102.0
CEE6 together	100.0	64.5	85.5	104.5	105.1
total Russian import	100.0	62.7	85.7	114.3	102.5

Source: Rosstat.

Table 6
Commodity pattern of Hungarian exports to Russia, 2007–2011
(per cent)

SITC		2007	2008	2009	2010	2011
0	Food and live animals	7.5	6.8	6.6	6.2	6.8
1	Beverages and tobacco	0.4	0.3	0.2	0.2	0.2
2	Crude materials, inedibles, except fuels	0.4	0.3	0.3	0.6	0.7
3	Mineral fuels, lubricants and related materials	0.8	0.4	0.8	1.0	1.0
4	Animal and vegetable oils, fats and waxes	0.0	0.0	0.0	0.0	0.1
5	Chemicals and related products, n.e.s.	22.1	21.5	25.0	21.0	25.2
6	Manufactured goods classified chiefly by material	7.0	7.6	8.1	7.5	9.2
7	Machinery and transport equipment	58.0	60.0	56.3	61.5	53.9
8	Miscellaneous manufactured articles	3.7	3.1	2.6	2.0	2.9
9	Commodities and transactions not classified elsewhere in the SITC	0.0	0.0	0.0	0.0	0.0
	<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>

Source: based on Hungarian Central Statistical Office database.

Nevertheless, the CEE Commodity export structure is still dominated by exports of TNCs, just as it was in the pre-crisis period. According to figures of *Table 7* the proportion of machinery and transport vehicles (SITC 9) was rather high in all CEE countries in 2010, except for Poland and Bulgaria. There is also a remarkable increase in the shares of this product group in all CEE cases compared to the pre-EU accession period. In 2010 Polish export structure was most diversified towards Russia, probably consisting more 'real' Polish products than it is the case for the other CEE countries. Bulgarian commodity structure also has its peculiarity since pharmaceuticals totalled to one third of all exports to Russia (see figure for 2010 in *Table 7*).⁶

⁶ Pharmaceuticals totalled to 17 per cent of all Hungarian product exports to Russia and 11 per cent of Slovakian exports in 2010 indicating a keen competition among CEE countries. Polish and Czech pharmaceutical export is also sig-

Table 7
Share of machinery and transport vehicles
in CEE exports to Russia, 2003, 2010
(per cent)

	2003	2010
Hungary	21	60
Poland	15	35
Czech Republic	51	63
Slovakia	33	85
Romania	28	66
Bulgaria	18	32

Source: Russian Federal Customs Service (Tamozennaya Statistika Vnyesnyey Torgovly RF, 2003 and 2010).

We believe that the state of bilateral CEE–Russian political relations has no decisive impact on CEE export performance on the Russian commodity market. Admitting that there is more room for impact on other kinds of bilateral economic co-operation (for example, trade in services or co-operation in investments, *etc.*), product export is mostly determined by

other factors. Trade with Russia, especially export to Russia has been correlating with trends of general trade in the CEE region for the past years. This can be explained by the growing role of both TNCs in CEE foreign trade flows and general impacts of the international environment.

4) Conclusions – CEE–Russian trade: politics or ‘business as usual’?

When speaking about Russia, politics is a number one issue, often preceding economic considerations. Indeed, in the time of searching for new CEE foreign policy orientations during the transition period of the 1990’s, Russia seemed to have lost its attractiveness as a business partner as well. CEE countries and their leaders focused on the euro-integration process, sometimes ignoring still rich opportunities in the East. Since Russia was also looking for Western partners, both political and economic CEE–Russian links weakened to a dramatic extent at the very beginning of the

nificant. Most probably this export product group also belongs to those branches where TNCs’ performance is substantial.

1990's. However, whether the decline in economic contacts happened by political intention or it was just the consequence of business attention turning away (and towards the developed economies), is still a debated issue. Nevertheless, as the example of the politically distant Poland shows, business commitment enabled to formulate strong and mutually beneficial trade links with Russia even in this period. This has been even more so since then and is more valid for commodity trade. We argue that the development of political relations and the trends in economic links with Russia do not necessarily follow the same path. The Polish example of the 1990's shows that in an area of frosty, but not extremely worsened, political relations business can flourish between the two partners.⁷ On the other hand, improving political relations will not automatically lead to outstanding successes on the Russian market. As the Hungarian trade experience of the 2000's indicates, the positive results, mostly seen by Hungarian politicians as direct consequences of political rapprochement, were not really remarkable in an international comparison. Impressive export performance between 2003 and 2008 was rather due to general good conditions of the Russian market than to political intentions. Nevertheless, the turn of several CEE countries towards pragmatism with Russia, instead of the former ideological approaches, also has its advantages in business. It can support their success in big Russian state purchases or other large-scale business where the state has its influence, but general business goes on in accordance with strict economic considerations. However, political factors and political will may matter when providing state guarantees or other kind of state support to companies doing business in Russia.

As a second major conclusion of this analysis we may state that CEE exports are usually more vulnerable to Russian market developments; Russian crises have had a deeper negative impact on their performances than on their Western competitors' ones. As a general trend CEE export decline periods are deeper and longer on the Russian market than Russian average trade fall. It is be-

⁷ Naturally, a dramatically worsened political relationship with Russia would have an immediate and drastic impact on economic relations, including trade. This was the case between Russia and Georgia during the second half of the 2000's when Russia introduced embargo on the import of Georgian wine and mineral water as a response to Georgian foreign policy, which Russia considered to be anti-Russian. Afterwards Georgian exports to Russia decreased dramatically.

cause CEE companies often do not have enough capital to survive during a crisis and in hard circumstances, especially without the necessary guarantees from the state, while Western firms grab all opportunities to strengthen their position. Nevertheless, these differentiations between CEE and Western opportunities have been diminishing for the past years. The impact of the third examined crisis of the Russian economy in the years 2008–2009 seem to be not so long-lasting in the CEE region than the previous ones. As an explanation we can state that CEE exports to Russia are already very much similar to Russia's other imports given the fact the TNCs are the most significant partners of Russian companies in both cases. The push of TNCs in CEE exports to Russia has been a side effect of CEE EU-memberships both in the V4 countries and in the Romanian and Bulgarian cases. We may conclude that TNCs' strategies are now major forces in determining CEE export performances in Russia instead of both the state of bilateral political relationships or national economic policy goals.

Russia is an important and big market generating keen competition among exporters. Due to historical reasons and geographical location Russia had been a most important economic partner for the CEE countries for decades. But for the past twenty years they seem to be superseded by their Western and Chinese competitors. The Russian market has other peculiarities as well: as the examples of the last two economic crises in Russia show, crises are extremely deep but end earlier and more 'easily' than expected. This is another reason for making efforts to maintain one's market positions in the country.

Russian economic crises have another feature: they are usually in close connection with low world market energy prices. This has a special consequence on CEE–Russian trade since CEE countries' major problem in their trade with Russia remains the same: they face huge trade deficits. Not surprisingly, these deficits usually decrease during Russian crises, since Russian economic problems usually coincide with or are amplified by low oil (and gas) prices. In post-crisis periods the normal way to decrease these deficits in CEE countries is by increasing exports.

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**SELECTED ISSUES OF THE
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INSTITUTIONAL ENVIRONMENT FOR PUBLIC-PRIVATE PARTNERSHIP IN UKREINE: DO INSTITUTIONS REALLY MATTER?*

Ievgen L. Cherevykov

Introduction

Many international economic studies prove that poor infrastructure impedes the development of the national economy and deteriorates its international competitiveness.^{1,2,3} Infrastructure projects have high public significance and the amounts invested annually into infrastructure by the public sector are vastly exceeding investments made by the private sector.⁴

Public-Private Partnership (PPP) has become a popular instrument of implementing public investment projects across the world. In contrast to a dominant international approach to PPP's

* Research report on the Project "Public-private partnership as a component of the strategy of state cooperation with international organizations and transnational corporations" (2012-2014). Institute for Economics and Forecasting of the National Academy of Sciences of Ukraine.

¹ World Bank Reports (2005–2006).

² Calderón – Servén,(2004).

³ Mantega (2003).

⁴ Delmon (2011).

definition, we consider PPP not only as a contractual but as an institutional relationship between public and private entities aimed at improving infrastructure and public services. Many governments have been using PPPs partly to implement and realise investment projects concerning highways, railways, airports, power plants, water sewage plants, hospitals, schools, and other fixed assets. Instead of paying for the asset from budgetary funding, governments engage in a contractual arrangement with private firms that will finance the design, construction, operation, and maintenance of the project. In exchange, the government makes a commitment to provide necessary funding to the firms to cover the expected costs not only for the initial design and construction of the asset but also for the subsequent operation and long-term maintenance of the project in addition to an anticipated level of profit.

PPPs allow governments to leverage private capital, deferring public outlays without deferring the benefits. PPPs have become particularly attractive to governments with annual budget restrictions, which expect less restriction or control on incurring liabilities in the future.^{5,6}

Additionally, PPP can be considered as a powerful tool of public regulation in context of investment, innovation, fiscal, competitive, social and regulatory policy.^{7,8,9,10}

1) PPP as a socio-economic institution

We offer a new concept of PPP as a socio-economic institution. The common use of the term “institution” makes it possible to consider PPP as an institution in five aspects: behavioural, cognitive, associative, regulatory and constitutive.

