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Kaliningrad in the Context of EU-Russia relations

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Summary

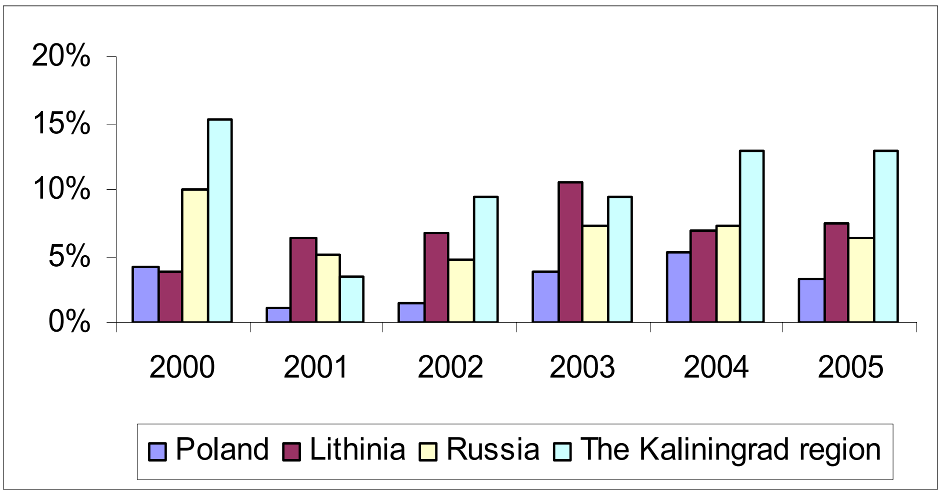
Kaliningrad's economy has been growing in recent years, but it still has a long way to go to catch up to neighboring Poland and Lithuania in productivity terms. As a Russian exclave inside the European Union, Kaliningrad plays a key role in Russia-EU relations. Much of Kaliningrad's economy now depends on the Special Economic Zone, whose benefits will be reduced when Russian joins the World Trade Organization. Accordingly, Kaliningrad needs to find a sustainable economic development model because simply maintaining the status quo only allows for moderate improvements.

Current socio-economic situation

The Kaliningrad region is one of Russia's smallest federal units, with a total area of 15.1 thousand sq km and population of 950,000 people. The only Russian exclave, it is separated from the country's mainland by EU member states and Belarus. In the 1990s it suffered a major economic decline, but is currently demonstrating one of the highest rates of economic growth in the country. This success is mainly due to the large-scale assembly and processing production spurred by the Free Economic Zone regime established in 1992, which was replaced by the Special Economic Zone (SEZ) regime in 1996, itself modified in 2006.

In particular, the gross regional product (GRP) grew 13 percent in 2005 (compared to 6.4% in Russia as a whole), and, according to preliminary estimates, this gap widened even more in 2006.

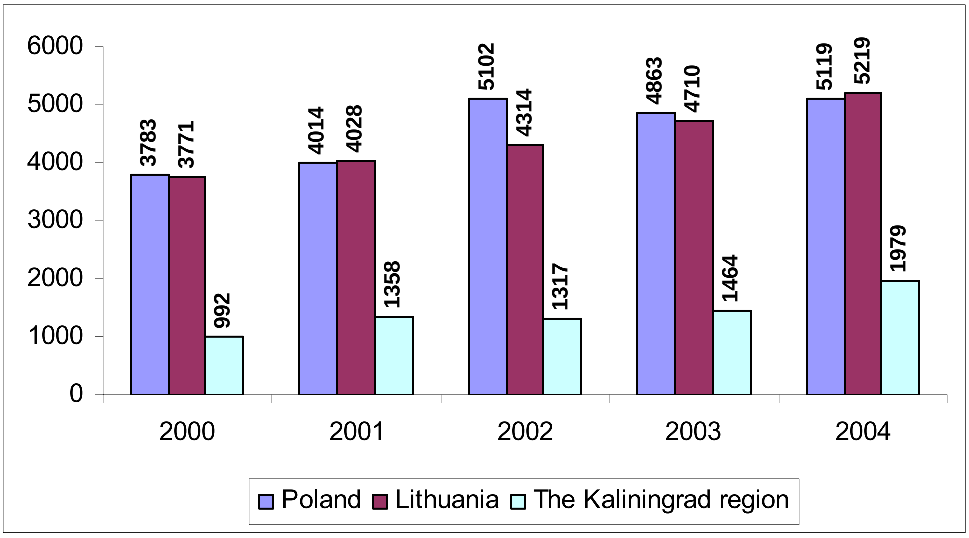
Figure 1. GDP (GRP) growth rate in Kaliningrad, Poland, Lithuania and Russia, 2000-2005



Source: Kaliningrad Region Government official website: http://www.gov.kaliningrad.ru.

