

Kaliningrad 2020:

**Its future competitiveness and role in the Baltic Sea
economic region**

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Foreword

The Kaliningrad region with less than a million inhabitants, just 0.6% of the Russian total population, plays a significant role in EU-Russian relations. This Russian exclave became almost completely surrounded by the European Union due to the EU membership of Lithuania and Poland in May 2004.

Even if Kaliningrad has been almost completely surrounded by the Union, several authors of the book suggest that the Kaliningrad economy has not suffered from the EU's enlargement. On the contrary, its economy continues to grow faster than the Russian economy as a whole. Furthermore, the region's external economic relations continue to expand. The major explanation for such a positive development is not the EU enlargement itself but Kaliningrad's special economic zone (SEZ), which is already expected to experience a legislative change in the near future. It is perhaps a paradox, but the future development of the SEZ can be even more crucial for the future development of the Kaliningrad region than was EU enlargement.

It seems evident that the Kaliningrad region continues to have a special place, not only in Russia's domestic policies but also in EU-Russian relations. The implementation of the road maps, particularly the Common Economic Space, would probably reflect positively in the movement of factors of productions between the EU and Russia. The Kaliningrad region is obviously one of the major beneficiaries of the practical implementation of these road maps.

Since Peter the Great, St. Petersburg has been Russia's window towards Europe. Similarly, one may conclude that Kaliningrad has become Europe's window toward Russia. Open windows are needed for creating a true partnership between Russia and the EU.

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Turku, October 4th 2005

Kari Liuhto

Keynote address: Kaliningrad – the region of cooperation

The region of cooperation – this is how Kaliningrad oblast is most often referred to. Understanding this word in the broadest possible sense, we associate all our plans and programs with it. Today the Kaliningrad region has undertaken a very important and honorable mission to become in a way a bridge of friendship and partnership between Russia and the uniting Europe. According to the President of the Russian Federation **Vladimir Putin**, for Russia Kaliningrad is “a strategically important territory, the future of which is directly linked with the national interests of the country”.

Implementing this strategy, we are aiming at the development of good relations with the neighboring countries and extension of interregional contacts with other subjects of the Russian Federation, development of efficient economic relations, as well as a large-scale cultural and humanitarian exchange. These particular ideas create a basis for the celebration of the 60-th Anniversary of victory in the Second World War, the 750-the Anniversary of Kaliningrad and the 60-th Anniversary of the Oblast foundation, which take place in 2005-2006.

We are open to cooperation and prepared to take part in all good will undertakings that lead to progress, sustainability, economic growth and social consent.

Vladimir Egorov
The former governor of the Kaliningrad Region

Keynote address: Kaliningrad 2020

The future development of the Kaliningrad oblast has been of high interest for the EU long before May 2004 when Kaliningrad became surrounded by new EU Member States. The EU got progressively involved as the enlargement date approached. As early as November 2002, Russia and the EU adopted a *Joint Statement on Transit between the Kaliningrad Region and the Rest of the Russian Federation*, laying the ground for the transit regime for persons which is now in operation since July 2003 to the entire satisfaction of both sides.

Kaliningrad also received high attention at the moment of EU enlargement, when the EU and Russia adopted a *Joint Statement on EU Enlargement and EU-Russia Relations*. On this occasion, the focus was on transit of goods and related issues such as in the field of customs cooperation. The jointly decided actions were all implemented during the following months, leaving the normal task to further improve the functioning of the system in practice.

Overall, therefore, the achievements made during the recent past can be considered as a success story. However, from the EU point of view, cooperation on Kaliningrad should not stop there.

We face a number of challenges in the region for which developments in Kaliningrad will be important, ranging from water pollution in the Baltic Sea to the spread of communicable diseases such as HIV/Aids. And there are plenty of opportunities to be seized as well, for increasing prosperity in the region as a whole. For these to be fully available, good infrastructure connections, a regulatory framework compatible with the relevant international rules such as from the WTO, and as many links as possible in the field of research and education are needed – just to mention a few of the prerequisites.

Responsibility for Kaliningrad lies of course primarily with the Russian government. But the geographic, economic, and social proximity with the EU, along with the fact that Kaliningrad's borders are now part of the EU external border, call for close cooperation.

Political leadership on Kaliningrad-related matters is important on both sides, while progress on the ground crucially depends on better understanding and coordinated action at expert level. The existing EU-Russia cooperation structures offer a number of mechanisms for specific discussions on Kaliningrad, such as the Cooperation Committee, which held a special meeting in Kaliningrad itself, and formal consultations under the Partnership Cooperation Agreement have also taken place. The Commission will continue to make its contribution at all levels.

The EU and Russia have recently launched discussions on the future of the *Northern Dimension*, which establishes a framework for cooperation at local level in the Baltic Sea area but also for the regional organisations such as the CBSS and BEAC.

Since many years, technical assistance has been provided to the Kaliningrad region from the Tacis budget; a new special programme of € 20 million has recently been launched. In addition, coordination with assistance projects inside the EU will improve on the basis of the so-called Neighbourhood Programmes.

The wide range of common interests and on-going activities as described above may, however, conceal the fact that here like in other situations governments may focus too much on the short-term needs and pay less than appropriate attention to the long-term prospects. Better understanding of the driving factors and likely developments in the Kaliningrad region should be of great help in early identification of future needs for action and the most appropriate ways of tackling them. This is why the long-term view offered by the Pan-European Institute should be of vital interest to all those working on the future development of Kaliningrad. I wish it a broad readership and recognition as a major reference point for policy-making.

Gerhard Lohan
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Managing asymmetric interdependence: A comparative approach on the Kaliningrad policies of core actors¹

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1. Introduction

It has been stated countless times and surely is true: the Kaliningrad Oblast of the Russian Federation² has a strong potential for a sound economic development, for functioning as Russia's showcase to Europe and as a place where the West and North of Europe meet with the East of the continent. It shall not be denied that since 1999 some progress has been made in tackling constructively with the Kaliningrad puzzle and in assisting the Russian oblast in adjusting to the new constellation of being a Russian exclave and an EU enclave at the same time. Isolation became not as strong as it was feared and economic parameters improved. A mayor step was made when Russia accepted that a Kaliningrad problem exists and the EU followed this view, although until 2005 both sides did not manage to agree about the nature of the problem and their attention for the region was mainly crisis-driven. In parallel disappointment and frustration accumulated among all parties as regards transforming the actual difficulties into an opportunity for sustainable co-operation. Increasingly it is talked

¹ This article is based on joint research conducted in the framework of the research project "Pilotregion Kaliningrad? Participatory Research on Conflict Prevention", generously supported by the Berghof Foundation for Conflict Research. References on the huge amount of academic literature as well as primary sources we drew upon will be found in the final report to the aforementioned research project. Here it should only be mentioned that we owe particularly lot to the Association of International Experts on the Development of the Kaliningrad Region (AIKE) and its activities (www.kaliningradexpert.org) as well as the 13 members of the Kiel International Ad-hoc Group of Experts on Kaliningrad and their contributions to the edited volume Hanne-Margret Birckenbach / Christian Wellmann: *The Kaliningrad Challenge – Options and Recommendations*, Münster: Lit Verlag, 2003.

² This is the official name. In economizing, it will be referred to it in the following only in short terms as Kaliningrad, the Oblast, the exclave and so forth.

about a "Kaliningrad fatigue" to grow among the main actors and a win-win scenario is by far not a self-fulfilling outcome.

The present constellation concerning the Oblast and its development is complex. It is also characterized by politically uploaded tensions among domestic and foreign actors, which do hard in co-ordinating and mitigating their interests and needs when they meet on Kaliningrad. Furthermore, the constellation is extremely asymmetric. When dealing with Kaliningrad the Russian authorities execute sovereign power over a part of the state's territory in line with the overall aims and instruments of domestic policy. Kaliningrad is basically a matter of internal relations. For all other players Kaliningrad is a foreign policy issue and a matter of international and transnational relations. Driven by what interests, perceptions and identities so ever, the non-Russian actors involved themselves into a matter that is of a certain relevance to them, but located beyond their own jurisdiction. Nevertheless, dependencies exist. Kaliningrad internal developments to some degree affect the neighbours without them having a direct grip on these developments whilst in turn internal problem-solving needs co-operation by outside actors because their acting influences what happens within Kaliningrad and what is possible there.

The consequences of the asymmetric interdependence are in particular felt by the Kaliningraders themselves. To any respect they are dependent not only on the developments in Russia, but also on the surrounding Western countries without having any reciprocate influence. None of the environs really desperately needs co-operation with the Kaliningrad region, but the people in Kaliningrad do need co-operative and non-rivalling support from them and co-ordination among them if the oblast shall live up to its potential role in a 2020 Baltic Sea Economic Region. Therefore, the challenge for the years coming is to improve those political capacities which allow to manage asymmetric interdependence in a way that reconciles and serves the Russian interests with respect to Kaliningrad and beyond as well as the interests of the neighbouring countries.

The assumption of this contribution is that the Kaliningrad policy of each of the actors is predetermined by a set of actor-specific general fundamentals of high continuity over time and throughout different policy fields. These determinants, however, are often in contradiction with those of other actors whilst at the same time they can not be abandoned in principal within a foreseeable future. Nevertheless, case by case and step by step they might

be gradually modified. Such modification is more likely to occur the clearer these fundamentals are communicated, the more they are principally recognized by the other actors and the more an attempt for modification is supported by their responding action. To put it in short terms: Problem-solving is the more probable, the higher the level of mutual responsiveness of the actors is. This article attempts to investigate the state of responsiveness of some actors of particular relevance for Kaliningrad and to identify possibilities how this state can be improved. Responsiveness refers to the degree to which an actor is prepared to enter into the position and views of its partners, to understand their rationale, to consider his own strategies in the light of the perspectives of the other actors, and to develop strategies that encourage mutual exchange, dialogue and action.

The guiding question is which information and knowledge the actors should consider if they want to escape from a vicious circle of frustrating each other mutually.

The analysis starts with the Russian Federation, not least because as the owner of Kaliningrad it is an actor different to all others and of prime importance. The main determinants of Russia's Kaliningrad policy are sketched and the expectations with regard to the foreign actors are described (Section 2). Concerning foreign actors, the list is long and a selection had to be made. This analysis focuses exemplarily on Lithuania as one of the immediate neighbours to Kaliningrad, Germany as the former owner of the territory and one of the large EU member states, Sweden as the main player in Baltic Sea regional co-operation, and Finland as the closest-ahead EU presidency from which it can be assumed that it will pay special attention to the Kaliningrad issue. Last, but surely not least, the EU becomes topical as the prime collective counterpart for Russia's Kaliningrad policy. Each sub-section tries to explicate the fundamentals which determine the actor's Kaliningrad policy and results in summarizing what this actor in the Kaliningrad context expects of Russia (Section 3). Finally, it is discussed how the differing fundamentals and expectations fit together, whether the policies meet the needs of responsiveness and how the latter eventually can be enhanced for the sake of avoiding the Kaliningrad issue to remain a stumbling block for the emergence of co-operative structures in the Baltic Sea region and Europe at large (Section 4).

2. The Russian Federation: Worries about integrity

The Kaliningrad Oblast contributes only 0.1 per cent to the territory of the Russian Federation and only slightly less than 0.5 per cent to its population. It is a very small piece of big Russia. Anyhow, in qualitative terms the region has quite a significance for Russian politics and society:

In a utilitarian perspective, issues such as the ice-free military and commercial harbours (the only one Russia holds in North-Eastern Europe), the sea-side resort function (compensation for the losses along the Baltic and the Black Sea shores), the relative closeness to the blue-water fishing grounds in the Atlantic or the amber and oil resources count.

From a politico-strategic point of view Kaliningrad "plays a special role in ensuring national interests of Russia in the Baltic Region and Europe" as it was expressed in the official report on a 2001 special Kaliningrad session of the Russian government. Kaliningrad is Russia's westernmost region; as an exclave it functions as a kind of outpost. Its significance may be translated into military and hard security terms. Anyhow, more important is a reading that Kaliningrad underpins Russia's claim to belong to the Baltic Sea region and to be a European state and not a power somewhere in the Eurasian off.

In terms of identity, Kaliningrad contributes to national myths, identity formation and self-consciousness. Russian sovereignty over Kaliningrad is a result of WW II. The region symbolizes an off-set for the suffering of the Russian people and it reminds them of the victory finally achieved in the "Great Patriotic War", the greatest success of the Soviet Union and the beginning of its rise as a world power. Even today the population continues to rate this victory no. 1 in the list of achievements a Russian can be particularly proud of.

With reference to the number of 15 Kaliningrad-specific legislative acts adopted by the State Duma or the President in the years 1991 to 1998 alone it may be concluded that no other subject of the Russian Federation (probably with the exception of Chechnya) had drawn more attention by the Federal Centre than Kaliningrad. Also in the years since 1999 which shall be in focus in the following the level of attention has remained high.

The core determinant of the Federal Centre's Kaliningrad policy is worries about the integrity of the Russian Federation. The "Russian soil" and its defence have an almost mythological connotation in the Russian national narrative. Securing territorial integrity and the territorially defined state, and defending its sovereignty over territory rank high and are strongly backed by the citizenry. In his first campaign and later, in office, President Putin gained high popularity by declaring it a top priority to bring an end to what was regarded the Yeltsin-chaos and to re-integrate the Federation.

In terms of the integrity discourse the situation in Kaliningrad constitutes a major challenge when taking into account such facts as the region's exclave location and history, the strong non-Russian influence the process of identity formation in Kaliningrad is subject to, and its

population's habit to assess their socio-economic situation to be worse than it is in the Russian context by taking as a measurement the immediate neighbours and not the Russian average. The Federal Centre is worried that by both, external and internal factors, a wedge will be driven between the exclave and the mainland, that the links between the two will weaken, and that alienation of the Kaliningraders from Russia might develop or even that secessionist attitudes will emerge.

Consequently, identity policy forms a strong component of the Centre's policy. Some examples are the construction of Russia's second largest orthodox cathedral in Kaliningrad, schemes for subsidizing youth groups visiting mainland Russia, and the newly established monumental statue of Tsaritsa Elisaveta (ruler of the region for seven years in the 18th century). A recent and quite striking case of identity policy was the festivities celebrating the 750th anniversary of the founding of the city of Kaliningrad, in German times named Königsberg. The event gave the impression that identity policy and measures for intensifying the exchanges with the mainland do not aim at nationalistically isolating the Oblast from its environment, but on the contrary at allowing it to entangle with its neighbours by counterbalancing their influence on identity formation and thus calming down the worries about the integrity of the Federation being at stake. In a Russian perspective intensified identity policy seems to be a precondition for intensified regional cross-border co-operation.