⁵ Perrot – Chatelus (2004).

⁶ Hemming (2006).

⁷ Revilla–Sarkis (2003).

⁸ Blankenburg (2000).

⁹ Silva–Rodrigues (2004).

¹⁰ Sawyer (2009).

According to the behavioural aspect, at the level of the national economy PPP should be regarded as an institution of strategic interaction between the public and the private sector to address socially significant competitive challenges of socio-economic development. At the micro level, such a strategic interaction is manifested in the investment project implementation. In our opinion, the relationship that forms the PPP institution can be found in the framework of rational choice institutionalism based on the game theory as a set of equilibrium repeated outcomes in the standard co-operative game.

According to the cognitive aspect, PPP is directly connected with the institutions of public confidence and social responsibility, which are the integral parts of the social partnership mechanism. The development of the social partnership in Ukraine requires the formation of the partnership ideology, in which the leading role belongs to the state.

In the associative aspect, PPP can be seen as an institution to reconcile private and public interests based on communitarian paradigm and effective mechanisms for the involvement of business elites in the process of providing public goods. At the same time, according to the regulatory aspect, PPP defines the parameters of partnership between the state, businesses and civil society expressed in the objectives, forms and results of their interaction at all levels. Instrumental PPP capabilities are fully revealed during the implementation of the national anti-crisis policy of creating jobs, introducing tax privileges, simplifying business environment for small enterprises, providing financial support for financial institutions and so on.

The constitutive nature of PPP is carried out through a system of state guarantees, which serves as a key factor in ensuring fair behaviour (the behaviour that matches the promises issued)¹¹ and stable partnerships, secured by the relevant regulations.

¹¹ Brennan–Buchanan (1985).

2) Concepts of PPP in Ukraine

In Ukrainian scientific literature public-private partnership is frequently translated as *state-private partnership* (SPP) but the term “public-private partnership” more precisely reflects the whole range of relations within this phenomenon based on the participation of both local governments and the public institutions.

Public-private partnership can ensure additional advantages in reducing the prime costs of projects, efficiently distributing risks, improving management, assuring a better quality of services, and raising the profitability of projects.

The potential of using PPPs in Ukraine is high due to the big share of the public sector in the national economy (37.0% of the GDP).¹² A considerable part of transportation, housing and communal services, energy and social infrastructure belongs to the public property. At the same time, the state of motorways, railways, seaports and airports is unsatisfactory for a European country. The depreciation rate of the capital assets of heat and water supply and sanitation exceeds 60 per cent, whereas that of the urban electricity transport is up to 90 per cent. Neither the state nor local budgets have the necessary financial resources for the modernisation of the infrastructure, and these resources are unlikely to appear in the near future. In this situation it is natural that the state is focusing on the development of PPPs.

In Ukraine, the PPP investment potential is underestimated, as evidenced by the figures regarding the implementation of infrastructure projects with private participation (*Table 1*). According to the World Bank database, private investments in infrastructure projects implemented on the principles of PPPs in developing countries totaled at USD 588.5 billion between 1990 and 2011. At the same time, all investments in infrastructure projects with private participation in Ukraine from 1990 to 2011 amounted to USD 12.1 billion, of which the telecommunications sector accounted for approximately 90 per cent. Furthermore, among 39

¹² Zapatrina (2011).

projects listed below only 18 can be seen as “quasi PPPs”¹³ and were implemented as “Greenfield” concession, management and leasing projects.

Such a trend of attracting private business in the implementation of publicly important infrastructure projects does not correspond to the priority areas of the development of investment in Ukraine’s economy. As defined by President Victor Yanukovich in the Programme of Economic Reform for 2010-2014 “Prosperous Society, Competitive Economy, Efficient State,” these areas are the following: power, new quality of life, infrastructure, design of the Olympic Hope-2022.¹⁴

The main reasons why the dynamics of PPP development in Ukraine do not accord with the requirements of the economy are the following: contradictory and inconsistent legal regulation; insufficient level of political and economic stability; lack of consistent policy and proper management on PPP; no effective PPP public support mechanism; complicated and inconsistent tariff regulation; low institutional capacity of government entities and the private sector in PPP implementation; poor qualification level of officials and low awareness of the private sector as regards PPP specifics and so on.

Most of the above mentioned factors, especially legal regulation, political and macroeconomic factors, PPP management and contracting, institutional capacity of government and private entities for PPP implementation have an institutional nature and some of them influenced negatively the implementation of the most significant “quasi PPP” investment projects (see *Table 2* column “Problems”).

¹³ “Quasi PPPs” are public investment projects with private participation, which were not classified and adopted as PPPs in accordance with the Ukrainian PPP legislation (Law of Ukraine “On State-Private Partnership”, the Decrees of Cabinet of Ministers of Ukraine # 81, 232, 279, 384). There are no fully-fledged PPPs in Ukraine yet.

¹⁴ The President specified the priority investment projects of Ukraine: <http://uaport.net/news/ua/go/UN10082559152>

Table 1
 Infrastructural investment projects with private participation in Ukraine, 1992–2011

Year of onset of project implementation and financing	Sector of PPPs implementation							
	Power		Telecommunications		Water supply and sewage		Total	
	Number of projects	Investments USD mln	Number of projects	Investments USD mln	Number of projects	Investments USD mln	Number of projects	Investments USD mln
1992	-	-	1	11	-	-	1	11
1993	-	-	1	72	-	-	1	72
1994	-	-	-	10	-	-	-	10
1995	-	-	-	18	-	-	-	18
1996	-	-	3	317	-	-	3	317
1997	-	-	2	187	-	-	2	187
1998	6	-	1	331	-	-	7	331
1999	-	-	-	242	-	-	-	242
2000	-	-	1	206	-	-	1	206
2001	6	160	3	255	-	-	9	415
2002	1	-	-	186	-	-	1	186
2003	-	-	-	370	1	-	1	370
2004	-	-	-	738	-	-	-	738
2005	-	-	-	1407	-	100	-	1507
2006	1	24	1	865	-	-	2	889

Year of onset of project implementation and financing	Sector of PPPs implementation							
	Power		Telecommunications		Water supply and sewage		Total	
	Number of projects	Investments USD mln	Number of projects	Investments USD mln	Number of projects	Investments USD mln	Number of projects	Investments USD mln
2007	1	83	-	1346	-	-	1	1429
2008	1	100	-	1364	1	102	2	1566
2009	-	121	-	934	-	-	-	1055
2010	4	89	-	413	-	-	4	501
2011	3	343	1	1607	-	-	4	1950
In all	23	920	14	10878	2	202	39	12001

Source: World Bank Private Participation in Infrastructure Database, Ukraine (*without the transport sector*).
http://ppi.worldbank.org/explore/ppi_exploreCountry.aspx?countryID=97

Table 2
Most significant “quasi PPP” investment projects in Ukraine

Name of Project	Responsible Agency	Type of Project	Location	Year of Inception	Year of Completion	Capital Value of Project	Outcome	Problems
Green Co – Group	Regional Council	Waste re-covery	Kyiv	2003	-	-	successfully concluded	-
<i>Lviv-Krakovets</i>	<i>Ministry of Transportation, State Road Agency “Ukravtodor”</i>	<i>Highway</i>	<i>Lvivska oblast</i>	<i>1999</i>	<i>2044</i>	<i>UAH 1.6 bln.</i>	<i>aborted after signing of contracts (2010)</i>	<i>Pilot project: lack of funding and experience; political factor</i>
Vanko International	Cabinet of Ministers of Ukraine	Oil and gas production	Black Sea shelf	2005	2013 (tentative term)	USD 15.0 bln. (0.33 bln. – preliminary stage)	aborted after signing of contracts (2008)	Political factor, faults in contracting
Luhanskvoda-Rosvodokanal	Regional Council	Water supply	Luhansk	2007	2031	UAH 0.75 bln.	successfully started	Abuses of public procurement procedures, tariffs were raised by 2.5 times in 2008

<i>Odessvodokanal- Infoxvodokanal</i>	<i>Regional Council</i>	<i>Water sup- ply</i>	<i>Odessa</i>	<i>2004</i>	<i>2052</i>	<i>-</i>	<i>successfully started</i>	<i>Breach of investment plan, tariffs were raised by 2.0 times in 2007</i>
Artemivskteplomere zha	Regional Council	Heating supply	Artemivsk	2007	2046	UAH 90.0 mln.	successfully started	-
“Kirovogradvodoka nal”-“Vodne Gospodarstvo”	Regional Council	Water sup- ply	Kirovograd	2006	2054	-	aborted in 2008	Problems with debt and water supply

Source: prepared by the author.