However, in terms of GRP/GDP per capita, the Kaliningrad region is still far behind its neighbors Lithuania and Poland, a fact largely explained by the low productivity level of the region's economy.

Figure 2. GDP (GRP) per capita (calculated according to purchasing power parity) in Kaliningrad, Poland and Lithuania, 2000-2004



Source: Kaliningrad Region Government official website: http://www.gov.kaliningrad.ru.

The recent economic growth positively affected the real income of the population (which grew by 30.3% in the course of 2005 alone), and contributed to improving the standard of living in the region. The unemployment rate (calculated according to ILO methodology) decreased from 7.1% in 2002 to 6.7% in 2005.

Despite this generally favorable economic background, the demographic situation in Kaliningrad remains difficult. Life expectancy in 2005 was below 62 years, while in Russia as a whole this indicator is above 65 years. The death rate has been double the birth rate for a number of years, with migration only partly compensating for the population loss (the inflow of migrants has in fact diminished in recent years).

The place and role of Kaliningrad in the context of EU-Russia relations

Kaliningrad has a special role and place in EU-Russia relations and co-operation. Owing to its unique geopolitical location – Russia's "island" in the midst of the EU – the region finds itself in a double dependency, relying simultaneously on decisions made by the Russian federal authorities and the European Union. In other words, conditions determining the region's socioeconomic development are regulated by Russian and EU legal acts. These acts primarily affect such vital areas as passenger and freight transit, trade, ecology, fisheries and power supplies. Kaliningrad-based businesses are in a less favorable competitive position than companies from other Russian regions (due to increased transit costs) and companies within the adjacent EU border areas, which enjoy direct access to EU markets and substantial development aid from EU funds. Were this disparity to widen or if currently functioning factories shut down, potentially dangerous conflicts could develop.

Figure 3. The Kaliningrad Region within Europe

In Russia's mid-term strategy towards the EU (2000-2010) adopted in 1999, Kaliningrad is designated as a pilot region for bilateral co-operation and dialogue. At the Hague summit held in November 2004, the parties agreed to establish a standing working group on Kaliningrad that would serve as a negotiation mechanism; unfortunately, that group has yet to be established. Currently, high-level discussions are being held on a regular basis between Sergey Yastrzhembsky, the Russian president's special envoy for relations with the EU, and Benita Ferrero-Waldner, EU Commissioner for External Relations and European Neighborhood Policy. However, the dialogue so far has mostly focused on policy issues, rather than specific joint actions and programs.

Overall, progress in solving Kaliningrad-related problems depends heavily on the level of EU-Russia relations and co-operation. Due to its special geopolitical location and the problems the region has faced in the aftermath of EU enlargement, Kaliningrad reflects the essence of EU-Russia co-operation: both its potential for further development and all of its current difficulties.

Kaliningrad is a testing ground for cross-border co-operation between Russian regions and EU member states. The region has already actively participated in a number of EU initiatives designed to promote co-operation on the common EU-Russia border, such as the Northern Dimension, Euroregions, Interreg and others. It is the only Russian region which in 2003 received a grant of € 25 million from the EU in the framework of a special funding scheme to support regional development. The newly launched EU cross-border co-operation program reserves around 135 mln. euros for the coordinated development of selected Polish and Lithuanian regions and Kaliningrad.

At the same time it should be noted that Moscow and the European Union pursue different interests as far as Kaliningrad is concerned. While Russia stresses the issues of sovereignty and hard security (namely, the loss of sovereignty over Kaliningrad in light of recent EU and NATO enlargements), the EU is more concerned with matters of soft security (illegal migration, cross-border crime, smuggling, pollution, the spread of diseases, and trafficking in people).

EU members Poland and Lithuania, as Kaliningrad's neighbors, have their own interests in this Russian region. Kaliningrad's passenger and cargo trains reach mainland Russia through Lithuanian territory, and Lithuania is keen to use this fact to strengthen its position in the EU, in general, and in EU-Russian relations, in particular. Lithuania currently plays the role of being a "Kaliningrad expert body" in Brussels, which means that EU representatives consult about the key issues related to Kaliningrad with Lithuanian representatives and experts in advance.

Moreover, in many respects, Lithuania plays the role of a pilot EU country in EU-Russia relations. In particular, Lithuania was the first EU member state which signed and ratified a readmission agreement with Russia. So Lithuania, along with Kaliningrad, are like prototypes in the larger process of European integration. Lithuanian business is very active in Kaliningrad and uses the region as a launch pad for penetrating the huge Russian market. This market is so large that Hansabank, which is the Russian subsidiary of a Scandinavian bank, recently opened a branch in Kaliningrad to serve EU (mostly Lithuanian) and local clients.