The strive for securing Russia's territorial integrity and the exclave's cohesion with the mainland also affects the policies in other fields of action, such as infrastructure development or economic and energy policies. The slow pace by which the overdue opening of Baltijsk harbour for civilian usage progresses and how it is responded to environmentalist criticism on the off-shore oil extraction activities provide respective evidence. Furthermore, the intensity of control executed by the Federal Centre over the region is atypical. The Oblast is the first Russian region to which the Security Council of the Russian Federation devoted a special session without any turmoil having occurred there in advance, and it constitutes the Federation's only subject for which the post of a Presidential Plenipotentiary was created.

As far as economic policy is concerned, the federal authorities seem to be quite aware of the need for defining a strategy which fits the peculiarities of the Kaliningrad Oblast. However, their governance is characterized by a certain indecisiveness and hampered by intensive dispute between the Federal Centre and the regional elite as well as within the decision-

making structures in Moscow. At the end of 2001 the federal government adopted the Task Programme for the Development of the Kaliningrad Region. However, it is underfinanced and the most relevant and resource consuming project, the construction of a gas-fired electric power plant, is an economically doubtful endeavour, mainly driven by the idea of making the Oblast more self-sufficient in terms of energy supplies – again a result of the strong influence of the integrity discourse. The existing SEZ regime had some positive growth effects, but on the expense of basing Kaliningrad's economy unhealthily on trade, import boosting, currency drain and tax evasion. Consequently, for meanwhile more than four years the Federal Centre is in search of and in decision-making on a new scheme which shall overcome the deficiencies of the present SEZ. However, how can it be managed neither to push the Kaliningrad economy into a complete collapse and thereby stir up the Kaliningraders against the Federal Centre, nor to allow the neighbours and the EU to play a major role in the development model as this perspective contradicts the priority of integrity and self-sufficiency? The decision-makers in Kaliningrad do not really help along, because relevant segments of the regional elite oppose substantial change as they profit from the tax and customs preferences as well as the fraud possibilities that the SEZ provides. Finally, in June 2005 a draft of a new law on the Kaliningrad SEZ made it for the first time to be presented to the State Duma and was adopted in a first reading. However, at present (August 2005) observers still doubt whether and when and with which contents it will finally be adopted and come into force.

Altogether, a clear Russian stance on the Kaliningrad issue is blocked, (a) by trying not to inspire secessionist attitudes, (b) by understanding "integrity" as not allowing any dependencies from the outside world to occur, (c) by attempts not to stir-up the domestic nationalistic forces, (d) by a presence of representatives of these forces in the decision-making structures too low for dominating them, but strong enough for trouble-making, and (e) by competing interests among the region and the Centre.

Notwithstanding Russia's responsibility, the Kaliningrad case cannot be treated solely in the mode of domestic politics. It has, due to its politico-geographical, socio-psychological, economic, and historical specifics, as well an international dimension which strongly affects the region's internal development. Kaliningrad receives targeted attention by foreign states and non-state actors. The fact that a multitude of foreign actors interfere in various respects and to a different degree into what happens in Kaliningrad, the strong foreign influence on the

region's inhabitants, and the need to deal with this constellation is still observed by the federal authorities with some suspicion, however, is meanwhile largely accepted as a matter of fact. Moscow nevertheless continues to emphasize that Kaliningrad is under Russian jurisdiction and its development is subject to Russia's sovereign decisions. To underline this notion, Moscow reacts with irritation when foreigners come along with suggestions which in fact or allegedly question the present status of the region. Careful control is executed over the Oblast administration's foreign contacts. The years of hesitation before finally allowing Sweden and Germany to establish consulates in the region also falls into this category. Even when basic agreements had been reached and the Consulates General had been accredited, the demonstration of who has the say continued for more than a year by withholding permission for moving into buildings which would allow the foreign representations to become operational.

The Russian authorities did hard with accepting that the Kaliningrad case has an international dimension. The basic step forward was done in 1999, first internally by presenting the EU a list of Russian concerns regarding the impact of EU enlargement on Kaliningrad and suggesting to start dialogue on the issue, and then publicly by Russia's mid-term strategy for its relations with the EU, in which the vision of developing Kaliningrad into a pilot-region for the relationship between Russia and the EU was launched. The strategy indicated that the Russian leadership had by and large acknowledged that problem-solving with respect to the region has an international component. Kaliningrad became an issue on Russia's foreign policy agenda.

This move from 1999 is very much in line with a general refocusing of Russia's foreign policy under Putin on a course that can be characterized as "strategic Westernization lead by a pragmatic nationalism": Russia wants to be a great power, strives for being respected as an equal player and is critical towards a uni-polar world order. However, it was increasingly realized, that Russia is not fit for taking such a role effectively without its internal performance first being improved. Such improvement is in the centre of national interest and foreign policy has to support this aim. Evidently, co-operation with economically interesting partners fits this purpose better than provoking them by big power play or to pretend that Russia was the hegemonic core of a self-sufficient Eurasian empire. With regard to matters such as economic development, technology, and foreign investment the Europe of the EU is most promising. Not an integration of Russia into the EU, but an integration with the EU, i.e.

a deliberate orientation of Russian politics on Europe and a strategic partnership with the EU on equal footing, is on the agenda.

This pragmatic foreign policy course is perceived with reservations by relevant segments of the Russian political elites and of the general public. What Putin is doing is criticized as a sell-out of national interests and capitulation. After years of crisis, decay and loss of international status the demand for grandeur and recognition is high. The direction Russia shall take is domestically under discussion; identity formation and the self-esteem which place Russia should take in the world is in flux, but has not yet been decided. Putin has to take this domestic mood into account. In a certain sense his foreign policy concept contradicts domestic policy needs. The best way out would be to "sell" his approach at home by presenting relevant successes.

Within this tension between the insight into Russia's needs and abilities on the one hand and the opposing domestic forces on the other hand, also the international dimension of Russia's Kaliningrad policy develops. This may explain much of its sometimes volatile, sometimes hesitating or offensive, but sometimes also constructive and consensus-oriented mode. In foreign policy terms the Kaliningrad issue is too unimportant for Russia to sacrifice for its sake the prospects of fruitful relations with the EU and to lose its good will with respect to WTO membership, in energy co-operation, trade policy etc. In terms of domestic policy the Kaliningrad issue is much too "hot" to allow the leadership to simply go ahead with the main foreign policy agenda, regardless of the impact on the Kaliningrad issue and how it is received at home in contrast to the demand for recognition, integrity and self-sufficiency. It is a kind of double-bind situation.

Expectations towards the West: The expectations Russia addressed explicitly or implicitly to the foreign actors are the resultant out of the domestic and the foreign policy vectors roughly sketched above. Some refer directly and exclusively to the Kaliningrad case, others only indirectly and have to be seen against a more general background, although not less important:

Russia demands to be heard with its interests by the Baltic Sea neighbors and the other European states. The Russian leadership is in search for any kind of success of its European foreign policy orientation, which allows to bolster it up against its domestic opponents. Russia strives for recognition and for acceptance of being different and a case of its own. It is denied that all standards the EU wants Russia to apply fit the needs of reform in Russia and it is claimed that a strategic partnership with the EU on equal footing calls for a framework different from the one suiting the relations between, for instance,

Moldova and the EU. Furthermore, one longs for particular attention by other larger European states.

Another set of expectations concerns response to indications by the Russian leadership of having perceived fundamental problems that need to be solved or kept under control. Concerning Kaliningrad, for Russia it is not just one more case of application of instruments for cross-border co-operation or border management procedures. Primarily it is a security issue and thus an utmost political matter. Although this cannot be spoken out officially and explicitly, Russia wants the West to understand that the Russian concern as regards Kaliningrad is about the Federation's territorial integrity and its future coherence, about how to establish safeguards against the eventuality of secessionism. The constant Russian call for establishing a high-level EU-Russia negotiating body exclusively for Kaliningrad issues instead of handling them in the existing structures of the Partnership and Co-operation Agreement (as the EU prefers just as constantly) has to be read against such background. Matters of security can not be handled by some rank and file officers, but by negotiation partners which can take political decisions. The suggestion to eventually conclude a binding agreement with the EU on Kaliningrad, first voiced in Russia's 1999 mid-term strategy for the relations with the EU and later repeatedly referred to by various politicians, points in the same direction. Although the idea remained vague it seems to aim at receiving from the EU a guarantee under international law of the Oblast belonging to Russia, instead of getting only judicially not binding political statements on the issue. Such agreement could counter the interpretation of international law which attests Russia to hold only de facto, but not de jure sovereignty over the region (reportedly the US position), as well as out-balance the lack of acceptance of the Russian ownership in certain strata of the surrounding societies.

In its 1999 "Mid-Term Strategy towards the European Union" Russia suggested to transform Kaliningrad into a pilot-region for EU-Russia co-operation. Although the Russian authors of this idea were obviously not too active to substantiate on it, however, voicing this idea publicly by writing it into a diplomatic paper, can very well be read as inviting the EU and its member states to contribute to substantiating the idea.

Since mid 1999, when the first respective non-paper was submitted to the EU, Russia repeatedly expressed its expectation towards the EU and its member states, not to treat the enlargement as if it were an internal affair of the EU and the candidate states alone, but to seriously take into account also the effects of enlargement on Russia in general and Kaliningrad in particular. The list of "concerns" is long and includes issues of utmost state-political significance, such as visa matters and the transit issue, including energy supplies for the region, border procedures for goods, and military transit, as well as matters of economic interest (e.g. quotas for Kaliningrad fishing industry) and development of transport infrastructure, and last not least the question of fate of the treaties Kaliningrad had concluded with neighboring counterparts.

The most prominent and heavily disputed claim concerned the transit of persons. Against the Russian understanding of integrity, as sketched above, the idea of the communications between two parts of the country being restricted, controlled, or complicated is indeed a major challenge. Russia expects the compromise it agreed upon in November 2002 to be only temporarily by becoming obsolete due to the introduction of a comprehensive visa-free regime between the EU and Russia in a foreseeable future. Mainly that a respective declaration of intent was included to the compromise allowed him to sell the outcome of the negotiations at home as a success.

3. Foreign actors

3.1. Lithuania: Securing independence

The Lithuanian statehood was a great power when in the Middle Ages it stretched from the Baltic Sea to the Black Sea. However, for most of their post-mediaeval history, the Lithuanian people were subject to foreign rule, by Poland, Tsarist Russia, Germany and the Soviet Union. In modern times, an independent Lithuania existed for altogether less than 40 years – and as a small state only. Historical memory plays an outstanding role in present day processes of Lithuanian nation-building and formation of collective identity, as well as in presenting the country internationally. The Lithuanian national narrative reports about both, the past times of grandeur as well as the subsequent centuries of suffering under alien masters which finally was overcome only recently.

Taken into account both, the historical experiences and Lithuania's existence as a small state, it makes not to wonder that the country's foreign policy is largely predetermined by security political considerations. Once, Russia, Germany and Poland denied the Lithuanian people its strive for self-determination likewise. Nowadays and against the freshest memory, i.e. the trauma of roughly 50 years of Soviet rule, it is almost exclusively Russia that is perceived as basically threatening Lithuania's national security. This holds all the more as Lithuania shares not only most of its Southern border with Russia (i.e. Kaliningrad), but factually is sandwiched between Russia proper and the exclave, although to the North-East Latvia and Belarus provide a territorial buffer of some 50 kilometers to the Russian mainland. Furthermore, Lithuania shares a long border with Belarus, which is not only closely allied with Russia in a bilateral Union, but as well hard to predict in its development under the authoritarian leadership of President Lukashenka.

Despite of the relations with Russia being officially described as developing by and large positively, it is Russia which in the public discourse and among the political elite continues to be perceived as a threat to the security and the sovereignty of Lithuania. Fears about Russia trying to regain its influence on the course of Lithuanian politics, may it be by means of

blackmailing, subversion or economic activity are strong. The dependence of Lithuania's economy on Russian energy and raw material supplies and the question to which scale Russian business shall be allowed to invest in Lithuania are highly politicized and disputed issues.

After regaining its independence in 1990 Lithuania clearly oriented to the West and conducted a policy of Euro-Atlantic integration. The security concerns had as a consequence that membership in NATO was top of the agenda. Nevertheless, accession to the EU was important as well – for economic as well as for political reasons (diversifying from the Russian market, underpinning the European belongingness, drawing a clear line of demarcation to Russia, etc.). Lithuania wants to be a good member of the EU. However, at the same time the predominance of security brings Lithuania to meet the EU also with some hesitations as it regards the Union neither to be capable nor willing to provide the country a strong and credible guarantee for its territorial security. To this respect only the US and a US-lead NATO are perceived trustworthy. The Western Europeans are perceived as lacking the will to invest sufficient resources into their military capacities. In particular one does not trust Germany and France, which are perceived as tending to establish a directory of big power EU-members and to develop relations with Russia on the expense of the smaller member states, not least those in the sphere of potential and potent Russian influence.

With regard to Russia, Lithuania prefers a multilateral approach and keeps bi-lateral relations on low-profile were possible. From the beginning Lithuania supported the British initiative to bring Russia closer to NATO by establishing a NATO-Russia Council, assuming that the closer co-operation is, the more possible Russian pressure will be dispersed on all NATO-members instead of being focused on the buffer states alone. With the EU it is basically similar. In order to feel reassured Lithuania wants the EU to deal with Russia. However, Lithuania is also concerned whether that happens in terms it regards adequate. Therefore and quite in line with Poland and the other Baltic States, it supports the EU's neighborhood policy, calls upon the EU to speak to Russia with one voice and at the same time tries to alter the EU's policies to be more critical towards Russia and aware of the threat Russia represents from a Lithuanian point of view. For this purpose differences in values between Russia and "Europe" are emphasized. Furthermore, Lithuania claims to be more competent in Russian affairs than the old EU member states are, and Lithuania offers its good services to the EU as concerns dealing with former Soviet countries.

To sum up: Lithuania's foreign policy is basically security driven. Not in the diplomatic documents, but for most participants in the public discourse, the academic and parliamentary debate included, the threat has a name: the Russian Federation. Russia, of course, is interesting and important to Lithuania in economic terms and it is strived for co-operation in the economic field. However, the basic political attitude towards Russia is negative. It is perceived as being imperialistic and not trustworthy; with the help of Euro-Atlantic partners it has to be contained and kept on distance.