3) PPP legislation and practice in Ukraine

Generally, Ukraine's legal framework governs the economic relations between public and private sectors through a number of laws and regulations, among them the Economic Code of Ukraine, the Civil Code of Ukraine, the Budget Code of Ukraine, the Law of Ukraine "On Leasing State and Communal Property," the Law of Ukraine "On Concession," the Law of Ukraine "On Concession for the Construction and Operation of Motor Roads," the Law of Ukraine "On the Administration of State and Communal Property," the Law of Ukraine "On Financial Leasing," the Law of Ukraine "On the Peculiarities of Lease or Concession Facilities of Centralised Water-supply and Sanitation that are Municipally Owned," the Law of Ukraine "On Peculiarities of Lease or Concession of State-owned Fuel and Energy Complex," the Law of Ukraine "On Local Government" *etc.*

Among the special legislations regulating the state's interaction with the private sector within the framework of PPP, we should single out the Law of Ukraine "On State-Private Partnership" (PPP Law) that is of a framework nature, and the Concept of the Development of Public-Private Partnerships in the Housing and Municipal Economy (approved by the Cabinet of the Ministers of Ukraine). The PPP Law specifies the following PPP forms: concession, joint activity and others.

The PPP Law contains many indirectly referring regulations. Choosing a particular form for the PPP project implementation, stakeholders should examine numerous pieces of legislation that may not be in sync with each other. Both the large number of laws that regulate the PPPs and the contradictions between them make the PPP implementation in Ukraine rather difficult. In addition, at the local government level investment projects are regulated by numerous local acts as well, which are also not always consistent with the regulations of the PPP Law.

In view of the existing contradictions in the legislative and regulatory base and the actual impossibility of fast implementation and the harmonisation of the Law of Ukraine "On State-Private Partnership" with other special laws, it is necessary to de-

velop PPP on the basis of PPP Law, which should serve as a framework law. It requires the following:

- 1) improving the PPP Law to ensure a clearer outlining of the competences of the authorities that become involved in PPPs at all stages at both central and local levels; more accurate formulation of PPP characteristics as regards delegating the functions and competences of the government to the private sector related to infrastructure development and public services; improving the list of PPP application areas; introducing the possibility of institutional partnership, including the creation of a 'special purpose company';¹⁵
- 2) harmonising regulations of the PPP Law with the special laws that regulate the contractual relationship between the state and the private sector in the field of concession, joint activity, lease and so on;
- 3) introducing tools of methodological support for PPPs by contractual forms;
- 4) legal regulation of issues of assets created under PPPs;
- 5) improving the mechanism of settling disputes arising out of any PPP agreement with the participation of a non-resident or an enterprise with foreign investments; and
- 6) further legislative efforts to introduce stimulating tariff regulation.

4) Problems of PPPs at local level

The activity of local authorities to involve the private sector in the PPP implementation remains extremely low due to the institutional causes while the main potential of infrastructure development and improving the quality of public services is at the local level. In Ukraine weak local PPPs are associated with the shortcomings of current legislation, low awareness of local government entities and private business of PPP features, lack of qualified staff in local governments for the PPP preparation and maintenance. The pri-

¹⁵ A Special Purpose Company is a project company which usually acts as a general contractor in a PPP project.

vate sector's willingness to participate in infrastructure projects remains quite low, as evidenced by the results of the survey conducted under the auspices of USAID.¹⁶ Only 3 per cent of the surveyed businesses have been involved in "quasi PPP" projects. However, only 39 per cent of business respondents are interested in participating in PPPs. At the same time, such a share of local government entities totals 62 per cent.

The key task of developing PPPs at the local level is to ensure the implementation of pilot projects via a unified algorithm of selection, examination, agreement, and by the involvement of appropriate experts.

PPP projects at the local level should involve financial resources both from oblast and municipal budgets that are responsible for constructing, operating and maintaining local infrastructure projects. The new legislative regulation of the relationship between local government bodies and the PPP unit (Department of Investment and Innovation Policy in the Ukrainian Ministry of Economic Development and Trade) will provide the right of local government bodies to make independent decisions on PPP expediency and implementation.

5) Conclusions

In order to improve the PPP management system in Ukraine, the government should establish relations with international institutions and promote more intensively the formation of national institutions whose activities should be oriented to the priorities of innovation-based modernisation of the national economy, using modern risk management approaches. The establishment of institutions should be carried out by observing the financial sustainability, resource diversification, investment risks minimisation, administrative pressure and corruption risks elimination requirements.

The role of financial institutions (special banks, state corporations and leasing companies, innovation funds, regional development funds and agencies, *etc.*) will be providing financial, adviso-

¹⁶ Besedina–Nizalov–Semko (2012).

ry and information support for PPP projects. Non-financial institutions (techno parks, industrial parks, business incubators, special economic zones, research centers, centers of technology transfer, and others) will advance the development of business infrastructure within the PPP framework, improvement in the qualifications of state officials and integration of PPP issues into the academic programmes for specialists prepared by state authorities and local government bodies. Training sessions, seminars and roundtables on PPP should be organised as well.

The necessity and effectiveness of co-operation between public and private sectors are determined by institutional factors associated with the level of economic freedom. Further PPP development requires an active participation of the community in the preparation and implementation of PPP projects, especially at the local level. Moreover, PPP as an institution in Ukraine needs to fix its principles in national and regional strategies for socio-economic development, the creation of institutional environment, improvement of its legal framework, and the introduction of public enforcement of contractual obligations by all partners.

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ENVIRONMENT, SUSTAINABILITY AND ECONOMIC PERFORMANCE – THE CASE OF THE NORTHERN ARAL SEA REGION

Alpár Szőke

1) The ‘topic’ of the Aral Sea

The Aral Sea region is the perfect example to show how negative externalities and mismanaged natural resources resulting in an environmental catastrophe can turn a prosperous region into an infamous area hit by both an economic and a social crisis. As the Aral Sea disaster is one of the most serious man-made environmental catastrophes the world has ever seen it can serve as an example for governments and other organizations of the importance of environmentally conscious decision-making for the sake of long-term economic sustainability.

The Aral Sea Basin had been a prosperous region until the 1960's when the first signs of an environmental catastrophe that later on led to the desiccation of the Aral Sea started to show. This has eventually caused huge biological and geographical damage and the economy traditionally based on the fishing industry collapsed as well. This process could not be reversed until the early 1990's.

As the issue of the environmental, economic and social crises of the whole Aral Sea Basin is too complex the interrelation between the ecology and economy will be examined in the context of the

'Little Aral' region located in Kazakhstan through analysing the economic performance of the Aralsk County and the city of Aralsk, a major former port of the county.

Firstly, the study will try to set up and prove the logical connection between the economy and the environment of a region with the help of the Aral Sea's example, by concentrating on its northern part, the Little Aral. As a first step it will analyse the region before the sea started to dry up. Secondly, it will describe how an environmentally ignorant economic policy led not only to an ecological disaster but social and economic crises as well. Thirdly, it will focus on the national and international cooperation that strived to save the sea and reinvigorate the area. By analysing the policies and actions of the period following Kazakhstan's declaration of independence, the study will show the effects that the environmentally conscious policies had on the economy of the Little Aral's region. The research comes to the conclusion that the Little Aral region cannot prosper without a stable environmental background, which in this case would be provided by the sea. The study shall attempt to prove the following hypothesis: the performance of a region's economy is dependent on the quality of the environment surrounding it.

This topic has been widely dealt with internationally, especially after the collapse of the Soviet Union. Hundreds of biologists, geographers, journalists and other professionals travelled from across the globe to have first-hand experience on this unique catastrophe. They have published numerous research papers, essays and articles about their findings. Even though these papers often mention the social and economic impacts that the crisis had on the area the number of articles thoroughly studying the economic impact of the catastrophe on the everyday life of people living around the sea is limited. For this reason the study will try to analyse the economic and social consequences of the environmental change.

In order to have a better understanding of the events that occurred in the region over the last 50 years and gather primary data the author made a field trip to the Northern Aral Sea and interviewed community leaders and chief officials. Some of them had been in senior positions since the Soviet era. There were directors, owners of fish processing factories, heads of the local government and other leading personalities from the community of Aralsk among the interviewees. With the help of all the information gleaned from the interviews the study will show how a

prosperous region turned into an infamous area and began to recover during the last decade thanks to the impact of governmental and foreign activities aimed to save the environment.

2) The history of the Aral Sea Basin

The Aral Sea is located in Central Asia and it is bordered from the north by Kazakhstan and from the south by Uzbekistan. Its water supply comes from two major rivers of the region, the Amu Darya (2,600 km, draining 692,300 km²) and the Syr Darya (2,212 km, draining 493,000 km²) with a combined average annual flow of 115.6 km³.¹ It used to be the fourth largest inland body of water on the planet. Before the 1960's it had a surface area of 68,000 km², its mean water level was 53.4 m and it contained 1,090 km³ of water.²

People living on the banks of the Amu Darya and the Syr Darya had been growing crops for several millennia and the area under irrigation was growing constantly until the end of the Soviet era. From the second half of the 19th century Central Asia came under the influence of the Russian Empire. The Russian leadership set its sights on transforming the area into a large agricultural and cotton producing region from the very beginning. This desire grew even stronger during the Soviet Union when initially Stalin's five-year plans and later on Khrushchev's "Virgin Land" project in the 1950's demanded and forced the expansion of cotton production in the area.³ Their ultimate aim was to transform the Soviet Union into the world's leading cotton producer.