In contrast to the Lithuanian case, the Kaliningrad aspect of Polish-Russian relations is not burdened with the issue of transit and has never been overly politicized. The Polish business community treats the Kaliningrad region mainly as a growing market for its products. There are currently over 500 companies with predominantly or entirely Polish capital in the region, plus a large number of companies doing business through their Russian counterparts.

Kaliningrad-Poland business co-operation is developing in the fields of energy, construction, agriculture, furniture manufacturing, and food processing, among others. A number of joint projects in the field of shipbuilding, marine transportation and energy are being considered.

Poland is among Kaliningrad's leading trade partners. Relations have developed dynamically during the last few years and the ongoing dispute over exports of Polish meat to Russia has not had any significant effect on Kaliningrad-Polish trade.

Table: Kaliningrad – Poland volume of trade in 2003-2005

	2003		**2004**		**2005**	
	mln. USD	**percentage change from the previous period**	**mln. USD**	**percentage change from the previous period**	**mln. USD**	**percentage change from the previous period**
The volume of trade	387.9	105.0	486.6	125.4	569.7	117.1
Polish exports to the Kaliningrad region	44.0	37.2	64.7	147.0	59.4	84.8
Imports from the Kaliningrad region	343.9	137.1	421.9	122.7	514.8	122.0

Source: Economic Department of the General Consulate of the Republic of Poland in Kaliningrad

Different priorities are reflected in how the parties treat Kaliningrad, and in their approaches to problem solving. However, all parties acknowledge the importance of the socioeconomic development of the region. And this is where their efforts may and should be joined, as a prosperous Kaliningrad may then more easily become an integral part of the Baltic Sea region, which will undoubtedly bring benefits to the overall partnership-building process.

The "Kaliningrad factor" in EU-Russia relations acquired a new dimension in 2005 with the adoption of the EU-Russia road maps for the common policy spaces: the Common Economic Space; the Common Space of Freedom, Security and Justice; the Common Space of Research, Education and Culture; and the Common Space of Co-operation in the Field of External

Security. The Kaliningrad region can and should play a key role in establishing these spaces, although it may hamper these processes if its own problems are politicized.

Challenges and opportunities for Kaliningrad in the aftermath of EU enlargement

Kaliningrad's current model of economic growth is artificial and may well prove unsustainable in the long run. One factor that may undermine the attractiveness of the Kaliningrad economy in the eyes of investors is Russia's upcoming accession to the World Trade Organization, which will erode the core of customs benefits currently provided in Kaliningrad. The risks related to the possible complication of transit procedures via EU territory (Lithuania) should not be ignored either, considering the strong dependence of the local economy on freight links with mainland Russia – a major market for local goods and the main source of raw material supply. The consequent closure of many of local import-substituting factories would inevitably result in higher unemployment and entail new economic problems.

Another issue is the new Law on the SEZ in the Kaliningrad region introduced in April 2006 and designed to attract large companies at the expense of small and medium-sized businesses, as it provides benefits to companies investing not less than 150 million rubles (about $5.5 million). Thus the major challenge for Kaliningrad now is to build a sustainable economy (i.e. one based on small and medium sized business and export-oriented companies) and to reduce the socioeconomic divide between the region and adjacent border areas of EU member states, which may widen further if Kaliningrad's fragile economic model fails.

Kaliningrad and the Schengen zone enlargement

With some 1.5 million people traveling between Kaliningrad and the rest of Russia every year, the issue of Kaliningrad passenger transit has long been a priority for the Russia-EU agenda. In light of the pending entry of Poland and Lithuania into the Schengen zone, many are concerned about the possible impact on established transit procedures, which were last revisited right before these two countries joined the EU in May 2003.

Then cargo transit through Lithuania became more complicated and costly due to a number of factors (increased fees for and frequency of veterinary and other controls; introduction of obligatory financial guarantees, etc.). For passenger transit, the authorities adopted a special scheme based on the introduction of no-cost visas and the so-called Facilitated Transit Document and Facilitated Railway Transit Document. This document is relatively easy to obtain and is free of charge. The scheme was a compromise acceptable for all parties concerned and proved its viability over time. But the fact that Lithuanian authorities may reject issuing such documents to a Russian citizen moving from one part of Russia to another shows that Russian concerns over the issues of state sovereignty were not fully taken into account.

The agreement on the visa regime and readmission between Russia and the EU is expected to come into force in the coming months, and will ensure easier procedures for Russian citizens seeking to visit new EU members states after they join the Schengen zone later this year.