Interestingly enough, this picture gets blurred when it comes to the Kaliningrad exclave. Supposedly, in no other country it is more closely tracked what is going on in Kaliningrad. About Kaliningrad it is talked less in terms of threat, but more in terms of opportunities, sometimes even in a tune as if Kaliningrad were not a part of Russia, but its victim. The more active and committed stance towards Kaliningrad as compared to Russia in general is a result of immediate neighborhood and vested interest, of course. Anyhow, it also seems to be rooted deeper in both, historical memory and political long term strategy.

Most of the territory of the Kaliningrad region is well-known in Lithuania as the largest part of "Lithuania Minor". Despite of the region's political affiliation with Germany, its rural districts were strongly populated by ethnic Lithuanians, and the region plays a strong role in the Lithuanian national narrative as a place of high significance in the period of Lithuanian national awakening and resistance against Tsarist rule. Supposedly, Lithuania is nowadays the country in which the society is accepting Russian rule over the Kaliningrad region least whilst own identification with the territory is strongest. For many Lithuanians "Kaliningrad" (or "Karaliaučius", as they call it), has a connotation different from "Russia" and it calls for higher attention and a more positive attitude than Russia as such. The radicalized and politicized variant of this basically cultural-historically grounded sentiment is represented by the proponents of the Lithuania Minor movement, a minority which calls for a demilitarization of the Kaliningrad region and explicitly claims it for Lithuania.

Official politics mirrors the societal sentiments, however and of course, not in the sense of raising any claims on the territory, but by building links to the region and to enter into dialogue and co-operation with the regional political, economic and intellectual elite in an intensity which domestically would hardly be accepted if it were with mainland Russia. Since

years already Lithuania is represented in the Oblast by a consulate general and conducts a very active Kaliningrad policy line, sometimes giving the impression as if Lithuania were a kind of godparent. The 1999 Russian-Lithuanian Nida-Initiative with an impressive list of joint projects to be brought forward in the framework of the EU's Northern Dimension provides another example. Also in 1999 an Intergovernmental Agreement on Co-operation between Regions of the Republic of Lithuania and the Kaliningrad Region was signed. Lithuania encouraged manifold sub-state co-operation activities between Lithuanian and Kaliningrad partners, not least the establishment of Euroregions. The organizations and cultural-educational institutions of the Lithuanian minority in Kaliningrad are supported and Lithuanian language teaching is promoted. Working relations with the Kaliningrad regional administration are well-established, Lithuanian business is most active in the Kaliningrad region, and so forth.

The Lithuanian interest in the region is well received in Kaliningrad itself. It brings investment, trade opportunities, various training possibilities, links to the outer world and some backing in the strive of the Kaliningraders to gain more space of manoeuvre in relations with the Federal Centre. Lithuania encourages to adjust in Kaliningrad to standards and norms common in the EU, and Lithuania supports opening the region to integrating with the Baltic space. Concerning Russia, resources for co-operation are strictly focused on Kaliningrad. A non-paper which Lithuania submitted to the EU in March 2003, presenting possible Lithuanian contributions to the EU's Neighborhood Initiative, lists proposals dedicated to the Ukraine, Belarus and Kaliningrad, but not a single measure is directed towards mainland Russia. The basic Lithuanian strategy seems to be to turn the exclave, as far as possible, into a friendly part of an overall frightening and unloved great neighbor. Doing so eases the security political discomfort of being wedged between its two parts, balances perceived German influence on the region, and allows to be prepared for the eventuality of Kaliningrad and the Federation drifting apart, a development which many voices in the Lithuanian public debate regard possible, if not even probable and desirable.

However, the Lithuanian friendliness towards Kaliningrad and the Kaliningraders has its limits. In line with the basic reservations against Russia, Lithuania takes a tuff stance if the issues concerned have the slightest connection with its understanding of sovereignty, if they concern the relationship with Russia (as compared to Lithuanian-Kaliningrad relations), or if they challenge Lithuanian interests, not least with respect to the EU. Such issues are military

transit or any suggestions for granting Russia special rights with respect to communications between the exclave and the Russian mainland. In the context of the debates on regulations for the transit of people, one was anxious to avoid any agreement with Russia and the EU which could afterwards be taken as a pretext for delaying Lithuania's accession to the Schengen area. One was also reluctant to accept any solution which would apply only for the Kaliningrad transit case, i.e. which in Lithuanian reading would singularize Lithuania.

Expectations towards Russia: Lithuania addresses one fundamental demand to Russia: It shall fully, unambiguously and explicitly acknowledge and respect Lithuanian independence and sovereignty. Russia shall not hinder Lithuania in any respect in taking its own, sovereign decisions. This demand derives from a perception of being threatened by Russia and is underlined by calling upon Lithuania's Euro-Atlantic partners to provide the country a trustworthy military guarantee of its territorial integrity and political sovereignty. Nevertheless, Lithuania does not base its call for respecting its independence on power political ambitions, but on the equality of states as stipulated by international law. Consequently, it is expected of Russia (as well as of the Euro-Atlantic partners) to scrupulously stick to the existing norms and common practice of international law when Lithuania is concerned. Lithuania is reluctant to accept any case-specific solutions which could be read as singularizing the country. Additionally, Lithuania indicates that from its point of view Russia questions Lithuanian independence as long as it does not admit the period of Soviet rule over Lithuania having been an occupation, i.e. illegal under international law and allowing to claim compensation. Concerning Kaliningrad, Lithuania keeps a close eye on what is going on there militarily, calls on the Russian authorities to show more flexibility in its Kaliningrad policy by granting the region more own space of manoeuvre and is eager to strengthen the Lithuanian presence in the region.

3.2. Germany: Restraint and commitment

German policy on Kaliningrad dates back to the last years of the Soviet Union and the German-Soviet talks on the future of the Soviet citizens of German origin. In this context, one idea was to develop Kaliningrad into a place for their settlement. The project was stopped again before it really came into life – however, as already some so-called Volga-Germans had moved to the Oblast, Germany was allowed to establish in Kaliningrad the German-Russian

House. This institution of foreign cultural policy was rather contested in Kaliningrad in its beginning, meanwhile however is well recommended. It became the first (semi-official) German representation in the Oblast, later followed by a branch-office of the Hamburg Chambers of Commerce and an information office of the German Federal State of Schleswig-Holstein. Finally, in 2004 a German Consul General in Kaliningrad received its accreditation. Germany has no claims any more on the former East Prussian territory. The territorial issue is regarded to be finally settled by the treaties regulating German reunification, primarily the so-called "2+4-Treaty". The social-democratic lead government was even more clear about that than the preceding conservative lead coalition. Nevertheless, Kaliningrad has remained a slippery issue of German foreign policy. When it comes to Kaliningrad, any German government sees itself confronted at home as well as abroad with both, mistrust and high, but contradictory expectations.

Societally, the expulsion of the German population from Eastern Europe after WW II, the Kaliningrad region included, is still traumatic and nourishes such contradictory sentiments and desires like seeking for political revenge and compensation vs. reconciling with Russia, forgetting about the territories lost vs. remembering and idealizing them, keeping on distance from the current local reality vs. coming closer to the present inhabitants (e.g. by providing humanitarian aid).

Although German reconciliation efforts were widely accepted abroad and only few people, whether in Russia or elsewhere, continue to accuse Germany of revanchism, it is nevertheless obvious that German policy is still met with quite many reservations, not least when it comes to issues of former German territories. In general, historically based worries that Germany could become too influential again or ally with Russia on the expense of other European nations are widely spread. The latter is particularly to be found in Lithuania and Poland, thus Kaliningrad's immediate neighbors, whilst ironically quite many Kaliningraders would like to see Germany acting as their supporter against the Russian centre. Some Russian voices are even convinced that Germany is interested to make a deal with Russia in order to allow the territory to return to Germany, a suspicion which however can also be detected in other countries, Great Britain for instance. On the other hand, there are also voices to be found throughout many states which argue that Germany might help to moderate Russian ambitions in the Baltic region.

Against this politically sensitive background the German strategy towards the Kaliningrad puzzle combines utmost restraint with strong commitment as regards the political, cultural and societal development of the Russian oblast.

Restraint means first of all that the Federal government is anxious to ensure that Kaliningrad does not become an issue for Germany. Consequently, even more than it is the case with German foreign policy in general, in Kaliningrad matters the government is strictly committed to the logic of being integrated multilaterally. The German government is clear about the fact that it does not open any negotiation line on Kaliningrad apart from the EU, and that it will not try to escape from obeying EU's decisions and negotiation positions. Germany did also not become active in order to overcome the EU's indifference towards the Kaliningrad challenge, because the issue having a low profile in the EU better allows Germany to stay in the background. Different to other policy fields, as regards Kaliningrad Germany abstains from mediating between differing positions of EU members or between Russia and the EU. However, it accepts France taking such a role when appropriate.

Restraint also characterizes the significance of Kaliningrad in the context of Germany's bilateral policy towards Russia. This policy is determined by a societally rooted attitude which longs for relations not governed by the belligerent past, but instead by the "normality" of partnership among equals. A pragmatic approach is conducted in order to achieve common goals where possible, in particular in the fields of economic and energy co-operation. Furthermore, it is aimed at establishing a privileged partnership between Russia and the EU in the policy fields meanwhile constituting the four so-called Common Spaces. German politics is well aware that Putin's policy is disputed among the Russian political elites from the left as well as the right of the political spectrum. Against this background, Germany basically supports Putin with his line of Europeanization against his opponents by full personal commitment of the German chancellor. This personal approach was already practiced during the Kohl-Yeltsin era and functioned also as the only channel by which Kaliningrad issues where so far addressed bilaterally. For instance, when Putin had hesitated to give support to Kaliningrad city celebrating the 750th anniversary of its founding, the German government abstained from pressing Russia, but indicated that the chancellor would not reject an invitation by Putin to attend the celebrations, also if they would be of a Russian format. In this way it happened, although the German foreign ministry had warned internally that a negative response by Kaliningrad's direct neighbors would be probable if they were not invited.

Conditionality is not a part of the German policy towards Russia, however democratic values do matter also in German-Russian relations. The German approach tries to avoid compromising the Russian partner publicly. Instead of public statements the German government prefers to use diplomatic methods to address the issues which it is concerned about. This vertical method is regarded to function more effectively, however, it lacks transparency. One will hardly find any public criticism also of the Federal Centre's policy towards Kaliningrad or of democratic deficits, criminal activities or other shortcomings in the Oblast. In case the government can not avoid to comment on such issues, e.g. due to a parliamentary request, it refers solely to Russian sources and desists from any dramatization or securitization. Instead, the social-democratic lead coalition established and supports some societally based instruments to address respective concerns off the governmental channels: The "Petersburg Dialogue", the "German-Russian Forum" and the institutions of foreign cultural policy allow frank communication among the elites and civil society on disputed issues, but are increasingly under criticism as they are said to suffer from centralization and the patronage of the two countries' leaders. One may add that the approach is limited to Germans and Russians and therefore is not suitable to build trust within the broader European civil society.

Finally, restraint is also the federal governments attitude as regards Baltic Sea co-operation and support for the participation of Kaliningrad within these structures. It is argued that the regional approach would only duplicate existing EU-structures and does not really provide solutions for the problems of this particular space where Russia meets the West. The German government strongly supported – despite early Russian objections – EU and NATO membership of Poland and the Baltic States, but kept its commitment to Baltic Sea co-operation quite limited and at low profile.

This abstention of the federal government in Baltic Sea regional affairs is criticized as well as partially balanced by some German Länder, not least Schleswig-Holstein. Concerning Kaliningrad, Länder, municipalities, commercial and societal actors developed outstanding intense and numerous activities, often based on formal partnership agreements with counterparts in the Oblast, thereby supplementing the policy of restraint conducted at the top level. These activities could unfold due to the multi-level power-sharing within the German federal system which explicitly allows the Länder to have a say in European affairs and cross-

border co-operation. The sub-national policy traditionally circumnavigates sensitive issues of high politics, relies very much on personal contacts and profiles with concrete projects of business training, cultural exchange schemes, co-operation of the police and in higher education (in Germany police and education are in the responsibility of the Länder), youth policy, humanitarian aid and social development, German language teaching and humanitarian aid. The majority of actors involved in these regional activities comply with the federal government's approach of delegating disputed issues to the EU-level, reconciling with Russia and conducting silent diplomacy on democratic values. Different is that the sub-state actors are trying to raise awareness of the Kaliningrad issue, commit themselves of actively including the Kaliningraders to the schemes of Baltic Sea regional co-operation and support the empowerment of the regional elites.

It has, however, also to be noted that the Kaliningrad Oblast also attracts German right-wing activists and that the organization of the East Prussian expatriates continues to claim East Prussia for Germany. An attitude, that Kaliningrad is ill-treated by Russia and hindered in its development is widely spread in the public although the conclusion that Russia should withdraw from the region remains mostly unspoken. The issue of geographical names and renaming Kaliningrad city has been crucial. The German federal government handles the issue carefully. Official statements always refer to the Russian names, despite the fact that in the German society and among parliamentarians preference is given to the former German versions what repeatedly caused trouble, more with Moscow than in Kaliningrad. When visiting Kaliningrad by occasion of the 750th anniversary the German Chancellor offered a fresh approach to reconcile the different use of names. After he had condemned "the criminal war of the Third Reich which resulted into the end of Königsberg" he added that "in the hearts" of those Germans "who were forced to leave the place and experienced unbelievable harm, the city continues to be Königsberg."

Expectations towards Russia: In line with its policy of restraint, Germany is extremely careful with voicing publicly expectations concerning especially Kaliningrad – and if there are any, they are of "soft" nature. Germany was quite successful in stopping German commitment in Kaliningrad being qualified upon on the Russian side as attempting to "re-Germanize" the region. One managed to get the notion of reconciliation largely accepted instead. Furthermore, it is regarded a kind of litmus test that the German history of the Oblast is not tabooed and that Russia takes some responsibility for the German cultural heritage in the

region. Such expectations are backed by foundations and civil society groups which assist Russian partners in restoring what survived the air-raids, the "battle on Königsberg" and the Soviet cleansing of German remnants. Apart from such "soft" issues Germany signals Russia to address its concerns and suggestions, may it regard EU enlargement, transit, border issues or minorities in the Baltic States, if necessary at all to the appropriate EU structures, but not to bother Germany. Although Germany constantly confirms the Russian stance that Kaliningrad's future is a matter of Russian responsibility, it encourages efforts to make Kaliningrad more business-friendly and to adjust to European standards. However, expectations regarding reforms such as improvement of administrative capacities, rule of law, fight against crime and corruption, simplified border procedures and taxing-laws, or protection of property rights are directed to the Russian Federation in general and have not been particularly voiced as regards the Kaliningrad oblast.