An initial step in the realisation of the project was to take the control over water management away from regional level and to transfer it into the hands of the centralised leadership. The sustainability of the irrigation system was destroyed when the small

¹ McKinney (1997).

² Glantz (1999).

³ In 1956 the Moscow leadership decided the "irrigation and reclamation of the virgin lands of the Golodnaya Steppe in the Uzbek S.S.R. and Kazak S.S.R. for increasing the production of cotton." Matley (1970) 342. Large-scale 'Virgin Land' projects originally and basically aimed at increasing Soviet grain production.

local farms were organised into large collective farms and a new irrigation system was created that demanded higher quantities of water. In order to satisfy the increased demand for irrigation, the flows of the Amu Darya and the Syr Darya rivers were diverted. This was essential for making the vast steppes and deserts of Kazakhstan, Uzbekistan and Turkmenistan fertile.

The two major feeding rivers of the sea originate from the mountain areas of Kazakhstan, Kyrgyzstan and Tajikistan. However, most of their flow is consumed by the two downstream countries, Turkmenistan and Uzbekistan.⁴ The Amu Darya feeds the sea from the south and flows through Turkmenistan and Uzbekistan while the Syr Darya flows through Uzbekistan and Southern Kazakhstan thus feeding the sea from the north. As the Aral Sea is no longer a coherent body of water it is more precise to say that the Amu Darya became the feeding river of the Southern Aral and the Syr Darya became the feeding river of the Northern Aral (or Little Aral).⁵

The following table shows the growth in cotton production over time in the Uzbek, Tajik and Turkmen SSRs. These data are relevant since exactly these three countries became the major producers of cotton in Central Asia. Figures also give an explanation why the extent of water withdrawal from the two rivers was constantly and necessarily increasing. While the Kazakh SSR had also increased its output of cotton it never became as influential as its neighbours. *Table 1* clearly shows that the Uzbek SSR was by far the major producer with roughly two-thirds of the whole Soviet production. Over the 75 year period presented in the table cotton production increased around 12-fold from the level of the beginning of the 1900's to the amount measured at the end of the Soviet era.

⁴ Spoor and Krutov (2003).

⁵ As a consequence of the diversions of the two rivers the Aral sea first split into two lakes, the Northern Aral and the Southern Aral. On the territory of the once united sea a desert called 'Aralkum' (Aral Sands) had been formed. Later on the Southern Aral Sea had also split into eastern and western lobes that remained connected at both ends. (<http://euroheritage.net/sovietcollectivization.shtml> and NASA Earth Observatory at http://earthobservatory.nasa.gov/Features/WorldOfChange/aral_sea.php)

Table 1
Cotton production in the Soviet republics, 1913-1988
(in thousands of tonnes of raw cotton)

	Tajik	Turkmen	Uzbek	USSR
1913	32	69	517	744
1940	172	211	1,386	2,237
1953	390	308	2,432	3,853
1956	415	334	2,857	4,332
1960	399	363	2,949	4,289
1963	609	553	3,904	5,662
1970	727	869	4,495	6,890
1975	836	1,079	5,330	7,864
1980	1,011	1,258	6,245	9,962
1985	935	1,287	5,382	8,755
1988	936	1,341	5,365	8,689

Source: Craumer (1992): 144

As a result of the increased agricultural activity in the 20th century the territory under irrigation in Central Asia increased from 3 million hectares (1900) to 5 million hectares (1960) and later to 6.5 million hectares (1980). Irrigation did not have a major effect on the sea until the 1960's but from that point onwards the sea level started to sink due to the ever increasing amount of water (132 km³ by 1980) withdrawn from the two rivers.⁶ The Soviet cotton production plan was clearly unsustainable from an environmental point of view.

With the expanding agricultural projects the two rivers could not satisfy the increased demand for water anymore and the quantity of water reaching the sea gradually decreased. Approximately half of the two major rivers' flow reached the Aral Sea before the increased agricultural activity. By the 1980's their supply of water stopped entirely on several occasions. This led to the gradual shrinking of surface water levels, higher salinity and growing pollution. The once 68,000 km² sea shrank step by step to a quarter of its original size. As the water retreated fishing villages were left several kilometres away from the sea. Due to the high salinity level all the indigenous fish died out (more than 20 species) leaving a large per cent of the local population, formerly

⁶ Micklin (1988).

engaged by the fishing industry, unemployed and the economy in ruins. Besides unemployment the society was left to cope with the damages caused to the environment affecting their everyday life.

In 1990 the water split into two parts.⁷ Since then the southern part situated in Uzbekistan is called the Big Aral and the northern part located in Kazakhstan is called the Little Aral. Today the Northern Aral Sea (Little Aral) is a lake of 3,306.7 km² in territory and 28.2 km³ in water volume.⁸ It is situated in the Kyzylorda region of the country under the direct jurisdiction of Aralsk County. The biggest town of the county is Aralsk, a former seaport that now is surrounded by a desert-like area and lies around 20 km away from the closest bank of the sea.

3) Theory and practice – environment and economy in the Northern Aral Sea

3.1. Mismanaged natural resources

In order to understand the underlying reasons that led to the disaster of the Aral Sea it is worth studying environmental theories. In the case of the Aral Sea natural resources are at the centre of attention, which are usually divided into the following three groups: renewable (*e.g.*: water, wind), non-renewable (*e.g.*: minerals, fossil fuels), and partially renewable (*e.g.*: timber).

According to Sándor Kerekes the requirements of Sustainable Development with regard to these elements can be summarized in the following three points:⁹

- (1) The rate of consumption of the natural resources must not exceed the rate of renewability;
- (2) the rate of waste generation by human activity should not exceed the capacity of nature to absorb these waste materials;

⁷ Fletcher (2007).

⁸ The Aral Department of the Kazakh Scientific Research Institute of Fisheries LLP .

⁹ Kerekes (2007) 32.

- (3) the use of non-renewable natural resources should be conducted in a wise and regulated way, at a timely pace so that their benefits could be maximised over a longer time span and they could be substituted with renewable resources after depletion.

Kerekes states that should the above-mentioned three criteria not be met it will lead to a shortage of resources if:

- (1) The natural resources in question are necessities for the economic system;
- (2) the natural resources cannot be substituted with human capital;
- (3) the depletion of natural capital cannot be outbalanced by technological innovation.¹⁰

The above-mentioned requirements were not applied in our case when the rate of the consumption of a natural resource (*i.e.* water) exceeded the rate of its renewability and the rate of waste generation (*i.e.* pesticides) by human activity (*i.e.* agriculture) exceeded the capacity of nature to absorb the waste materials. As Kerekes explains if the natural capital in question is a necessity for the economic system, which cannot be substituted with human capital or outbalanced by technological innovation, it will lead to a shortage of resources like it did in the Aral Sea region as water became scarce.

Before the new irrigation system was implemented the Soviet leadership tried to assess the possible effects it might have on the regional environment. Naturally the reduced water flows reaching the sea through the Syr Darya and the Amu Darya were foreseen by everyone, however, the results that this would cause created some debate. The general belief was that even though the sea level would be substantially reduced this is a ‘worthy’ trade-off as one cubic meter of water brings more value when used for irrigation than it would bring in the Aral Sea. The calculation was based “on a simple comparison of irrigated agriculture against tangible economic benefits from the sea”.¹¹ Many experts shared the opinion that the shrinkage of the Aral Sea is not only inevitable but desirable in order to use the water to increase the economic gains from agriculture. Only a small number of scientists warned against the serious effects of the Aral Sea’s desiccation while others argued that this would have almost no effect on the region’s economy or its environment. Even the obvious

¹⁰ *Ibid.*, 32.

¹¹ Micklin (1988).

assumption of large quantities of salt from the bottom of the dried-up seabed being blown onto the adjacent agricultural fields was dismissed.¹²

Contrary to these reports and opinions the consequences of the partly dried-up sea on the region's environment were far-reaching and serious. Huge, previously unheard of storms had been reported in the area since 1975, and the climate of the region became more extreme with winters becoming colder and summers becoming hotter and extremely dry. The salt and dust from the dried-up seabed has been blown all over the place by the wind, causing major damages in the cultivated lands. Traces of salt have been found as far as 1000 km away from the sea. In addition, more than 20 fish species disappeared from the sea as water levels dropped and salinity increased 2.5-fold.¹³

3.2. The lack of sustainability

The above-mentioned evidence clearly shows that regarding the water management of the Aral Sea Basin the principles of sustainable development – *i.e.* “development which meets the needs of the present without compromising the ability of future generations to meet their own needs” – were completely neglected.¹⁴ Soviet decision makers have clearly put short-term development ahead of long-term consequences, thus hugely damaging the environment and transferring this damage to society and the economy as well. They not only decided to use the water resources of the Syr Darya and the Amu Darya for irrigation purposes but they did so in an extremely inefficient manner as well. The watering of vast cotton and rice monocultures was badly organized thus allowing huge amounts of water to run off from the cultivable territories instead of nourishing the plants. Moreover, the large quantities of fertilisers that had been used to improve the productivity of these lands were washed back into the rivers and were carried into the sea. This was an additional element that compromised the quality of the sea water. Even if the decision makers in Moscow controlling the events did not anticipate the problems beforehand that were trig-

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ UN (2010) 2.

gered by their actions they must have realised them afterwards when the evidence was visible. However, even at that stage they did not alter their plan to become a cotton-producing superpower even at the high cost of destroying the environment.