Although not all details concerning possible implications of Schengen zone enlargement for Kaliningrad are clear, it is obvious that it will cause mixed feelings among Kaliningrad citizens. On the one hand, a Schengen visa entitles its holder to free movement in the majority of European countries, which is why a large number of Kaliningrad tourists and businessmen applied for it in the past. In a few months time, they will no longer need to apply for a Polish or a Lithuanian visa in addition to the Schengen visa already in their passport to visit these countries. Another piece of good news is that there will be several consulates issuing Schengen visas in Kaliningrad (up until recently, this was done only in the General Consulate of Sweden), which will presumably result in shorter processing times.

On the other hand, many of those who regularly visit Poland and Lithuania have no intention of going elsewhere in Europe. Given the fact that a Schengen visa will cost 35 euros for Russian citizens (no exception envisaged for Kaliningrad residents in this case), and that the requirements for obtaining such a visa are stricter than those for getting a Polish or a Lithuanian one, some people will now faces greater hurdles (as an illustration, more than 170,000 visas were issued by the General Consulate of Poland in Kaliningrad in 2005).

Scenarios for Kaliningrad's socio-economic development

At the moment, the regional mid-term and long-term Kaliningrad Region Strategy for Socio-Economic Development, adopted by the regional government and approved by the federal authorities, envisages four possible scenarios for the region's development:

Scenario 1 – "Status Quo". This scenario is based upon local business securing, and moderately improving, its current status in the Russian market. It implies that the issue of the region's development will be discussed more in political than economic terms. Even though the scenario is far from being appealing, it is likely to become a reality if no projects capable of changing the current socio-economic trends emerge. In this case, the leaders of transit-dependent economy will remain unchanged. The same moderate pace for infrastructure development in the transport and energy sectors will be maintained with no breakthrough allowing for the implementation of large projects. If the situation in the Baltic region remains stable, this model foresees moderate economic growth of 5-7 percent for the coming 3-5 years.

Scenario 2 – "Competition in the Russian North-West". This scenario envisages local business being able to achieve a "strong" position in the Russian market, where Kaliningrad's participation is determined by the specialization it achieved during the 1990s. In the current circumstances, this is the least probable scenario, as it implies intense competition with other Russian regions in existing or newly emerging internal markets. At the same time, in the long run, promoting Russian interests in the Baltic area is a much better outcome than competition between Russian regions for limited internal investment funds.

At the moment, Kaliningrad is the undisputed leader in terms of the manufacturing and distribution of canned good and electronic consumer products on the Russian market. However, despite this advantage, which is largely conditioned by customs and tax benefits granted under the SEZ regime, these firms make up an insignificant part of the local economy.

Scenario 3 – "European Outsourcing". This scenario envisages the integration of traditional and new types of products and services into EU-based supply chains It is realistic and moderately positive for the socio-economic development of the region.

This scenario ensures sustainable growth for Kaliningrad-based contributors to the supply chains, at least in the midterm. Moreover, European quality factories will move to Kaliningrad, improving local labor skills to international levels and developing sustainable distribution channels. Under this scenario, the economy will be oriented toward foreign markets, and the region will become integrated into the socio-economic processes determining the situation in the Baltic region and in the North-West of Russia.

Most relevant will be economic sectors and fields of activity which cannot be developed in the EU because of environmental reasons, a lack of necessary skills, or other reasons. These are, first and foremost, energy-consuming production (some types of metal processing, assembling, shipbuilding), and some types of agriculture. The envisaged GRP growth will be 7-8 percent per annum and will gradually decline as the competitive advantages (cheap labor and energy resources) wane by 2016.

Scenario 4 – "Macroregional Lead". This scenario will require not just the implementation of a pool of infrastructural projects, but also a rather aggressive expansion on European markets. The success of this scenario is directly linked to the revision of Kaliningrad's status within the Baltic region. This outcome will only be possible with the establishment and implementation of a conceptually new set of initiatives and projects with the objective of shaping a new "portfolio of resources".

Under this scenario, a cluster policy would be most promising. Clusters may be developed on the basis of the traditional production specialization of the region: sea transport, some segments of the food industry (fishing and fish processing), production of certain types of consumer goods (furniture, textiles), retail trade, and tourism and the hospitality industry.

An alternative to cluster development could be the launch and implementation of large projects allowing the further enhancement of regional specialization by means of shifting the focus onto specific activities that are in demand in the macroregional context.

If this scenario becomes a reality, Kaliningrad's GRP may grow at an annual rate of 7-10% for an extended time period (until 2025), in part through institutional changes and the attraction of large investments.

Considering the current conditions and the long-term interests of Russia in the Baltic region, Government experts believe that the most expedient scenario for socio-economic development of the region would be scenario No. 4 "Macroregional Lead," complemented with certain elements of scenario No. 3 "European Outsourcing".

The Program of Socio-Economic Development of the Kaliningrad region for 2007-2016, based on the above strategy, was approved in the form of Kaliningrad Region Law no. 115 on December 28, 2006.