3.3. Sweden: Creating a security community

Sweden commits itself rather actively, carefree and pragmatically in Kaliningrad affairs. It regards the Oblast being a direct neighbor to its southern regions, just as Poland and the Baltic States. Kaliningrad is far from being marginal to Sweden. It is perceived as providing a functional opportunity for Sweden to continue with its independent foreign and security policy which is based on the adaptation of Sweden's long-standing neutrality to the conditions of the post-cold war era. Apart from Sweden's strong commitment to global peace, the current concept of neutrality is based on two pillars: firstly, active participation in Western security structures, in particular within the EU and also NATO's Partnership for Peace Program (PFP) included, but short of military integration, and secondly, promoting independently from these structures common security, based on Baltic Sea co-operation. The latter includes a strengthening of bi-lateral co-operation with all littoral states, support for EU-membership of Poland and the Baltic States, intensified regional co-operation, broadening of the activities within the PFP, and as well, fostering integration of Russia into the European structures and institutions. The approach is not meant for isolating from the rest of Europe. EU-membership and Baltic Sea co-operation are perceived as overlapping parts of a European security architecture which complement each other.

Sweden regards its policy as being beneficial also to its neighbors and aims at motivating other littoral states to join in. Nevertheless, by most other countries the concept of neutrality is traditionally received with reservations. Sweden is challenged by doubts whether it is reliable, trustworthy and up-to-date when sticking to neutrality. Consequently, a first task for Sweden is to built trust in its reliability among its Nordic and Baltic Sea neighbors. Because the Swedish constituency is highly polarized on the country's EU membership, the Swedish government has, secondly, to demonstrate to its own people, that it can impact the EU according to Swedish priorities (soft and human security, including ecology, gender, social welfare). Thirdly, Sweden is under pressure to give proof of its ability to serve the EU's interest also when remaining a neutral country. And fourthly, Sweden has to convince Russia of being welcome as a participant in Baltic Sea co-operation despite of Sweden's own integration into Western structures.

The Swedish policy towards Kaliningrad is subordinated to this multi-faceted challenge. In some way Kaliningrad is a kind of acid test for Sweden as regards its capability to provide regional stability and security by participating as a neutral country in Western structures and by promoting a policy of regional co-operation.

Within the EU context Sweden focused on bridge-building and lifting Kaliningrad onto the agenda. In the course of its EU presidency in the first half of 2001 Sweden sought for opening new schemes of co-operation with Russia following the idea to prevent a deepening of the welfare-gap between Russia's north-western regions and the Baltic Sea neighbors and thus the emergence of new dividing lines. Kaliningrad was given a priority because it is small and isolated enough for demonstrating – not at least to the Swedish constituency – that Sweden can impact Russia *and* the EU in line with Swedish values. When Prime Minister Persson in December 2000 introduced Kaliningrad as a priority for the Swedish presidency he stated: "It is possible for us to do something." The presidency working plan itself announced that "the Presidency will seek to arrive at a common view within the EU on Kaliningrad, on areas where EU-Russia co-operation could be encouraged and on an appropriate follow-up." The Swedish presidency was successful in the sense that it marked the take-off of the EU-Russia dialogue on Kaliningrad. Only since then the future of the Oblast has been on the agenda of the Commission and the Council. Against earlier Russian objections the late Swedish Foreign Minister Anna Lindh visited Kaliningrad together with EU-Commissioner Chris Patten,

encouraged Moscow to deal with Kaliningrad internationally and to allow the representatives of the Oblast to participate in the EU-Russia dialogue on Kaliningrad.

Despite its commitment to Kaliningrad as a part of Russia the Swedish government has always been clear on not allowing Russia to play the Kaliningrad card against the Baltic States. Sweden had frankly indicated that it would not place bridge-building towards Russia prior to their interests. Because Sweden is not in the position to guarantee by its own the independence of the Baltic States, and as it does not want to become drawn into Baltic-Russian rivalry, the EU is regarded to be the appropriate security provider for them. Thus, Sweden was on the forefront of promoting accession to the EU of Poland and the Baltic States.

Mediating the interests of Russia with those of the Baltic States is no prime matter of Sweden's EU-policy. The Swedish assumption is that a balancing of interests can more likely be achieved by the networking structures of Baltic Sea co-operation. Unlike Germany, Sweden regards the regional structures of co-operation not as a duplication of EU structures, but as a bottom-up supplement within and beyond the EU. Sweden aims at bringing Kaliningrad into this stability producing network of regular and numerous face-to-face contacts and projects run by a multitude of actors in a broad range of subject areas. The mission statement for the recently established Swedish Consulate General in Kaliningrad explicitly calls for supporting a far-reaching involvement of the Kaliningrad region in Baltic Sea co-operation.

The Swedish contribution to this strategy of building security with Russia extends from co-operation among Swedish and Russian military defence structures (including the Baltic Fleet in Kaliningrad) to soft security issues such as technical support for police forces, maritime safety, disaster management, SAR activities and, of course, environmental protection. Furthermore, the focus is on improving regional and local capacities for problem-solving, on development of local democracy, the institutions of health care and social security as well as civil society. In particular the regions and municipalities of Southern Sweden have become active in twinning with Kaliningrad partners. In the Swedish understanding, security policy includes as well enhancing societal stability by economic development. Thus, Sweden aims at enhancing the competencies of the Kaliningrad business community and at motivating local actors by encouraging visions such as a Kaliningrad that functions as a bridge between the

wealthy Europe of the EU and a developing Russia proper. The promise is, that if Kaliningrad opens to the international environment and better integrates to the Baltic Sea region, it will more easily attract foreign investment.

Most Swedish sub-state and civil society based Kaliningrad activities are directly or indirectly supported by the Swedish government. The Foreign Ministry runs a program "Developing a Security Community" and the Swedish International Development Agency is quite active with respect to Kaliningrad. Furthermore, it is noteworthy that Sweden more than any other country does not only support bilateral projects, but as well – and fully in line with its aim of establishing a security community – multilateral activities and dialogue on Kaliningrad. Consequently, it encourages international expert-meetings and Swedish diplomats use to participate in dialogue-oriented fora more frequently and listen more intensively than diplomats from other Western countries do.

Expectations towards Russia: Sweden invited all littoral states to participate in creating a security community and thus would like to see stronger commitments and participation from all, Russia being no exception, but the particularly important addressee. Against the background that the Swedish neutrality meets reservations by most of its EU partners whilst at the same time Swedish EU membership is heavily disputed in the country itself, Swedish politics could surely need a Russian response which allows for making the success of the approach better visible. Sweden's search for intensified co-operation with and on Kaliningrad was generally positively received in the oblast, however, reservations must exist in the Federal Centre and caused disappointments on the Swedish side. When Sweden hoped the Nordic Council could open a Nordic information office in Kaliningrad Russian authorities did not respond. Also it took years to get hold of all permissions necessary for establishing the Swedish Consulate General in Kaliningrad. Furthermore, in the Swedish conceptualization progress with respect to Kaliningrad needs a friendly political climate in throughout all of the Baltic Sea region, the relations between the Baltic States and Russia included. Consequently, Sweden expects of Russia to be wise enough not to offend the Balts. Due to the domestic background and EU obligations Swedish politics would then clearly have to back the Baltic States against Russia.

3.4. Finland: Europeanizing Russia

Mostly together with Sweden, Denmark and Nordic financial institutions, Finland provided technical and financial assistance to a number of Kaliningrad-related projects. They primarily dealt with issues of soft and human security, i.e. HIV-epidemic, environment, energy, education and training. However, Finnish direct involvement in the Kaliningrad region has been modest compared to the Russian regions in the immediate vicinity of Finland (Murmansk, Karelia, St. Petersburg, Leningrad Oblast). Finland's attention to Kaliningrad does not result from a particular interest in the Oblast. Kaliningrad counts because the issue is functional to the Finnish desire to take an active and fresh part in the EU's foreign and security policy towards Russia.

After the end of the Cold War Finland – like Sweden – continued with its policy of neutrality: combining military non-alignment with an active foreign policy, emphasizing Nordic cooperation, the OSCE and the UN. Nevertheless, the understanding of neutrality was changed considerably when embedding the Finnish foreign and security policy into Western collective structures. Different to Sweden with its strive for forming a regional security community, no major foreign policy line was established apart from these structures. Finland appreciates NATO as the very organization for providing military security in Europe and welcomes the US to be militarily committed to Europe. Furthermore, in 1995 Finland gained EU membership. The organization is appreciated for providing stability among its members and beyond, due to its economic and political potential. Consequently, Finland strongly supported the internal market including the European Monetary Union, the enlargement of the EU, and the developing of a value based common foreign policy. Finland regards itself as a country which brings added value to the EU's foreign policy ambitions particularly as regards the EU–Russia relationship. According to the Finnish view the country is determined to be a gateway to Russia for two reasons. Firstly, more than any other EU country it has own experience how to assert itself against "imperial" Russia and how to negotiate with it. Secondly, due to 1,300 kilometers of common border with Russia, Finland has a lot of experience in border management with Russia. The Finnish initiative from autumn 1997 to launch a Northern Dimension of the EU was an attempt to profile with these pounds within the EU's CFSP.

The ND, however, was received less enthusiastically as the country had wished. As Finland and the adjacent Russian borderlands are located in the periphery of Europe as well as of the

EU the area is far from attracting much attention in the centre. This is how and why Kaliningrad came into Finnish considerations. Finland learned that Kaliningrad oblast matters more than other Russian regions do, and that Kaliningrad provides a chance to the Finnish foreign policy ambitions to score points with its emphasis on the importance of cross-border regions. Different from the draft proposal for the ND, which did not mention Kaliningrad, a revised concept came into life in May 1999 that featured the Oblast in an own sub-section. Since then only, Finland has recognized emerging tensions and has considered a particular significance of the Oblast to Europe at large. For instance, in 2000 Rene Nyberg, then Head of the Finnish Foreign Ministry's Russia Division, repeatedly characterized Kaliningrad as being the "flashpoint of the Baltic Sea region", stressed that the question of transit was the "most likely issue to create tension" and emphasized that "the future of Kaliningrad concerns the whole of Europe".

Based on such assessment, Finland made the Kaliningrad case instrumental for profiling by a) offering its Russia-specific knowledge on border management to the EU, by b) introducing a concept of Europe that links peripheries to centers and by c) conceptualizing an approach on Russia which calls for it to "Europeanize":

a) Border management: Finland opposed making the Lithuanian and Polish borders with Russian Kaliningrad a particular case by applying any derogation from the Schengen acquis. It demanded that all acceding countries sharing a border with Russia adopt a border regime on par with its own. The demand was substantiated by pointing to the Finnish experiences with implementing the Schengen rules which had proved to be appropriate, flexible and secure. Similarly, Finnish politicians opposed the Russian quest for a visa-free regime because according to Finnish experience Russia was lacking the respective prerequisites.

b) Linking peripheries to centers: When Finland during its 1999 EU Presidency succeeded with getting the ND adopted as a part of the CFSP it had introduced as well an underlying philosophy that emphasizes cross-border political space and its multilateral networks as being a resource for bringing forward European integration. The ND is regarded an example how Finland as one of the smaller member states can contribute to the EU project of integration. Peripheries are linked via larger cross-border regions to the European centers. Thus, different from the Lithuanian attempt of co-operation with Kaliningrad, Finland pleads for an approach, which does not treat Kaliningrad isolated, but makes it a part of a comprehensive regional policy towards Russia.

c) Europeanizing Russia: After the dissolution of the Soviet Union Finland avoided taking the role of a facilitator assisting Russia in receiving a fair response from the EU. Finland did not want to listen too much to its Eastern neighbor as it was accused even with respect to the ND-Initiative by some Danish and Swedish parliamentarians, for instance. Instead, the Finnish idea is to entangle Russia to a process of "Europeanization" based on Western values and not allowing for any Russian otherness. Such orientation resulted from the revisionist discourse on neutrality which Finland had passed through and which placed the country into the West,

presumed Russia to be a potential threat and stipulates for Finns a particular role in a Western mission of civilizing Russia by supporting democratic change, market economy, civil society and Russia's adherence to common values. Thus, in the Finnish reading, as it underlies not least the ND, 'Europe' principally includes Russia and has to be open towards Russia, but at the same time stipulates that one can only be 'European' to the extent that one adheres to Western standards.

The idea of patronizing Russia through a regional approach is inscribed to Finnish statements on Kaliningrad such as the warning in March 2000 by the then Finnish Foreign Minister Tuomioja that Russia should take Kaliningrad as an opportunity to catch up with 'European' norms and standards because the otherwise emerging normative divide along Russia's borders with Estonia, Latvia, Lithuania and Poland will pose serious obstacles to economic co-operation and leave Russia running risk to falling back into fateful isolation. Another example is the way the Russian proposal on a pilot-region was received. Tuomioja responded several times to the proposal, however offered a Finnish interpretation of the term when reading it one-sided as expressing Russia's ability to put at test in Kaliningrad reforms with wide implications for the whole of Russia.

Expectations towards Russia: The shift in the Finish understanding of its neutrality may have come as a surprise to Russia, however there is no way to bypass this development. In some way Finland seems to pursue the most demanding approach towards Russian policy. The idea that Finland may teach Russia how to adopt to the EU values, norms and standards, however, has a bit the notion of an over-estimation of its possibilities. Anyway, Finland belongs to the group of those countries that believe Russia must fully adopt to EU values, norms and standards and should stop to lobby for exceptions. There is no space for Russia to claim any "Russian otherness". If Russia wants to be recognized as a member of the European family it must adopt, otherwise it remains in the off and risks destabilization. Russia should start the process of adaptation with its North-Western regions, including Kaliningrad.

3.5. The EU: Reaction, no pro-action

The EU is dealing with Kaliningrad primarily in the framework of its foreign policy towards Russia. However, conceptualizing this policy was and is a major challenge to the EU. Not only had the organization few experiences on the Soviet Union and the following Russian Federation and had unrealistic expectations regarding the Russian transformation process. The

differing attitudes towards Russia among the growing membership became increasingly politicized. Moreover, the idea of transferring to the community level further responsibilities in the field of foreign and security affairs has been disputed in the Union since the very beginning. When Russia became a test case for the Union's ambition of pursuing at all a Common Foreign and Security Policy (CFSP), the EU's internal problems with establishing a CFSP were more in the foreground than the situation in Russia. The Kaliningrad issue also became subordinated to the aim of unifying the member states policies towards Russia. Furthermore, Kaliningrad is considered to be only a comparatively marginal tessera within the much larger mosaic of EU-Russia relations, not in need of any special forum or proactive policy line being developed.