In a study published in 1998 by D. Pearce and G. Atkins a quantitative formula was introduced to measure sustainable development. With the help of this formula it is possible to analyse the performance of the implemented governmental projects in the Aral Sea region from the point of sustainability. The formula implies the following three variables: *man-made capital* (KM), *human capital* (KH) and *natural capital* (KN), where (KM) stands for the goods produced by humans, (KH) represents the knowledge and skills possessed by mankind and (KN) refers to both renewable and non-renewable natural resources.

These variables have to satisfy the following equation in order to meet the definition of sustainability:

$$dK/dt \geq 0, \text{ where } K = KM + KH + KN^{15}$$

This implies that “the change of aggregate assets at any point in time must be at least zero in aggregate.”¹⁶ This correlation stands for a so-called ‘weak sustainability’ as it suggests that the different forms of capital are interchangeable as K stands for the aggregate asset stock. According to the weak sustainability a decrease in *natural capital* can be outbalanced by an increase in *human capital*. This means that even the effects of a major natural disaster could be outweighed by improvements in the other factors.

In response to the critiques that natural capital cannot be traded off for other forms of capital, the theory of ‘strong sustainability’ has been formed.¹⁷ Strong sustainability does not necessarily dismiss ‘weak sustainability’; rather it supplements it by stating that the stock of natural capital should not decline:

$$dK/dt \geq 0 \quad \text{and} \quad dKN/dt \geq 0^{18}$$

¹⁵ The change of capital (dK) over a period of time (dt) has to be greater or equal to zero. Where total capital (K) is the sum of the following three variables: (K_M), (K_H), (K_N).

¹⁶ Pearce and Atkinson (1998) 6.

¹⁷ *Ibid.*

¹⁸ Strong sustainability (SS) requires both equations to be true at the same time: The change of capital (dK) over a period of time (dt) has to be greater or equal to zero while the change of natural capital (dKN) over a period of time (dt) has to be greater or equal to zero as well.

By stating that natural capital should not decline, ‘strong sustainability’ does not require renewable and non-renewable resources to remain constant. KN is a heterogeneous form of capital that can be measured by adding a monetary value to the stock. However, the valuation of resources is constantly changing and no one can predict what a barrel of oil or a km² of forest would be worth ten years from now. In other words we cannot know what value today’s trade-offs will hold for future generations.

In addition, Pearce and Atkinson list a couple of reasons why strong sustainability is favoured:

- (1) Trade-offs between natural capital and other forms of capital should be treated carefully until we do not have the perfect knowledge about the operation of the ecosystem. In this case it is better to conserve natural capital than to do some irreversible harm.
- (2) The asymmetry between the reversibility of different forms of capital is also a reason for favouring strong sustainability. While harm done to man-made capital is generally reversible this is not the case with natural capital.
- (3) The uncertainty about the scale of effects that are caused by the loss of some form of critical natural capital. For example, there is a broad disagreement over the magnitude of harm done by global warming.¹⁹

If these aspects are not considered carefully they may lead to environmental catastrophes just like in the case of the Aral Sea where the theories of both strong and weak sustainability were neglected. Even though strong sustainability states that natural capital cannot be traded off for other forms of capital, this was exactly what Soviet politicians intended to do, claiming that “a cubic meter of river water used for irrigation would bring far more value than the same cubic meter delivered to the Aral Sea.”²⁰ Nonetheless, if we carefully examine this claim which in itself would satisfy the theory of weak sustainability, “the change of aggregate assets at any point in time must be at least zero in aggregate,”²¹ it is clear that not even the requirements of weak sustainability were met albeit the plans of the Moscow leadership were successful and the cotton and rice production have multi-

¹⁹ Pearce and Atkinson (1998) 15.

²⁰ Micklin (1988).

²¹ Pearce–Atkinson (1998) 3.

plied due to the extensive irrigation introduced along the two rivers. In order to have a look at this we have to take the equation based on weak sustainability, introduced above, showing the interrelation between the different forms of capital as $K = KM + KH + KN$. The increase in cotton output can be accounted as a positive change in man-made capital (KM) but looking at the change in natural capital (KN), the losses and the damages have been huge. It is difficult to make a cost-benefit analysis based on exact calculations, due to the methodological limits of this study and the difficulties of collecting precise data from the Soviet era when the numeric results of economic actions were altered, hidden or misreported many times only to please the central leadership. That is why this article will only list some of the major environmental damages that had or still have a negative influence on the economy. Since the 1960's there were obvious signs of the deterioration of the environment and until the early 1990's the following phenomena have been observed. The water level of the sea has dropped 14 meters, its surface has shrunk by 40 per cent, its water mass has dropped by 65 per cent, its salinity level has increased 2.5-fold and the sea has retreated in some places more than a 100 km from its original shores.²² As a result of these changes in the living habitat of fish all species (more than 20) became extinct in the Aral Sea²³ that "previously yielded 7 per cent of all fish caught in the former USSR"²⁴ and made up a reported commercial catch of 48,000 metric tonnes (in 1958). As a direct result approximately 60,000 people, who used to be directly or indirectly employed by the fishing industry, lost their jobs.²⁵

The former seabed became uncovered over an area that exceeds 2 million hectares. The dust and salt from this land is now carried to the former agricultural lands by windstorms making cultivation impossible. Agricultural activity is further hindered by the climate change that caused long, dry and extremely hot summers followed by long and extremely cold winters.

The environmental changes did not leave society unaffected. The overall mortality rate doubled between 1970 and 1990,²⁶ acute respiratory problems became high in number, just like liver

²² Lipovsky (1995).

²³ Micklen (1988).

²⁴ Lipovsky (1995).

²⁵ Micklin (1988).

²⁶ Lipovsky (1995).

and kidney diseases from the contaminated water.²⁷ It is hard to define the cause of each type of disease that made the population suffer but the pesticide-contaminated water sources, the dry, dusty and salty air together with the extreme climate are all to blame. “The people in the area clearly suffer from the effects of an environmental health crisis.”²⁸ The health deterioration of the population had a negative effect on the economy by increasing healthcare expenses and decreasing the value of human-capital (KH). Going back to the capital equation again ($K=KM+KH+KN$) it is obvious that natural-capital (KN), together with human-capital (KH) suffered a huge blow. While it is hard to accurately determine the monetary value of the agricultural benefits from the extensive irrigation or the losses suffered by the fishing industry, the economy and society around the Aral Sea, it can be assumed that not even the principles of weak sustainability were met and the overall stock of capital (K) suffered a great loss during the period in question.

Even if in many cases it is hard to determine the monetary value of the environment, as regards the Aral Sea the harm done by the deterioration of the natural-capital is so great that it is clear the Soviet leadership had not estimated the costs and benefits correctly before undertaking the project. Looking back on the theory of strong sustainability Pearce and Atkinson list a couple of reasons why strong sustainability should be favoured. Their warnings consider the lack of perfect knowledge that humans have about the ecosystem before undertaking a project and the irreversible damage that this might cause which is exactly what happened in our case when the prognosis about the effects of the irrigation project were overoptimistic. Unfortunately, this is not the only warning that turned into reality in the case of the Aral Sea as the scale effects caused by the loss of some form of critical natural capital, in our case the sea, were also underestimated when Soviet experts played down its role in the climate and biodiversity of the region. While the harm done to man-made capital might be reversed over time, the natural capital (biodiversity) of the region will never be the same.

²⁷ Wilsh–Wilson (2002).

²⁸ *Ibid.*

3.3. The Northern Aral Sea region

As already mentioned, the tragedy of the Aral Sea will be examined through the case of the Northern Aral Sea region. By analysing only a fraction of the Aral Sea Basin it will grant the opportunity to unveil some interrelations between the environment and economy in a more detailed fashion. The northern part of the sea is situated entirely in Kazakhstan in the Kyzylorda region and it is under the direct jurisdiction of the city of Aralsk, the centre of Aralsk County. Besides the city of Aralsk there are 23 villages in the county with a total population of 72,500 out of which about 38,000 people live in Aralsk.²⁹

The fact that the population of the county used to be around 80,000 people at the beginning of the 1960's shows the extent of emigration from the area due to the dramatically worsened living conditions. The region was severely hit by the negative circumstances deriving from the extensive agricultural proceedings along the banks of the Syr Darya and the Amu Darya.

The economy of the region used to be stable similarly to the environmental and living standards until the 1960's. The local economy was dominated by the fishing industry which made a huge contribution to total former USSR's fish production.³⁰ Fishing activity in the region was co-ordinated by a big industrial complex, "Aral Rybprom". It had 1,500 employees with a processing capacity of 6,000 tonnes.

There were nine collective fish-farms under its control³¹ together with six fish-processing factories.³² The situation, how-

²⁹ Nurgaliev (2012). Sabidzhan Nurgaliev, Head of the Agricultural Department of the Aralsk County Office, was approached to provide general information about the size and population of the county and its centre, the city of Aralsk. He has been leading the Agricultural Department of Aralsk since the 1970's, thus he was able to share his first-hand experience about the tendencies that shaped the region since the 1960's such as employment, emigration, the history and the present of the local fishing industry. As a conclusion of the interview he expressed his personal opinion on the policies and measures that have been implemented since the country gained independence.

³⁰ Lipovsky (1995).

³¹ Nurgaliev (2012).

ever, started to deteriorate quickly from the 1960's onwards as the effects of the extensive cotton production started to appear in the region. During the 1970's the activity of "Aral Rybprom" had to be cut back and the number of fish-farms had been reduced to three. The living conditions in the Aral Sea region had been worsening year by year, thus the previous rate of fishing was impossible to maintain. According to the data received from the Aral Department of the Kazakh Scientific Research Institute of Fisheries LLP (*Table 2*) the highest catch in the Aral Sea was recorded in 1962 at 41,170 tonnes. That particular year the sea level was above 53 meters, its territory was 66,646 km², the volume of water totalled at 1,072.6 km³ and the salinity level stood at 10.26 per cent. Parallel with the shrinkage of the sea territory and the decline in water levels the salinity of the water increased causing a decline in the number of fish. By 1967 the volume of fish-catch went under 20,000 tonnes and by 1976 under 10,000 tonnes.

By 1984 the industrial fishing activity ceased to exist in the whole Aral Sea Basin including Aral County. Most species became extinct as the volume of sea water decreased to 320 km³ and salinity level reached 29.6 per cent. Nevertheless, the labour force employed by the fishing industry was safe during the Soviet era as the regime did not allow unemployment. The central leadership decided to transport fish from other parts of the country, mainly from the Baltic Sea, to be processed in the factories of "Aral Rybprom".³³ Meanwhile the fishermen were transferred periodically to other lakes and seas within the Soviet Union to continue their activities. With these measures "Aral Rybprom" could continue its activity despite the environmental catastrophe.

Even though the effects of the environmental disaster on the economy and society were toned down by the Soviet regime the living standard of the county was rapidly declining. The shrinking employment possibilities coupled with the worsening quality of life caused a large wave of emigration from the county.³⁴

³² Aimbetov (2012). Adilbek Aimbetov – owner of the "Aral Service" fish processing factory and former director of the Soviet fish processing conglomerate "Aral Rybprom" – was approached because of his first-hand insight into the fishing industry during both the Soviet times and nowadays. He explained how the fishing industry operated in the region during the Soviet Union, how the sea started to dry up from the 1960's and what were the responses of the factories to these changes. He also explained the way he bought and operates now one of the former factories to process fish.

³³ Aimbetov (2012).

³⁴ Nurgaliev (2012).

Table 2
Basic data on the Aral Sea
(1961–1989)

Year	Water level (m)	Sea territory (km ²)	Sea volume (km ³)	Salinity level (%)	Fish catch (tonnes)
1961	53.38	67,888	1,092.4	9.90	34,160
1962	53.12	66,647	1,072.6	10.26	41,170
1963	52.72	64,935	1,045.2	10.49	39,670
1964	52.46	63,957	1,026.6	10.76	41,120
1965	52.26	63,875	1,027.2	10.51	31,040
1966	52.06	62,244	1,000.2	10.92	25,060
1967	51.06	61,196	975.6	11.09	21,820
1968	51.44	60,676	961.8	11.20	16,470
1969	51.66	59,777	938.6	11.35	18,900
1970	51.56	60,359	969.6	11.13	17,460
1971	51.26	60,297	961.8	11.62	14,960
1972	50.80	59,323	923.6	11.74	16,730
1973	50.28	58,512	832.3	12.06	16,970
1974	50.14	58,293	834.8	12.38	15,500
1975	49.36	57,202	839.6	13.72	13,462
1976	48.52	56,030	732.2	13.95	9,027
1977	47.90	55,140	758.6	14.33	6,007
1978	47.31	54,229	725.6	15.24	4,045
1979	46.38	53,392	696.0	15.82	2,009
1980	46.22	52,482	677.0	16.50	2,935
1981	45.29	50,900	621.2	17.42	656
1982	44.60	49,680	585.4	19.18	76
1983	43.82	48,294	544.0	20.29	0
1984	42.90	46,730	498.0	21.98	0
1985	42.00	44,400	466.0	23.50	0
1986	41.45	42,500	424.0	24.74	0
1987	40.72	41,330	383.0	26.55	0
1988	39.87	38,665	361.0	27.90	0
1989	38.80	37,330	320.0	29.60	0

Source: Aral Department of the Kazakh Scientific Research Institute of Fisheries LLP.

3.4. The post-Soviet era

With the dissolution of the Soviet Union, Uzbekistan and Kazakhstan became independent countries in December 1991. This brought an end to the former large-scale co-operation that had been introduced to maintain the activity of the fish industry in the Aral Sea Basin and to guarantee employment for the people. According to Adilbek Aimbetov, the former director of “Aral Rybprom”, the company faced a severe crisis after the collapse of the Soviet Union. Former collaboration could not be revived with the newly independent states and there was a steady wave of making workers redundant in an attempt to fight bankruptcy. In 1997 “Aral Rybprom” had been privatised but bankruptcy still could not be avoided and two years later its activity was shut down.

Besides “Aral Rybprom” further participants of the fishing, shipping and other sea-related industries have been shut down as governmental subsidies faded. The agricultural sector was also seriously affected due to the rising concentration of salt in the soil. This resulted in a reduction of crop quality and crop yields. Right after gaining independence unemployment soared in the region.

With Uzbekistan and Kazakhstan now being independent, the Aral Sea Basin was divided between the two countries. Since 1991 the Northern part of the Aral Sea, often called Little Aral, has been recognised as a separate part and since then it belongs under the jurisdiction of the Aral County. From this point onwards the future of the Northern Aral Sea was entirely in the hands of the Kazakh government which was short of resources to do anything notable at that time. Foreign journalists, scientists and other experts started coming to the Aral Sea Basin in increasing numbers but their ideas regarding the saving of the region were usually too theoretical and far-fetched. Locals tried to revive the northern part of the sea by building dykes in an effort to prevent water from flowing away towards the south into the vast dried up seabed. Without the adequate resources these dams were too primitive to last more than two years and to withhold the water when its level rose too high.³⁵

³⁵ Pala (2005).

The 1990's was a crucial period in the life of the sea. After shaking off the burden of centralisation the countries of Central Asia could take matters in their own hands. All of them gradually realised that their respective water safety requires a certain level of co-operation, thus several international organisations have been formed (e.g.: the International Fund for the Aral Sea, the Interstate Council on the Aral Sea Basin Problems) with the agenda of solving the problems of the Aral Sea. Even the United Nations Educational, Scientific and Cultural Organization (UNESCO) appointed a Scientific Advisory Board for the Aral Sea Basin (SABAS). However, none of these organisations managed to achieve any tangible result except for writing documents and reports about different scenarios.³⁶ After the failure of several organisations the World Bank together with the United Nations Environment and Development Programs initiated a new programme to address the crisis. The Executive Committee of the Interstate Council for the Aral Sea was established to take care of developing and implementing policies of the World Bank that aim to "mitigate the impacts of the environmental degradation, to develop sustainable water management strategies, and to develop regional institutions with the capacity to implement the program."³⁷ In addition, since the early 1990's the economic fortune of Kazakhstan has changed considerably. With huge incomes from natural resources the Kazakh government has had enough capital lately to tackle some of the issues in the Northern Aral Sea Region and despite many pessimistic beliefs and forecasts the government of Kazakhstan decided to implement actions that would repair the damages done and foster sustainability.

A big achievement was reached in 2003 when the World Bank and the government of Kazakhstan agreed on a jointly funded USD 85 million project that resulted in the implementation of a 13 km-long, new dam being built on the southern border of the Little Aral and included works that reduced irrigation waste along the Syr Darya.³⁸ The construction of the dam was finished in 2005 and it brought instant and visible changes to the region. The water level, the sea territory and sea volume have all been stabilised since then making it possible to restart industrial fishing activity in the region.

³⁶ Wish-Wilson (2002).

³⁷ McKinney (1997) 5.

³⁸ Pala (2005).

It is important to mention that according to some experts this new dam hinders the chances of reinvigorating the Aral Sea as a whole because it keeps the water away from the Southern Aral.³⁹ At the same time many scientists argue that if the Kok Aral dam were not in place, the water would flow away and spread across the dried-up seabed without ever reaching the Southern Aral. However, one thing is for certain. The Northern Aral region has greatly benefited from the completion of the dam and this achievement fuels hopes for further improvements in the future. *Table 3* shows the important role it played in stabilising the sea level and reinvigorating the fishing industry.