So far, the Northern Dimension (ND) remains the only CFSP instrument which explicitly mentions Kaliningrad and regards it – together with the Arctic region – to be in need of a particular approach. This early understanding was supported by the then Foreign Relations Commissioner, Chris Patten, who in 1999 offered the ND as an instrument to tackle with the unique situation of Kaliningrad and hoped it would work out for negotiating appropriate solutions for customs, transport and visa policies, an orientation well received by Russia. In practice the ND focused regional issues of North-West Russia. It addressed in the format of jointly conducted projects specific development gaps and sectoral issues, mainly of soft security notion. The fight against organized crime and integrated border management enjoys a priority as regards Kaliningrad. However, the 1999 Lithuanian-Russian Nida-Initiative for conducting in the ND-framework a range of joint projects failed to materialize and in general experts agree, that the ND fell behind initial expectations and did not live up to the once envisaged contentional scope. Nevertheless, the EU is working on a third Action Plan to be finalized in 2006.

The EU demonstrated a low interest in Kaliningrad affairs and tried to be concerned with the issue as little as possible. The EU chose to react only. It responded to emerging tensions, but never addressed Russia proactively. Already in the early 90ies, the European Parliament had tried to attract the EU's attention to the Oblast in order to prevent the risk of its isolation – however, in vain. The Commission and Council started to come in only several years later, after Russia in mid 1999 had floated a proposal to discuss the consequences of EU enlargement on Kaliningrad. This met the Union unprepared and by surprise. Even when Commissioner Patten in 2001 spoke about Kaliningrad being a part of an "arc of danger and

instability" that rings the EU and warned about a risk of Balkanization of the Baltic Sea cooperation, his worries were downplayed and he was brought back into line. The EU's attention to the Kaliningrad issue rose only to the intensity by which Russia in 2001/2002 took steps on the ladder of escalation as the enlargement came closer.

Apart from the desire not to complicate the emerging CFSP, one more reason for the reactive approach to the Kaliningrad issue is the EU's understanding of its enlargement project. According to this understanding enlargement is solely a matter within the EU and its relations to the candidates for accession. Third parties, how so ever affected by enlargement, should have no say at all. It had to be made sure that the Baltic States and Poland fully implement the acquis without allowing the process to be disturbed or slowed down by Russian reservations. Interventions by Russia against the introduction of strict visa requirements in the forerun of the accession of Poland and Lithuania to the EU were strongly rejected and qualified upon as being unreasonable and illegitimate. Even this issue was understood as a matter of the EU's and the candidate states internal affairs although the existing visa-free or visa-eased regimes were contract-based.

Despite of its partnership rhetoric, the EU's performance in Kaliningrad affairs was basically shaped by its strive to profile as a unified policy-maker, powerful enough to determine procedures, aims and solutions regarding the Kaliningrad issue, whilst Russia was degraded to be a policy-taker. This general approach was already marked quite clearly in the Commission's Communication "The EU and Kaliningrad", issued in January 2001 and being the first publicly identifiable strategy paper on an EU policy on Kaliningrad. The Communication regards the terms of enlargement as a fait accompli. It maintains that enlargement will impact Kaliningrad positively and be an opportunity for its economic development. The Russian concerns are portrayed as being unreasonable, neglected or reinterpreted into secondary technical issues, but not considered in substance. However, the Communication also admits that in the course of enlargement some agreement between Russia and the EU is necessary with respect to some more technical matters and determines the bodies for respective technical negotiations. Furthermore, the EU several times offered its financial and consulting assistance to Russia as regards the development of Kaliningrad and financed respective projects.

A fair balance has to state that whenever Russia dramatized the situation (2002 transit of persons, 2004 transit of goods), the EU was flexible enough to compromise to a degree and at a stage still sufficient for bringing escalation to a halt. This includes that the EU convinced the Kaliningrad neighbors to accept the compromise and implement it. However, such crisis-driven consent-building had the price of contributing to an overall deterioration of EU-Russia relations on both sides.

Finally, when considering the EU in its role of establishing a degree of coherence among the member states which does not allow them to continue in the bad traditions of permanent rivalry and confrontation among the European states (the European peace-project), one may also point out, that the EU at least succeeded in avoiding more confrontational and less compromise-oriented orientations among its members and candidates to become effective. The EU represented, so to say, the average out of the diverse voices on the issue. Furthermore, it allowed Germany to delegate an issue uncomfortable for its national policy to the European level or introduced a non-provocative language by making sure that meanwhile it is constantly spoken about "the Russian Oblast Kaliningrad", "Kaliningrad a part of Russia" or similar phrases which link Kaliningrad with Russia. Thus, in a direct as well as a figurative sense the EU managed that as far as Kaliningrad is concerned it is indeed spoken "with one voice".

Expectations towards Russia: Due to its low interest in the Kaliningrad issue the EU somehow failed to articulate any concrete expectations towards Russia on the issue, apart from the appeal to stop with what was regarded an undue attempt to interfere into the enlargement process. Generally the EU would like to see more Russian commitment in carrying out projects with visible results in such soft security fields as environment, communicable disease and border control. The main expectations towards Russia are of a more general nature, however. Russia should not circumnavigate the EU by using bilateral channels and undermine the making of a CFSP, organized and coordinated in Brussels. The EU also wants Russia to accept the idea of EU expansion being benevolent and a chance for Russia and its exclave, and that a positive development needs little more than good will on behalf of Russia and a few technical provisions, but surely no political ones. The EU is definitely not interested in discussions that go beyond pragmatic issues, such as identities and related ideological matters. Furthermore, the EU is tired of Russian-Baltic quarrels, in particular with respect to the pending border agreements and the Russian complains over treatment of the Russian speaking

minorities in Estonia and Latvia. The EU would indeed like to see these Baltic-Russian disputes to be settled, being well aware that it is obliged to take the position of the Baltic States against Russia – as it had to happen in any other case of tensions between an EU member state and a non-member.

4. Conclusions: The need for increased responsiveness

Comparing the essential interests of the Russian Federation and the expectations it articulated on the one side with the policies, interests and expectations of the five foreign actors on the other side, the conclusion is rather obvious: Russia's attempts for seeking a positive response suffers from various factors, all of them being not easily to understand for a Russian audience.

1. It might be unjust, but Russia holds a negative record in all Western countries and as a matter of fact its image has worsened instead of improved during the recent years. The negative connotations of Russia range from being a threat (Lithuania), needing to become civilized (Finland), being a difficult partner (Germany / Sweden) to Russia being an unwilling counterpart (EU). The reasons why, relate only partially to the current Russian reality, some other are deeply rooted in history, some are caused by identity needs of Western countries. Nevertheless, the Chechen war, some violations of human rights, a lack of democracy and rule of law in Russia are a matter of legitimate concern on part of the abroad.
2. West-European actors agree in expecting of Russia to understand that their priority is with the security and sovereignty of the Baltic States. In case of tensions these small states count more than big Russia. If Kaliningrad is regarded as an important place, the reason is more that it borders EU-countries than because it is a part of Russia.
3. EU member states share the conviction that Russia should not be allowed to get a say on what is regarded to be an EU-internal matter, enlargement and candidates included. If problems emerge, e.g. regarding Kaliningrad, they shall by no means restrict the options for expansive integration of the EU and of the states willing to participate in the process.
4. Furthermore, Western actors do not accept, that their acting, enlargement again included, contributes to the emergence of any problems Russia might have with Kaliningrad. In Russia, this attitude is widely regarded ignorant and arrogant, an accusation that in turn is incomprehensible on the part of the EU and its member states. They perceive themselves to be by nature of the European peace project benevolent to Russia and its exclave as indicated besides else by generous offers of assistance for developing Kaliningrad.
5. Reciprocal loyalty is strong among EU-members and all agree that the worst to happen would be that Russia succeeded in undermining this loyalty. Notwithstanding, conflicting views exist also among the EU members, but the institutions and mechanisms of the EU seem to be able to channel and smoothen the diverging interests. This, however, also means that the margins of manoeuvre for the Kaliningrad policy of each actor are mutually restricted. Lithuania, for example, is pressing for speaking a stronger language to Russia and is warning against a Russia friendly attitude of Germany, but is itself continuously reminded by the EU to improve relations with Russia and not to fuel tensions on Kaliningrad. The Swedish attempt to include co-operation on and with

Kaliningrad to its concept of a Baltic Sea region security community is scarcely supported by the German Federal government and the Finns because it is perceived as bypassing the EU's attempts for a common foreign policy and as competing with the Finnish ambitions to profile through the ND. The Finnish ND-initiative however met the criticism of directing too much attention on Russia and remote regions and did hard in gaining sufficient EU support. Furthermore, it contradicts the Lithuanian concept of concentrating co-operation efforts on Kaliningrad, as compared to mainland Russia. Even EU members do hard in understanding how their interests are interwoven and it is far more difficult for an outsider like Russia.

The mechanisms described and the complexity of its internal relations often make the EU to appear inflexible and inefficient, however, provide at the same time a basis for its internal success: Indeed, none of the members can really win against the other, but at the same time, no one can really lose – and that counts. At the same time one may doubt whether the overall constellation meets the requirements for constructively managing asymmetric interdependence in the external relations and – in the case under consideration – to make Kaliningrad a place of enhanced EU-Russia co-operation.

Taking into account the determinants and expectations of the various actors outlined above and how they relate to each other, the question arises whether and where opportunities can be identified for widening the margins of manoeuvre and for blurring restrictions in the perspective of gradually and mutually increasing the degree of responsiveness in the Kaliningrad case. An answer shall be tried by investigating firstly into what each party primarily regards relevant and a legitimate matter of concern. Secondly, an answer calls for looking into the requirements for domestic backing of respective moves in the foreign policy context. Thirdly, possibilities for improving the common agenda with respect to contents and procedures seem to be crucial.

Recognition of relevance and concerns

For all foreign actors Kaliningrad is less important than for Russia. This holds even for Lithuania although there it is a highly securitized issue. It is relevant to Sweden as being a case for profiling its architecture of present neutrality. It is a matter of attention in Germany for historical reasons. It is somehow functional for Finland to bring added value to the EU's CFSP via the Northern Dimension. For the EU it is of low importance compared to the overall relations to big Russia. The EU's attention to Kaliningrad arises when Russia takes a step towards escalation. This however does hardly allow Russia to gain in terms of long-term co-operation, as it assigns to Russia the thankless role of being a troublemaker, spoiling the

anyhow difficult EU-Russia relationship. Or attention arises, when the issue can be used by foreign actors in a functional manner in order to satisfy their own priorities.

A Russian audience may regard the consequences to be unpleasant. Anyhow, if Russia wants to motivate its foreign counterparts to develop a more constructive approach towards the Russian problems with Kaliningrad and to be heard with its legitimate interest, it must consider not only its own but also their interests and respond to them. This would mean, for example, to let no opportunity pass by without reassuring Lithuania to be recognized as a sovereign state, even if this is felt superfluous. Russia can hardly adopt the Lithuanian reading of the past Soviet rule over the country. Differing views on a history mutually uploaded with emotions and interwoven with identity need a long term perspective to be bridged. However, symbolic gestures may count. Just as the EU does it by constantly mentioning also Russia when it refers to Kaliningrad, Russia could make it regular practice to add "independent" when ever speaking about Lithuania.

The Swedish concept of neutrality may sound strange to a nuclear power, in particular as it enjoys meager reputation among the majority of EU member-states. Sweden's motivation to raise attention within the EU on Russian concerns – and it has done this rather successfully during the Swedish presidency – depends on Russia respecting this approach and its contribution to Baltic Sea co-operation. Similarly, it would help Finland to give proof of its approach to regional co-operation not being naïve, but worthwhile, if Russia overcame much of its reservations against relevant segments of the ND, in particular the environmental component.

Positively one may mention that in the recent years Russia has considerably responded to the German wish for recognition of the cultural German heritage of the Kaliningrad Region. Unfortunately, the progress was rarely taken notice of by the other EU-members. As it is widely distrusted both countries, both should seek opportunities to increase transparency of their interactions and share their efforts with other European participants.

The most difficult challenge is to attract a stronger commitment of Brussels. Due to the specifics of the EU's political system, blockades are most likely to be strengthened by any unilateral top down approach via a bigger member state. For achieving change in the EU it is crucial to pay considerable attention to the smaller countries as well. Generally spoken, the

opportunity structure for change in Brussels will widen only, if Russia makes additional efforts to improve its relations with the Baltic States, Finland and Sweden in their capacity as EU members. As long as these countries do not lobby for making Kaliningrad a more prominent element in EU-Russia relations, Brussels will not feel obliged to overcome its reluctance.

However, the challenge is not solely on the Russian side. Particularly, the foreign actors did not respond appropriately to Russia's main concern, the perceived danger of the exclave drifting apart from Russia. So far, the issue was ignored, denied to exist at all, or only internally registered for then being tabooed. 'Don't touch upon it; we could offend Moscow or get trouble by being drawn into Russia's domestic politics.' Initially such down-playing conformed with the Russian understanding of Kaliningrad not being an item for an international agenda. However, when Russia changed this view and indicated that it would like to start a dialogue, the strategy of tabooing became outdated. Nevertheless, the EU and the Western actors in general continued to ignore the issue. Russian worries are not regarded to be serious, but declared to be unreasonable.

The EU and Germany repeatedly stressed that no government questions Russian rule over Kaliningrad, but it was neither somehow dealt with the ambiguous positions of the proponents of East Prussia in Germany, nor with those of the proponents of Minor Lithuania in Lithuania. Furthermore, that reading of international law which concludes that Kaliningrad is only de facto, but not de jure under Russian sovereignty was left uncommented, although (or because?) it is as well the position by the US. Anyhow, the current Russian concerns are indeed primarily not about foreign actors questioning Kaliningrad to be Russian, but about domestic developments, not least a result of the exclave location which exposes the Kaliningraders to strong foreign influence whilst weakening the exchanges with Russia proper. When the issue of secessionism becomes topical, it is usually downplayed by referring to opinion polls. Apart from the question whether these polls are trustworthy and how to read their results against a background of research literature on secessionism (a minority of six or eight per cent respondents which confess a secessionist attitude might very well make an impact if politicized respectively) such "response" fails to meet the point: What counts is not the probability of secessionism (which is anyway difficult to assess), but that the Russian concerns exist as a matter of fact. Thus, Western actors should first acknowledge that worries exist and focus on supporting a policy that makes secession in Kaliningrad less attractive, a

policy orientation which however first of all needs new efforts to dialogue on the very question.