Table 3
Basic data on the Northern Aral Sea

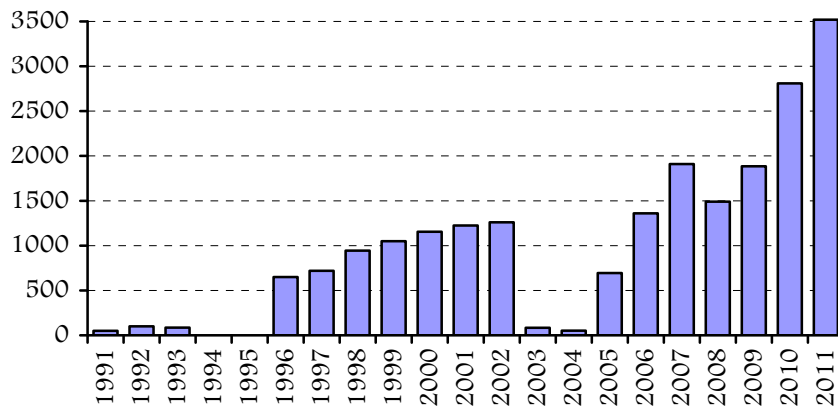
Year	Water level (m)	Sea territory (km ²)	Sea volume (km ³)	Salinity level (%)	Fish catch (tonnes)
1991	39.0	2650	19.26	33.8	50
1992	39.0	2650	19.26	28.6	100
1993	40.0	2,868.9	22.02	22	85
1994	40.0	2,868.9	22.02	19.4	0
1995	40.0	2,868.9	22.02	20.1	0
1996	41.0	3,087.8	25	20.4	650
1997	41.0	3,087.8	25	20.5	720
1998	41.0	3,087.8	25	14.5	945
1999	39.0	2,650	19.26	16	1,050
2000	39.0	2,650	19.26	17	1,155
2001	39.0	2,650	19.26	18.6	1,225
2002	39.0	2,650	19.26	15.1	1,260
2003	39.0	2,650	19.26	10.7	83
2004	40.0	2,868.9	22.02	12.4	52
2005	42.0	3,306.7	28.2	10.3	695
2006	42.0	3,306.7	28.2	8.9	1,360
2007	42.0	3,306.7	28.2	6.3	1,910
2008	42.0	3,306.7	28.2	12.1	1,490
2009	42.0	3,306.7	28.2	12.8	1,885
2010	42.0	3,306.7	28.2	11	2,810
2011	42.0	3,306.7	28.2	9.9	3,520

Source: Kazakh Scientific Research Institute of Fisheries LLP Aral Department.

³⁹ See, for example, the NASA Earth Observatory;
http://earthobservatory.nasa.gov/Features/WorldOfChange/aryl_sea.php

Table 3 shows how the water level, sea territory, sea volume, salinity level and fish catch have been changing from year to year. The table also includes the effects of actions done by the local communities to revive the sea. From 1991 to 2005 the values of the five variables are fluctuating from year to year as a result of successful attempts to gain control of the Little Aral. However, none of these attempts proved to be of lasting results until the completion of the Kok Aral dam that permanently stabilised water level at 42 meters, the sea territory at 3306.7 km² and the sea volume at 28.2 km³. Salinity level is still fluctuating; a factor that cannot be controlled by a dam or a dyke, but the number of fish has been constantly growing at a fast rate, making it possible to restart the industrial fishing activity in the region. After the level of 83 and 52 tonnes caught prior to 2005 this figure reached 3,520 tonnes already in 2011. The following figure represents the change in fish catch in the Northern Aral Sea over time.

Figure 1
Fish catch in the Northern Aral Sea, 1991–2011
(tonnes)



Zaulkhan Yermakhanov, director of the Aral Department of the Kazakh Scientific Research Institute of Fisheries LLP⁴⁰ is confi-

⁴⁰ Yermakhanov (2012). Zaulkhan Yermakhanov was interviewed as he is the person who has been leading the institute that regulates fisheries in the region and has been replenishing the Little Aral with fish. He explained the effects of the intensified irrigation on the Aral Sea and the fish species that used to live in the sea. He talked about the past actions that were directed at saving species and the current government policies that are in place to control the fishing activity and to ensure the reproduction of fish.

dent that the situation will improve. He guesses that the maximum capacity of the Little Aral is around 6,000 tonnes per year that could be reached within 3-4 years. Since the completion of the dam more than seven types of fish can be found in the sea again. This great achievement is mostly due to the work done by the organisation lead by Zaulkhan Yermakhanov. The 15 employees of the institute regularly monitor the quality of the water and the number of fish divided into species. Based on these numbers they propose yearly quotas to the government. While the salinity levels of the sea were high the organisation introduced a fish named Kambala from the Azov Sea that is more resistant to such circumstances. Today Kambala is one of the most dominant species in the sea. The activity of the organisation ensures that fishing remains at a sustainable rate at which the number of fish in the sea increases year by year.⁴¹

3.5. Reorganised fishing industry

In order to ensure that fishing is kept within the sustainable rate set by the Aral Department of the Kazakh Scientific Research Institute of Fisheries LLP the government decided to divide the Northern Aral Sea into 10 fishing zones and distribute Individual Transferable Quotas (ITQs) between several companies. The quotas clearly define the allowed extent of fish catch from the sea and guarantee their transferability between parties. So far one tender has been held, in 2006, which granted operating permits to seven companies.

With the quota system introduced in 2006 the Kazakh government ensures that the conditions of an efficient ownership system described by Kerekes are met.⁴² The below-mentioned conditions were impossible to meet before due to the nature of the Soviet economy where public ownership was predominant:

- (1) universality: natural resources are considered to be in private hands when all ownership rights are clearly set and defined;
- (2) exclusivity: all benefits and costs arising from the ownership and use of a resource affect solely the owner of that resource;

⁴¹ *Ibid.*

⁴² Kerekes (2007).

- (3) transferability: the owner has to be in power of transferring the property rights of the resource;
- (4) enforceability: the owner has to be protected against the forceful appropriation of the property.

Nowadays the circumstances are completely different. *Universality* is guaranteed by distributing the quotas to private companies. Rules and regulations such as the limit set on the quantity of catch ensure *exclusivity*. The actual work is delegated to hired fishermen (*transferability*). The laws of the country protect the owners against forceful appropriation (*enforceability*).

In contrast to the Soviet times the industry has many actors now. The companies holding the quotas do not have fishermen on permanent payroll anymore. During the fishing season fishermen use their own equipment and sell the catch to the companies owning the quotas. Many of these companies do not have processing plants thus they are forced to either sell the catch to factories or buy their services. The increasing volume of fish created a demand for new processing factories which in turn created new jobs. “Atameken Rybprom” was established in the city of Aralsk in 2009. It is owned by a Kazakh investment group called “Atameken Holding” that had acquired the services of a Korean company to build the factory and equip it with modern technology. Their capacity permits them to process 6,000 tonnes a year which is the potentially maximum capacity of the Northern Aral Sea. This is why nowadays they intend to process fish from other parts of the country as well. Currently they process between 1,500 and 2,000 tonnes a year and they employ between 65 and 95 people depending on the season. This quantity already permits them to export globally with their target markets being the EU, Canada and the CIS countries. They plan to find new partners to buy fish from, either from the Aral Sea or the Lake Balkhash or the Caspian Sea. As soon as they achieve their aim they will have to double the number of their employees and start working in two shifts thus providing even more jobs for local people.⁴³

⁴³ Abdulaiev (2012). Shukirbai Umarovich Abdulaiev – the director of the fish-processing factory “Atameken Ribprom” – was chosen for interviewing because of his up-to-date insight into the reorganised fishing industry. He talked about the investments made in the region; he explained the business model practiced by his company and by their competitors, the quota system introduced by the government to control fishing activity on the Little Aral and their plans for the future.

The example of “Aral Rybprom” is not unique. One of their competitors is Aral Service, a factory that is situated in one of the former “Aral Rybprom” buildings. Adilbek Aimbetov, the former head of “Aral Rybprom” that controlled fishing activity during the Soviet Union, decided to acquire what was left of the old factory building, renovate it and restart its activity. Today it operates under the name of Aral Service, it employs more than 40 people and has a capacity of 4,000 tonnes out of which it uses 200 currently. The fish processed in this factory are sold only in Kazakhstan yet but they are planning on entering the European markets.

The main reason behind the low utilisation rate of the two factories is the quota tender that was organised in 2006 prior to their establishment. The new tender will be held in 2013 when a new division of the sea is expected after which these factories would be able to increase their activity.