Presenting policies at home

Misperceptions, feelings of threat and insecurity, obsolete identities and other expressions of challenged subjectivity will hardly become transformed into a more realistic rationale within one generation. They need a long term approach. The process, however, needs to be initiated before it can gain momentum. There are "don'ts" and "do's".

Values: Something went wrong with the European discourse on values. Many Russians feel that Western complaints are frequently used only as a pretext not to respond to Russian needs or that only vague and somehow arbitrary criteria exist. The lack of concepts on how, how fast and with which priorities Russia can and should adopt to common standards, norms and values or to what respect it even may contribute to them is evident. Some demands Russia sees itself faced by are contested as well in Western countries (nuclear energy, federalism vs. centralism), some being established there only since short and far from being fully implemented at the Nordic level by all EU member states (environment).

Due to a strong demand by the European public for value-oriented policies, the impetus to impose values on Russia will hardly disappear in the near future, neither will Russian criticism on it. However, some change seems to be possible. Exactly because values matter in Europe, they are subject to dispute. This should not be taken as a trouble, but as an incentive for dialogue, which unfortunately today is nearly absent. Therefore, it seems worthwhile to consider whether the next Finnish EU presidency could seek for achieving a supplement to the ND that focuses on methods and means to establish a forum for a differentiating dialogue on values and strategies for implementation.

Recognition of success: Democratic governments must present their policies to their constituencies and defend themselves against their domestic opponents. In substance, not in form, this is also true for a less democratic country like Russia. A considerable number of EU documents on Kaliningrad (e.g. the memo from July 2002) apply a rather ignorant and patronizing language and certainly do not support Putin's policy of Europeanization in gaining ground at home. A fairer and more sensible style of communication would be wholesome and

could better motivate the Russian side to improve its Kaliningrad policy – which, by the way, at balance shows a better record than it is spoken about in the West.

Presenting success at home was made anything but easy for the Russian President. The November 2002 compromise on the transit of persons was reached only after Putin's clue to take the EU by its rhetoric about freedom of movement and after he had sought support from the French President at a bilateral meeting in Sochi. Only then the EU became more flexible in its reading of the Schengen acquis and willing to allow for facilitated travel procedures which better fit the needs of the Kaliningrad case. In the end and according to the then presiding Danish Foreign Minister it took an extraordinary and most difficult approach "to reconcile the effectiveness of Schengen with Lithuanian sovereignty and Russian dignity." One is tempted to pose the question why the EU did not prevent the obvious escalation by applying a more proactive approach? It was warned early enough that the Russian concerns were serious and legitimate.

More and above, after the compromise was implemented, why did the EU fall back into apathy again and declared all problems were solved? Factually, even nowadays and one more Kaliningrad-related crisis later, many of them are still pending. The issues of transit of goods (transport tariffs, customs procedures, energy supplies etc.) came more prominent on the agenda in early 2004 in the context of the question whether or not Russia extends the Partnership and Co-operation Agreement unchanged to the new member states. The debates and disputes on the transit of goods issue are partially still ongoing. At present a question closely related to the problem of energy security for Kaliningrad puts strain on the relations between Russia and Germany on the one hand and Poland, Lithuania and the Ukraine on the other hand, after Germany and Russia agreed constructing a sea-bedded, instead of a land-routed gas pipeline between both countries. What is largely ignored in the present debate is the fact that the sea-bedded option came up on the Russian side also with respect to allowing for a Russia internal energy supply of Kaliningrad. The envisaged pipeline will connect not only Germany, but also Kaliningrad to the gas fields in Russia proper.

Improving the common agenda and procedures

Russia surprised the EU when it placed its concerns regarding the future of Kaliningrad on the EU-Russia agenda. It signaled the wish to negotiate on a "binding agreement" on Kaliningrad, it launched the idea of a pilot-region and it strived for establishing a particular body to

negotiate on Kaliningrad. None of the proposals was directed against the interests of the EU and member states, but none of them was received constructively or even rewarded. Of course, Russia should have been more precise regarding the contents and methods envisaged. However, each of the other actors could have encouraged such attempts by contributing own ideas. What happened was almost the contrary.

The Russian idea to negotiate on a "binding agreement" was never explored. It was generally rejected as being superfluous, empty regarding contents and too difficult to agree upon within the EU-structures. One may criticize the suggestion to be of defensive and legalistic nature, however, the opposite is surely true as regards the vision of a pilot-region. Nevertheless, this proposal was regarded as being bloomy and lacking substance. Finland was the only country which in some sense explicitly responded to it.

The Russian desire to find a new institutional frame for negotiations on Kaliningrad apart from the existing PCA-structures remained unheard as well, although EU-officials admit that the existing bodies operate only inefficiently due to the incompatible structures of the two political systems. Russian proposals for establishing Kaliningrad-specific negotiation bodies were constantly rejected by the EU, regardless of whether the Russian call was for a Special Working Group or for a High Level Group on Kaliningrad. It was argued by the EU that such bodies would only increase inefficiency. This point might be true in the EU's perspective, as Kaliningrad is marginal to the EU. Nevertheless, the reasoning is rather questionable from the Russian perspective in which Kaliningrad features high in terms of the Federation's integrity and the need for successful negotiations is – different from the EU – considerable. The issue of the negotiating forum may further serve as an example for how unclear communications between the two partners seem to be organized. Russia states that at the autumn 2004 summit Putin and his EU-counterpart Prodi had agreed on the High Level Group. The EU however insists on the interpretation that agreement was reached on establishing a Working Group on Cross-Border Co-operation in which it could be dealt also with Kaliningrad issues. The same had already happened with respect to the summit in autumn 2001 and the Special Working Group. What seems to be only a formalistic and therefore superfluous dispute, is in fact of high significance because it mirrors the difference in the political decision-making structures and cultures of Russia and the EU as well as the differing political priority both sides assign to the issue. In consequence, one has to conclude that the parties so far did not even manage to agree on the format for a continuous dialogue – not to speak about its contents.

Obviously, the Kaliningrad challenge is characterized by a constellation where disentanglement of the various interests and needs is not as easy as one might wish. Constructive co-operation appears to be hardly possible without fresh institutional arrangements that encourage the actors to better take into account the needs, priorities and perceptions of each other. Europe is in the position that a number of international organizations could provide the political instruments to cope with such an constellation. Unfortunately none of the parties are prepared to ask the OSCE, the Council of Europe or other to provide their good services. Thus, other channels will be necessary in order to break a path. Because political leaders hesitate, much burden will be on business and civil society actors, including the intelligentsia. They should of course keep on distance and remain critical as regards the Russian power structures. Such an attitude would not be in contradiction to the insight, that at the present stage of developments in Russia a continuation and stabilization of the current Westernizing course of Russian policy largely depends on a strong position of the President. Domestic support for his course will most probably decrease further, if the West continues with projecting its strength on Russia, trying to settle any issue on its own terms. Kaliningrad will not gain from such an attitude.

The role of Northern Dimension in developing cooperation between the European Union and Russia in Kaliningrad

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1. Introduction

Since 1999 the Kaliningrad *oblast* has enjoyed a prominent place on the bilateral EU–Russia agenda. At the EU–Russia summit in Helsinki in October Vladimir Putin – then still the Prime Minister of Russia – presented its European partners with Russia’s medium-term EU strategy (2000–2010). During the meeting Putin also brought up the idea how Russia envisaged that Kaliningrad could, in the future, become a special “pilot region” where closer forms of interaction, cooperation and even integration between the European Union and Russia could be experimented with.

Now well over five years later it is evident that the idea has largely failed to materialise. In fact, instead of becoming an unequivocal success story, since the Helsinki meeting the fortunes of Kaliningrad have fluctuated heavily on the EU–Russia agenda. Clearly the dynamic concerning the *oblast*’s role in the relations has been linked to the Union’s grand eastern enlargement, which was completed in May 2004: What was already Russia’s exclave became from the Union’s vantage point an enclave encircled from all fronts by new EU member states and the Baltic Sea.

This change has had repercussions on wider EU–Russia relations as well. As such, it was in 2002 that perhaps the lowest point was reached because of the row over the Kaliningrad transit. Although an agreement about facilitated travel documents was reached in the EU–Russia summit in November 2002, persistent tensions have remained over the issue,

especially when it comes to the transit of goods to and from Kaliningrad.³ By contrast, high points and successes concerning Kaliningrad in the EU–Russia context are much harder to identify. This is partly due to the fact that over the recent years the whole “strategic partnership” between Brussels and Moscow has experienced symptoms of systemic malaise where the at times enthusiastic rhetoric notwithstanding the parties have found it very difficult to take the actual concrete agenda forward.

Therefore, instead of becoming a pilot region with special significance, Kaliningrad has become another addition to the growing list of EU–Russia irritants. Perhaps symptomatically of this growing disillusionment with “Europe,” Russia itself has ceased the rhetoric about Kaliningrad as a special pilot region. Part of the reason for this state of affairs is undoubtedly found from the fact that during Putin’s two terms as the President of Russia, he has advocated and implemented policies aiming at the strengthening of the vertical authority of Moscow over the at times reckless autonomy of regions. As such, Kaliningrad can, due to its special geographic location alone, be seen as a veritable special case especially in the domestic politics of Russia and one where the drive for further regionalisation and integration with the European structures can be seen as being especially problematic.

As a reflection of these trends, the European Union has been equally slow in coming up with new ideas and initiatives concerning Kaliningrad. To a certain extent the lack of initiative is perhaps to be expected, after all the Union already has a full plate of its own with institutional restructuring, increasingly difficult future enlargements, new (eastern) neighbourhood policy, transatlantic relations and promoting a rule based international order, to name but a few of the most pressing current concerns. However, one initiative that can be identified is the Northern Dimension (ND) policy. This article takes a look at the initiative, which could be seen as having special role as a conduit for EU–Russia cooperation also and especially in the context of Kaliningrad. So far, however, the results have not been very promising. As the discussion below will reveal, the Northern Dimension has to a certain extent failed to live up to the original expectations and promise. What is more, the role of Kaliningrad has been fairly weak and inconsistent in the policy. This state of affairs could and should be improved in the future. The coinciding of the forthcoming Finnish EU presidency and the expiration of the current

³ See *Joint Statement on Transit between the Kaliningrad Region and the Rest of the Russian Federation*. Tenth EU–Russia Summit, Brussels, 11 November 2002. Available at http://europa.eu.int/comm/external_relations/russia/summit_11_02/js_kalin.htm, accessed 31 August 2005.

second Northern Dimension action plan at the end of 2006 is a window of opportunity for the rejuvenation of the policy concept as well as some fine-tuning concerning the role of Kaliningrad within it.

To be frank, many problems remain on the future path of the Northern Dimension, and not nearly all of them reside under Brussels' jurisdiction. First and foremost, it is Russia itself who must make up its mind concerning the future of regionalism in Russia in general and the role of Kaliningrad *oblast* in the Baltic Sea region and wider European integration in particular. Only then can the EU begin devising the appropriate policy responses in earnest. But before examining the specific role of Kaliningrad in the Northern Dimension, the initiative and its development and content merits to be discussed at length, as the constraints inherent in the initiative thus far are crucial in understanding the current and future limits of the policy also in the context of the Kaliningrad *oblast*.

2. The Northern Dimension of the European Union's policies

The term “northern dimension” appeared first during the Finnish and Swedish EU accession negotiations. Especially the Finnish team of negotiators used it in order to highlight the fact that with its northern enlargement the EU was about to have new member states with drastically different conditions compared to the central and western European ones. But the accession of Finland and Sweden had not only internal but also external repercussions for the Union: It brought the Union for the first time into direct physical contact with the still turbulent Russian Federation in the form of a 1300-kilometer Finnish–Russian border.

In September 1997 the Finnish Prime Minister Paavo Lipponen linked the thus far empty slogan with the Union's external relations. In a speech titled “The European Union needs a policy for the Northern Dimension” he argued that the Union and its member states share vital common interests in northern Europe and that those interests should translate into a new EU policy.⁴ Lipponen's approach to the initiative was quite ambitious, as he linked its role to making the Union a more effective global actor. Moreover, in a letter sent to the President of

⁴ Paavo Lipponen, *The European Union Needs a Policy for the Northern Dimension*. A speech to the “Barents Region Today” Conference, Rovaniemi, 15 September 1997.

the Commission Jacques Santer earlier the same year, Lipponen had already stressed the strategic qualities of the Northern Dimension, proposing that it “should define which are the economic, political and security interests of the Union in this area, especially in the long-term.”⁵

Geographically Lipponen’s original vision was rather Russia-centric, but it also included a wider interpretation of the reach of the initiative, including the United States and Canada. The main emphasis was, however, put to a host of different threats emanating mainly from the northwestern parts of Russia, such as the poor standard of the environment, including the burning question of nuclear safety. Another set of challenges was derived from the existence of one of the perhaps deepest welfare gaps in the world on the Finnish–Russian border: the fear of uncontrolled immigration together with the danger of rampant transmitting diseases, such as HIV and drug-resistant forms of tuberculosis. These threats were and indeed still are a legitimate source of concern, as the north-western parts of Russia, and the Kola Peninsula and the Kaliningrad region in particular, represent one of the most toxic and dangerous environmental hotspots on the planet.⁶

By no means was Lipponen’s speech only a list of hardship and obstacles. The “positive” side of the initiative was based on the idea that in the future the European Union will be increasingly dependent on imported energy and that the northwestern parts of Russia is a vast reserve of these resources. However, and in order to exploit these economic opportunities, the region would require an immense amount of investments in basic infrastructure, including oil and gas pipelines, rail and road connections, harbours, airports, border-crossing facilities as well as improved telecommunication systems. These are all things that, according to Lipponen, ND could help to provide.

As can be seen, the high level of ambition in the original thinking concerning the initiative is equally matched by the amount of challenges that the Northern Dimension should tackle. Therefore, it is somewhat surprising that the actual ways through which the initiative should

⁵ Paavo Lipponen, Letter from Paavo Lipponen to the President of the EU Commission, Jacques Santer, Helsinki, 14 April 1997, Prime Minister's Office, Ref. 97/1510, quoted in Nicola Catellani, *Short and Long-Term Dynamics in the EU's Northern Dimension*. COPRI Working Papers 41/2001.

⁶ These challenges have been analyzed in detail in Christer Pursiainen, with the assistance of Pekka Haavisto and Nikita Lomagin, *Soft security problems in Northwest Russia and their implications for the outside world. A framework for analysis and action*. Programme on the Northern Dimension of the CFSP/UIP Working Paper 31/2001.

deliver what had been envisaged were painted with a very broad brush. Lipponen's approach can be summed up as "no new money, no new institutions," as it explicitly made clear that benefits to be derived from ND would come from a better coordination of already existing policies and instruments instead. However, also this emphasis reflects the strategic undertone belying the initiative, as the means through which this was to be achieved, was through an identification of clear priorities for future actions.

After the speech, the initiative's ascension on the EU agenda was rather swift, sailing through the European Councils of Luxembourg (1997) and Cardiff (1998) and landing in Vienna in December 1998, where the Commission presented its views on the topic in the form of an interim report. In the report, much like in the prime minister Lipponen's original speech, the actual content of the Northern Dimension was described mainly as a list of negations, i.e. what it was not supposed to be: new institutions, more money or a new form of regionally based co-operation in northern Europe. Instead, a central notion was the "added value" that ND should bring, mainly through increased coordination of already existing actions in the North. The report also clarified the geographical scope of the initiative giving it a much more regional focus, as the global dimensions of the United States and Canada were excluded. Instead, the Northern Dimension would consist of EU member states together with the so-called partner countries, Estonia, Iceland, Latvia, Lithuania, Norway, Poland and Russia.⁷

The usefulness of the concept has been, however, hampered by the fact that despite prime minister Lipponen's original intentions, the Northern Dimension has not been devised along strategic lines where certain issue-areas would be given priority over others. Also the ways and the means by which the goals should be reached have remained largely un-defined. This is reflected especially well in the interim report which tended to remain a vague declaration as every problem, threat and remote economic prospect in the region were enumerated, while the concrete proposals for the realization of these goals were almost entirely neglected.

The Vienna European Council invited the Council to identify, on the basis of the Commission's interim report, guidelines for actions in "the relevant fields."⁸ In turn, the General Affairs Council in May 1999 set its own guidelines for the implementation of the

⁷ *A Northern Dimension for the Policies of the European Union*, COM(1998) 589, 25 November 1998. http://www.europa.eu.int/comm/external_relations/north_dim/doc/com1998_0589en.pdf, accessed 1 September 2005.

⁸ *Vienna European Council, Presidency Conclusions*, 11 and 12 December 1998.

Northern Dimension mainly along the earlier lines of the Commission, as the “added value” in the initiative would come solely from increased synergies resulting from a better coordination and complementarities of the Community and member state actions in northern Europe.⁹

The Cologne European Council in June 1999 noted the Council’s earlier guidelines and invited the partner countries to take part in the Foreign Ministers’ Conference on the Northern Dimension, which was to be arranged in Helsinki during the Finnish presidency in November the same year.¹⁰ Originally, making the ND more concrete with the Foreign Ministers’ Conference was supposed to be among the highlights of the Finnish presidency. Unfortunately the time, which so far had been on the Finns’ side, was turning against them, as the year preceding the presidency was an exceptionally unfortunate one for the initiative’s prospects.

First, the August 1998 financial and political crisis in Russia evaporated the European hopes for a rapid transformation of the Russian economy. Second, the war in Kosovo in the first half of 1999 turned the gaze of the European Union southwards at the time when it was just supposed to be locked into the North. And finally, the second war of Chechnya, which began in earnest in October 1999 managed to cripple the EU–Russia relations. Both the Northern Dimension and especially the Foreign Ministers’ Conference fell victim to all these three events and thus it is no surprise that in essence it failed to agree on almost anything substantively new other than that the Helsinki European Council should decide on drafting an action plan for the Northern Dimension.¹¹ Indeed, the Helsinki European Council did invite the Commission to prepare an action plan.¹²

3. The Action Plans

An important milestone for the Northern Dimension was reached in June 2000 when the Feira European Council adopted the first action plan. It was undeniably the final breakthrough for

⁹ See the *Conclusions of the 2186th Council meeting – General Affairs – Brussels, 31 May 1999, PRES/99/171.*

¹⁰ *Cologne European Council, Presidency Conclusions, 3 and 4 June 1999.*

¹¹ *Foreign Ministers’ Conference on the Northern Dimension, Conclusions of the Chair, 11 and 12 November 1999.* http://www.europa.eu.int/comm/external_relations/north_dim/conf/formin1/index.htm, accessed 1 September 2005.

¹² *Helsinki European Council, Presidency Conclusions, 10 and 11 December 1999.*

the initiative, as the existence of an action plan consolidated its place on the highly competitive EU agenda. But the content of the document represented also a source of disappointment and even disillusionment for the ND: By failing to develop a truly strategic approach to the concept and make it thus more concrete, the action plan fell short of the mark. What is more, in certain respects it actually managed to dilute some of the ambitious features to be found in the original Finnish approach.

The action plan, initially adopted for the years 2000–2003 is divided into two parts. The first, horizontal part, lays out the framework for the Northern Dimension. The main idea and limitation of the dimension is spelled out very clearly in the beginning where the action plan states that the added value is to be gained “through reinforced coordination and complementarity in EU and Member States’ programmes and enhanced collaboration between the countries in Northern Europe,” and that “the Northern Dimension is an on-going process without a specific budgetary appropriation.”¹³ Otherwise the horizontal part is almost identical to the earlier Commission report as it goes through the most important sectors in the initiative.

The role of the action plan in actually guiding the actions of the member states is put in a rather careful wording as the document is called as a “political recommendation to be taken into account by relevant actors whenever appropriate.”¹⁴ As a political obligation, this is of the weakest kind. Moreover, it is indeed in the realm of “relevant actors” that the biggest setbacks in terms of the content of the initiative have taken place. The role of the three most important regional councils, the Council of the Baltic Sea States (CBSS), the Barents Euro-Arctic Council (BEAC) and the Arctic Council (AC), which in the original initiative had a central role in the implementation of the Northern Dimension has been reduced to a vague wording, according to which they “may assume a significant role in consultation with the Council of the EU in identifying common interests of the Northern Dimension region.”¹⁵ The role of other, mainly sub-regional actors, such as the Nordic and the Baltic Councils of Ministers, has been reduced even further where they only “may also be consulted in

¹³ *Action Plan for the Northern Dimension with external and cross-border policies of the European Union 2000-2003*. 9401/00 (14 June 2000), I.1, I.6.
http://www.europa.eu.int/comm/external_relations/north_dim/ndap/06_00_en.pdf, accessed 1 September 2005.

¹⁴ *Ibid.*, I.5.

¹⁵ *Ibid.*, I.22.

accordance with EU internal rules and procedures when implementing the Action Plan.”¹⁶

The second, operational part of the action plan gives an in-depth account of the different sectors ranging from infrastructure and environment to public health and justice and home affairs.¹⁷ The list is once again quite exhaustive but the action plan fails to bring significant new “added value” in terms of clear priorities that would in turn easily yield concrete proposals or actions to be taken during the first four-year term. The shortcomings in the document have become even more visible in practice: the lack of clear priorities, unclear relationship between the Commission and the sub-regional players and adequate funding were all highlighted during the operation of the first action plan.¹⁸

Some of these shortcomings were addressed in the second plan (2004–2006), which was adopted by the Brussels European Council in October 2003.¹⁹ The second action plan sought to improve the focus by identifying five sectors – economy and infrastructure, social issues (including education, training and public health), environment, nuclear safety and natural resources, justice and home affairs, and cross-border cooperation – where clearer objectives and steps were needed.²⁰ The document also contained a new conceptual innovation, as subsidiarity was mentioned for the first time in the context of Northern Dimension.²¹ Although this can be seen as a sign of the Commission’s growing appreciation of the role of partner countries and sub-regional councils, it may also be a move to shift the burden of the ND’s implementation and financing to the regional level, and subsequently losing its problematical image of being the prime engine in the development of the policy. This would spell trouble for the entire region-building project in the north, as it could result in a decrease in overall EU interest and funding in the region. This would put the north-western regions of

¹⁶ *Ibid.*, 1.22.

¹⁷ All the sectors found in the action plan are energy, transport, telecommunication/information society, environment and natural resources, nuclear safety, public health, trade, business cooperation and investment promotion, human resources development and research, justice and home affairs, regional and cross-border cooperation and a special reference made to Kaliningrad (see more below).

¹⁸ Holger Moroff, “The EU’s Northern Soft Security Policy: Emergence and Effectiveness”. In Holger Moroff (ed.) *European Soft Security Policies – The Northern Dimension*. Programme on the Northern Dimension of the CFSP No. 17 (Helsinki and Berlin: The Finnish Institute of International Affairs and Institut für Europäische Politik, 2002), pp. 206–19.

¹⁹ *The Second Northern Dimension Action Plan, 2004-06*, available at http://www.europa.eu.int/comm/external_relations/north_dim/ndap/ap2.pdf, accessed 1 September 2005.

²⁰ It is too early to assess the significance of this innovation. At first sight, however, it would seem that the Commission has only coupled previously separate sectors into larger ones without improving the list of priorities as such.

²¹ *The Second Northern Dimension Action Plan*, p. 2.

Russia particularly in a precarious position, as they are largely dependent on Western funding for cross-border cooperation with the EU.²²

4. The problems in the current approach

The Commission's attempts at burden-sharing are understandable: the ND has proved to be a difficult policy to handle, for two reasons. First, the initiative has called for an unprecedented amount of coordination between previously separate pillars and programmes within the Union. This has not been an easy task, as the persistent problems in combining funding from, for example, the Tacis and Interreg programmes have shown.²³ Second, the ND's successful implementation requires a multi-level approach, in which actors external to the Union must play a significant role.²⁴ This has resulted in both internal and external complications. Internally, implementing the ND model in full would require that the partner countries as well as the regional councils were given a role in developing and agreeing the content of EU policies and strategies. But not all in the EU have approved of discussing policies with third parties before a unified EU stance has been reached.²⁵ Externally, the ND requires that the partners and a host of sub-regional actors are willing to be subordinated to the aims of the ND. But this would mean that they become for all means and purposes mere sub-contractors of an EU policy that has been adopted outside the region. In most cases, and especially in Russia, this has been out of the question.

Russia – the main and after the eastern enlargement virtually the only partner – has been another source of problems for the ND. Russia has not devised a coherent policy towards the ND and has not at any point articulated a clear set of priorities and objectives on the issue.²⁶ This has not, however, prevented the central government in Moscow from voicing its general

²² Natan M. Shklyar, "Russian Regions in Subregional Cooperation". In Renata Dwan and Oleksands Pavliuk (eds), *Building Security in the New States of Eurasia: Subregional Cooperation in the Former Soviet Space* (Armonk, NJ and New York: East-West Institute and M. E. Sharpe, 2000), p. 110.

²³ For more about these problems, see Moroff, "The EU's Northern Soft Security Policy", pp. 167–69.

²⁴ For more on multi-level implementation of the Northern Dimension, see Nicola Catellani, "The Multilevel Implementation of the Northern Dimension". In Hanna Ojanen (ed.), *The Northern Dimension: Fuel for the EU? Programme on the Northern Dimension of the CFSP No. 12* (Helsinki and Berlin: Finnish Institute of International Affairs and Institut für Europäische Politik, 2001).

²⁵ Hanna Ojanen, "The EU and Its 'Northern Dimension': An Actor in Search of a Policy, or a Policy in Search of an Actor?" *European Foreign Affairs Review*, vol. 5, no. 3, 2000, pp. 359–376, p. 373.

²⁶ Oksana Antonenko and Kathryn Pinnick, "Cross-Border Cooperation between Russia's Northwest and its Neighbours". In Kathryn Pinnick and Jill Dobson (eds) *Northwest Russia in the Baltic Sea Region* (The IISS Russian Regional Perspectives Journal for Foreign and Security Policy, Issue 1, 2002), p. 8.

dissatisfaction with the content of the initiative. Moscow has frequently complained that its priorities are flawed, with too much emphasis on soft security threats and not enough money being devoted to developing Russian infrastructure and industries, issues that for obvious reasons are not high on the EU's agenda.²⁷

But there is also a deeper problem. The EU's emphasis on fostering "positive mutual interdependence" and attempts at subordinating local activities under the ND framework are generally unwelcome in Russia. Instead of accepting limits to its autonomy by embracing interdependence with the EU, Russia seeks to preserve and maximise its sovereignty and freedom of manoeuvre.²⁸ The very logic of the ND is alien to Russian thinking about what kind of relationship is feasible with the EU.²⁹

The weak role of Russia's north-western regions has also caused complications. The effect that Russian regionalism has had on the ND must be examined against the backdrop of the internal struggle between the centre and the regions in Russia. The tumultuous events of the 1990s – when the very existence of the Federation seemed to be at risk – gave the regions a great degree of independence. As a consequence, the very concept of regionalism has had a negative ring to it in Moscow, where it is seen as uncontrolled and unwanted devolution due to the erosion of central power. There is a fear that regionalism could make secessionist conflicts more likely, especially on the outskirts of the Federation.³⁰ Russian President Vladimir Putin has emphasised the territorial integrity of the Federation, and strengthened the power of the centre over the regions.³¹ This has resulted in the regions often lacking the autonomy and resources to make a meaningful contribution to the ND.³²

²⁷ See speech by Viktor Hristenko at the International Forum for the Northern Dimension, Lappeenranta, 22 October 2001, at http://arcticcentre.urova.fi/pohjoinen_ulottuvuus/lapr_docs/O_Hristenko_EN.pdf, accessed 1 September 2005. For a more fuller account of Russian expectations vis-à-vis the ND, see Igor Ivanov, "Co-operation between the EU and Russia in the European North", in *Foreign Ministers' Conference on the Northern Dimension*.

²⁸ Dov Lynch, *Russia Faces Europe*, Chaillot Paper 60 (Paris: EU Institute for Security Studies, May 2003), pp. 14 and 58.

²⁹ For more about this issue, see Hiski Haukkala, "The EU and Russia: A Problematic 'Strategic Partnership'", in Dov Lynch (ed.), *EU–Russian Security Dimensions*, Occasional Paper 46 (Paris: EU Institute for Security Studies, August 2003); Lynch, *Russia Faces Europe*; and Marius Vahl, *Just Good Friends? The EU–Russian "Strategic Partnership" and the Northern Dimension*, CEPS Working Document 166, March 2001.