The future seems bright for these factories as the amount of fish in the Little Aral Sea has increased at a yearly rate of 25 per cent, 50 per cent and 25 per cent between 2008 and 2011 (see Table 3). Furthermore the 3,520 tonnes of fish catch, registered in 2011, is expected to double in the next few years.⁴⁴

As a down-side of the newly introduced capitalist structure of the fishing industry at the Northern Aral Sea it does not provide any protection or support for fishermen. The companies owning the fishing quotas expect them to use their own ships, equipment and shelters during the season. They are paid after the amount of their catch and they are not offered any other support. While during the Soviet regime they had been working as permanent employees of “Aral Rybprom” using the equipment provided by the company, now they have to cover everything for themselves and make a living for their families from what they receive for their catch. In 1998 a non-governmental, non-profit organisation called “Aral Tenizi” was founded within the framework of a Kazakh-Danish fishery project entitled “From Kattegat to the Aral Sea.” It aims at supporting the growth of fish catch, improving the living standards of people and decreasing unemployment. They support fishermen by building camps where they can live in mobile houses during the fishing season and by supplying them with the necessary equipment. They operate five camps currently for their 500 members. Each of them has to pay a yearly member fee in return for the support. The number of members has been in-

⁴⁴ Yermakhanov (2012).

creasing by 50 on average each year. The organisation tries to attract donors from around the world to fund its operation. Since 2009 their activity has been co-funded by the World Bank with support also coming from a Japanese group.⁴⁵

3.6. Environmental improvement, economic growth, rising social standards: the role of the state

In the last twenty years many of the principles listed in the document called “Caring for the Earth” (IUCN) have been realised in the Northern Aral Sea Region.⁴⁶ The Kazakh government has “created global alliances” (IUCN) with several international organisations and started co-operating with neighbouring countries in order to restore the environmental stability of the region. Governmental agencies such as the “Barsakelmes” nature reserve office together with non-governmental groups like “Aral Tenizi” work to “conserve the Earth’s vitality and diversity” (IUCN) while at the same time promote ideas such as “respecting and caring for community and life” (IUCN) in an attempt to change the personal attitudes and practices of the local population. This is a directly opposite attitude to the one shown during the Soviet era when none of the principles were adopted by the leaders of that time. However, some of these principles, for example “conserv[ing] the Earth’s vitality and diversity,” were clearly violated by the implementation of extensive irrigation projects.

The Aral County Office of the Kazakh Labour Ministry also had an important role in the economic improvement seen in the region by helping both individuals and enterprises get back on their feet. The following employment data draws a clear picture of the improvement achieved. In 2000 9,562 people turned up at their office asking for help in their job pursuit. By the end of that year the office managed to find employment for 8,212 of them.

⁴⁵ Baimakanova (2012). Aina Baimakanova – director of the “Aral Tenizi” organization that was established with international help to support the fishermen of the region – was chosen for interviewing to find out more about the everyday life of fishermen including their social and financial background. Baimakanova talked about the activity of the organisation aimed at helping fishermen get back on their feet and restart their activity in a capitalist way.

⁴⁶ IUCN (1991).

They closed the year with 1,350 active, officially documented job-seekers which was a 4.7 per cent of the county's total working-age population (28,600). The environmental improvements that lead to the economic growth of the region can be clearly seen if we compare the official unemployment data of 2011 with the one from eleven years earlier. 3,145 people registered as active job-seekers in 2011 and by the end of the year only 212 remained without a workplace. With an active population of 35,207 this means a 0.6 per cent official unemployment rate.⁴⁷

Since the completion of the dam and the revival of the fishing industry the rate of unemployment has been steadily decreasing. This has been enhanced by nationwide programmes designed by the government that help both individuals and enterprises in an attempt to decrease unemployment. The latest national programme is called "2011–2020", with the aim of decreasing the national unemployment rate from 8.5 per cent to 5.3 per cent; it offers to finance a registered job-seeker's salary for a certain period once they have found a job. Thanks to this, enterprises such as the newly established fish-processing factories around the Northern Aral Sea may employ registered job-seekers for a KZT54,000 (about USD 370) monthly salary and pay only 50 per cent of their salaries in the first 6 months, 25 per cent in the next 3 months and 15 per cent in the last 3 months. The Aral County Office of the Labour Ministry has been collaborating with three fish-processing factories where they delegated 40 workers in 2011 and already 30 in the first quarter of 2012.⁴⁸ The revived activity of the fishing industry has clearly had a strong positive effect on employment which has been fostered by governmental projects as well.

The World Bank's involvement in saving the Aral Sea had a strong effect on the domestic policies of Kazakhstan. The policies of sustainable development and the findings of the "Development and the Environment" report, published by the World Bank in 1992, are clearly reflected in recently adopted policies and actions of the government. Unsustainable irrigation schemes have not been subsidised since the country gained independence and the quotas were distributed in 2006 to ensure the sustainability and transparency of fishing on the Northern Aral Sea. Actions were also taken to provide access to sanitation and raise the level

⁴⁷ Kazakh Labor Ministry's Aral County Office.

⁴⁸ Zhaimakov (2012).

of education in the remote areas of the region. The children of Aralsk County benefited from the “100 schools, 100 hospitals” presidential programme that raised the level of education in the area by establishing four new schools.

The living standards and the economy of the region have been continuously improving in the recent years due to the environmentally and socially conscious policies introduced by the government. The high state revenues guaranteed by the abundance of natural resources are likely to provide enough capital for the government in the future to carry on implementing policies that protect the environment and foster growth and development in the region.

Furthermore, the president of the country is determined to bring back the sea to the former port of Aralsk which would require the construction of an even bigger dam that would further raise the territory and the volume of the sea. This would not only give an extra boost to the fishing industry but to agriculture as well and it might contribute to restoring the former climate of the region and putting an end to the fatal illnesses that claim many victims every year.

4) Summary

The case of the Aral Sea is one of the biggest environmental catastrophes the world has ever seen. Unlike many others this has been an entirely man-made disaster that was brought about by the desire of economic gains coupled with irresponsibility, ignorance and short-sightedness. The irrigation schemes designed and implemented by the Soviet leadership in Central Asia, mainly in Uzbekistan and Kazakhstan, starting from the middle of the 20th century caused the desiccation of the Aral Sea while the excessive use of pesticides in an attempt to enhance the output of cotton monocultures has permanently damaged the soil quality in the region. It is a good example of a government-implemented project where questions related to the environment were completely overlooked and most of the principles of environmental economics known today were violated, such as sustainable development, caring for the Earth, efficient use of resources, *etc.*

As a result of the extensive irrigation projects the water level of the Aral Sea has started to gradually shrink from the early 1960's

onwards. Eventually this resulted in the desiccation of a major part of the sea and the division of it into two parts: the Southern Aral and the Northern Aral, the latter being the main focus of this paper in an attempt to prove the connection between the performance of the economy and the state of the environment.

The effects of a strong human intervention in nature started to manifest themselves since the 1960's when the water level began to drop in the sea basin. Simultaneously, the salinity level started to rise causing the gradual extinction of more than twenty fish species living in the sea which later proved to be a major blow to the region's economy that had been overly dependent on the fishing industry. However, the effects of the destruction were successfully mitigated during the Soviet era when there was a possibility for a wider interregional co-operation between fisheries.

The drop of sea level has also resulted in the desertification of the area, making agricultural activity almost impossible. The salty dust and sand carried by the wind from the dried-up seabed has been causing high numbers of respiratory and other illnesses unseen before in the region. The damages done to the environment of the Northern Aral Sea region left a strong mark both on the economy and society.

This trend has only reversed after the collapse of the Soviet Union when Kazakhstan gained independence. The opening up of the borders made it possible for the world to learn about the catastrophe which started an influx of foreign scientists and experts. International organisations like the different branches of the UN and the World Bank started gradually to deal with the issue. So far the biggest achievement has been the completion of the Kok Aral dam within the framework of a co-financed project of the World Bank and the Kazakh government and it restored hope to the region. Since the completion of the construction of the dam in 2005 the territory and seal level of the Northern Aral Sea has been slowly stabilised and this let fisheries replenish the sea and restart economic activity. This has already created hundreds if not thousands of jobs but the future is even brighter with the newly established fish-processing plants planning on operating internationally in the short run which is expected to bring along increasing growth and development.

The Kazakh government has instantly stopped subsidising the harmful irrigation projects after gaining independence but they did not have the financial sources needed to deal with the problem until the last decade. With the help of the World Bank they

managed to complete the new dam and implemented several governmental projects in order to support the local economy and the society. Not only has the fishing industry been benefiting from the stabilisation of the Northern Aral Sea but to the whole region as well as it has had a good effect on the climate and biodiversity. All in all, the economic situation of the region has started improving only after the activities harmful to nature stopped and the government adopted an environmentally friendly policy targeting sustainability. As long as the central leadership ignored the state of the environment and considered only promoting the industry, the region of the Northern Aral Sea had been in an economic and social crisis. However, after a change in policy which resulted in a more environmental friendly way of thinking and planning hope has been regained about saving the region and restoring its former prosperity. Initial results are already visible.

Even though many experts predicted that neither the economy nor the biodiversity of the Aral Sea region could be restored, the government of Kazakhstan together with the local population and international organisations proved these predictions wrong. Unfortunately, their achievements are limited only to the Northern part of the former sea at moment.

This achievement, which is already great in itself, might prove to be only the first step in the restoration process of the Aral Sea which is a dream for hundreds of thousands of people living in the area. However, for this the combined efforts of all Central Asian countries would be needed, supplemented by the support of major international organisations such as the UN and the World Bank.

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