³⁰ Tair Tairov, "Turbulence in Russia and Border Cooperation". In Lassi Heininen and Gunnar Lassinantti (eds), *Security in the European North: From 'Hard' to 'Soft'* (Rovaniemi and Stockholm: Arctic Center, University of Rovaniemi and Olof Palme Center, 1999), pp. 172–73.

³¹ These reforms have been discussed in, for example, Peter Reddaway, "Will Putin Be Able to Consolidate Power?" *Post-Soviet Affairs*, vol. 17, no. 1, 2001, pp. 23–44; and Robert Sharlet, "Putin and the Politics of Law in Russia". *Post-Soviet Affairs*, vol. 17, no. 3, 2001, pp. 195–234.

³² Antonenko and Pinnick, "Cross-Border Cooperation between Russia's Northwest and Its Neighbours", pp. 8–9.

Despite Putin's efforts at internal consolidation, the final outcome of these reforms remains unclear. While regional leaders have nominally agreed to these changes, there is a gap between how the law is written and how it is implemented – or rather not implemented – on the regional level.³³ This does not necessarily yield positive results for the ND, as it does not empower the regions to take part in cooperation. Rather, it betrays the lack of rule of law that is endemic to the Russian system. This failing constitutes a source of chronic problems in the wider EU–Russia relationship as well.

There are other problems and obstacles on the regional level that have to be overcome. Some of them are a direct result of the backwardness that cooperation is supposed to surmount, such as the lack of basic infrastructure on the Russian side. These are deep asymmetries and structural problems, and these are likely to hinder cooperation well into the future. In addition, historical animosities, an abundance of bureaucracy and a chronic lack of reciprocal funding on the Russian side and differences in mindsets on both sides of the border have also made cooperation difficult.³⁴ In many cases, cooperation is dependent on funding provided by EU partners and, as a consequence, often more closely resembles development or even humanitarian aid than cooperation between equal partners.³⁵

5. The role of Kaliningrad in the Northern Dimension

The discussion above reveals how the EU has been put into a rather precarious position with regard to its Northern Dimension. The unclear situation in Russia has both hindered and cautioned against further engagement, especially on the regional level. This has led the EU to adopt an incremental and careful approach.³⁶ This has been reflected also in the status of Kaliningrad *oblast* in the Northern Dimension. For example, the Commission web pages on

³³ Sharlet, "Putin and the Politics of Law in Russia", p. 222.

³⁴ C. Brown-Humes, "Border Neighbours Build on Finnish–Russian Links". *Financial Times*, 18 August 2001. See also Tarja Cronberg, "Euregio Karelia: In Search of a Relevant Space for Action". In Lars Hedegaards and Bjarne Lindström (eds), *The NEBI Yearbook 2003: North European and Baltic Sea Integration* (Berlin: Springer, 2003).

³⁵ Hiski Haukkala, "Every Man for Himself? Russian Regionalism in a European Context". In Markku Kivinen and Katri Pynnöniemi (eds), *Beyond the Garden Ring: Dimensions of Russian Regionalism* (Helsinki: Kikumora Publications, 2002), p. 134.

³⁶ *Ibid.*, pp. 139–40.

Kaliningrad open with a sentence: “Kaliningrad is part of the Russian Federation and responsibility for its future development lies with the Russian authorities.”³⁷

This careful stance has been reflected in the official ND documents which betray a similar careful and underdeveloped line on Kaliningrad. For example, the 41-pages long first action plan mentions Kaliningrad altogether only fourteen times without elaborating any concrete agenda for the region. Often, the *oblast* is mentioned in passing in the context of wider EU–Russia cooperation, such as the fight against organised crime, where “bilateral and common measures will be co-ordinated to promote further cooperation with those Russian regions that are of special interest to the Union, such as north-west Russia including Kaliningrad.”³⁸ The closest thing to a concrete proposal is to be found at the end of the document, when “an EU study on the prospects of the Kaliningrad oblast, the support already provided to the region and the possible steps to further promote co-operation between Russia and the enlarging EU *could* be considered.”³⁹ Such a study was indeed commissioned and prepared in 2001 but with mainly equally vague conclusions and proposals, as the main suggestions of the document consist mainly of things to be “studied” or “discussed” further.⁴⁰

By contrast, the 44-page second action plan refers to Kaliningrad 36 times. Moreover, Kaliningrad is identified as a special “cross-cutting theme” together with the Arctic region, which means that the issue has been “main-streamed” within each key priority areas within the action plan.⁴¹ Although the document develops some concrete themes for cooperation, such as development of border-crossing and the fight against organised crime, once again, the actual concrete measures are to be found mainly wanting.

During the last few years, Kaliningrad has not been without a dynamism of its own. Since 1999 it has experienced fairly robust economic growth that has been well above the Russian averages⁴². The *oblast* has also managed to attract promising amounts of foreign direct

³⁷ Available at http://europa.eu.int/comm/external_relations/north_dim/kalin/index.htm, accessed 31 August 2005.

³⁸ *Action Plan for the Northern Dimension with external and cross-border policies of the European Union 2000-2003*, p. 6.

³⁹ *Ibid.*, p. 38. Emphasis added.

⁴⁰ *The EU and Kaliningrad*. A Communication from the Commission to the Council. COM(2001) 26 final, Brussels, 17 January 2001, pp. 10–11, at http://europa.eu.int/comm/external_relations/north_dim/doc/com2001_0026en01.pdf, accessed 31 August 2005.

⁴¹ *The Second Northern Dimension Action Plan*, p. 13.

⁴² See the other contributions in this volume.

investments, as exemplified by the German car maker BMW that has opened an assembly line with the help of local partners.⁴³

Regardless of these positive tendencies, the current situation remains far from satisfactory. The *oblast* is in continued danger of lagging increasingly behind its Baltic and Polish neighbours, which enjoy from the full economic and political fruits of joining the European Union. Also the other challenges facing Kaliningrad are real and pressing. On one hand, they relate to access transport and power networks and grids in the region. For all means and purposes, Kaliningrad remains largely separated from the transport and other networks in the Baltic Sea region.⁴⁴ This has repercussions not only on the movement and travel of ordinary Kaliningraders but also on the future economic development and potential of the *oblast*. On the other hand also soft security challenges remain prominent in Kaliningrad. They include organised crime, especially smuggling, communicable diseases and serious environmental concerns. Finally, the region is not entirely void of military significance, either, as it still remains the host to Russia's Baltic fleet.

In light of these challenges, it is hardly a surprise that the Northern Dimension has not been the only instrument through which the EU has sought to engage the Kaliningrad *oblast*. The Tacis programme is another, closely related instrument and the Commission has opened a Tacis support office in Kaliningrad city. But to be frank, the economic assistance in total flowing from the Union has been fairly insignificant compared to the needs of the region enumerated above. All in all, since 1991 some €40 million has been chanelled via the Tacis to the development of Kaliningrad: Some €10 million has been earmarked for the development of the Free Economic Zone/ Special Economic Zone (FEZ/SEZ) in the region with additional support going to enterprise restructuring, human resource development and the promotion of small and medium-sized enterprises in the *oblast*. Other sectors of cooperation include border management, port development, environment, and health and education.⁴⁵

⁴³ See

http://www.bmwgroup.com/e/nav/index.html?http://www.bmwgroup.com/e/0_0_www_bmwgroup_com/untern_ahmen/unternehmensprofil/standorte/standorte.shtml, accessed 5 September 2005.

⁴⁴ These issues have been discussed, for example, in Stephen Dewar, "Kaliningrad: Key Economic Issues". In James Baxendale, Stephen Dewar and David Gowan (eds), *The EU & Kaliningrad: Kaliningrad and the Impact of EU Enlargement* (London: Federal Trust, 2000).

⁴⁵ http://europa.eu.int/comm/external_relations/north_dim/kalin/index.htm.

Summing up, to date the European Union's policy on Kaliningrad has remained largely scattered and underfunded. However, and as has been argued above, this has only partially been the Union's own doing as the main party concerning the development of the *oblast*, the Russian Federation, has been slow and inconsistent in its own approach concerning the region. Nevertheless, the approach of the next Northern Dimension action plan from 2007 onwards could offer the Union with an opportunity to re-engage Russia also in the context of Kaliningrad.

6. Conclusions

The Northern Dimension has proven to be a problematic initiative. This has been equally true for both the European Union and Russia. For the Union, the initiative has posed internal difficulties in combining different policies and financial instruments under the new umbrella concept. For Russia, the initiative has been difficult to wholeheartedly embrace due to the perceived and unwanted bias towards too much environmental problems and the external expectation of increased regionalism within Russia. Therefore, despite its original promise, and notwithstanding the vast potential of and dire need for, cross-border cooperation in the North, the actual results have been slow in coming.

Despite the many challenges, the Northern Dimension can nevertheless be seen as having significant potential in the future. Utilising it, however, requires that the present shortcomings are addressed and overcome. The coinciding of the expiration of the current action plan and the Finnish EU presidency at the end of 2006 offers a window of opportunity for the rejuvenation of the initiative.

Kickstarting the Northern Dimension requires modifications both within the Union and outside of it. Internally, the Union should seek a more wide-ranging consensus on the importance of the initiative. It is here where the role of Kaliningrad could come to the fore, as giving more attention to the *oblast* could alleviate the internal problems the initiative has faced in the Union. All of the Baltic Sea littoral states have an interest in the future

development of Kaliningrad and want to avoid a situation where they are faced with an enclave of desperation among their community of prosperity.⁴⁶

Also Moscow seems to be increasingly aware of the dangers of leaving the *oblast* to fend for itself. But it has been clearly unwilling to develop the concept of “pilot region” any further. As such, the Northern Dimension’s low political and functional approach could offer an avenue through which concrete cooperation and badly needed EU–Russia success stories could be developed. This approach would also help the partners to escape from the overambitious yet vague notion of a “pilot region” that has clearly made both parties more uncomfortable than excited.

Achieving these gains will neither be easy nor automatic. On both sides of the EU–Russia border political choices must be made. The EU must become more responsive to its partner’s needs while also developing the Northern Dimension internally along more concentrated and coordinated lines. Russia must, firstly, become seriously engaged with the initiative and, secondly, be more willing to experiment with forms of regionalism that are more compatible with the EU’s modes of operation than the present ones. Crucially, in the end of the day the ball is on Russia’s hands. It is on one hand Moscow and on the other Kaliningrad itself that have take the decisions concerning their role in the Northern Dimension and wider European integration. Therefore the Union does have a point when it insists that “Kaliningrad is part of the Russian Federation and responsibility for its future development lies with the Russian authorities.”

⁴⁶ The External Relations Commissioner Chris Patten went in 2001 as far as calling Kaliningrad a “hell-hole enclave.” See Chris Patten, “Russia’s hell-hole enclave.” *Guardian Unlimited*, 7 April 2001. Available at <http://www.guardian.co.uk/Archive/Article/0,4273,4166918,00.html>, accessed 5 September 2005.

The enclave-specific vulnerability of Kaliningrad

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1. Introduction

Kaliningrad has been swinging up and down on the Russian mountains from its birth as an exclave in 1991. The region is detached from the mainland Russia and geographically included in the European Union while remaining under the Russian sovereignty. The Kaliningrad's position makes it vulnerable. The region is exposed to continuous shocks caused both by the changes in the Russian politics and in the EU-Russian relations. The paper analyses the problem of Kaliningrad's political and economic vulnerability mainly from the viewpoint of the theory of enclaves and exclaves, in particular in the framework of the mainland-enclave-surrounding state triangle. The principal questions are on the nature of Kaliningrad's vulnerability, its sources and the ways to deal with it.

In the beginning, let us define the terms used throughout the paper to avoid ambiguity. *Enclave* is a part of the territory of a state that is enclosed within the territory of another state. Conversely, an *exclave* is an isolated part of a state that is surrounded by the territory of another state or states. An exclave can possess access to sea. It can also be surrounded by more than one state. The decisive criterion is its separation from the respective mainland. It is crucial to understand that any enclave is simultaneously an exclave, but not every exclave is an enclave as it can be surrounded by more than one state as Nakhichevan or Kaliningrad are. For the state that surrounds an enclave/exclave, the term '*surrounding state*' will be normally used. The state of which an enclave/exclave makes a part of is called a '*mainland state*'. For those enclaves that are entirely enclosed within the surrounding state, the term '*true enclave*' is utilized. In contrast, a *semi-enclave* is a part of a state enclosed within the land territory of another state, yet in possession of a sea border (that is, not fully surrounded). The enclaves of this type are also called '*coastal enclaves*' both to distinguish them from true enclaves and to

incorporate the availability of sea access (see Vinokurov 2004b for more details). There exist at least 283 enclaves and exclaves in the world, of which 256 are true enclaves.

Is the term ‘exclave’ necessary since we already have the term ‘enclave’? I believe it is for the following reasons. First of all, it corresponds to the notion of exclavity, stressing the region’s detachness, in contrast to the notion of enclavity that concerns the region’s embeddedness in the surrounding state. Therefore, it is useful for understanding the nature of the enclave in the triangle mainland state – enclave – surrounding state. Second, there are so-called ‘*mere exclaves*’. Mere exclaves are such regions that, while being isolated from their mainland, are surrounded by more than one state. Thus, they are not enclaves in relation to other states but merely exclaves in relation to the mainland. The enclave-specific problems stemming from embeddedness in a single state can be lacking in such cases (although not necessarily) but the exclave issues caused by the isolation from the respective mainlands remain. An interesting case in this respect is Kaliningrad. It has to do with the specific nature of the European Union. Kaliningrad can be technically described as a mere exclave since it is surrounded by two states, Poland and Lithuania. On the other hand, both states are the members of the European Union so it is quite possible to say that Kaliningrad is a semi-enclave of the EU. This view is reinforced by the fact that the enclave-specific issues of the movement of people and goods etc. lie within the competence of the EU. In general, this term is logically forceful when looking from the mainland’s side.

The paper proceeds with the following outline. Having reviewed the existing literature, it starts with the elaboration of the analytical framework of the mainland-enclave-surrounding state triangle. The problems of economy and access are viewed within this framework as intrinsic and enclave-specific issues. This is followed by the analysis of how the vulnerability can be mitigated. The paper comes to the following conclusions: first, Kaliningrad’s vulnerability is intrinsically connected to its enclave/exclave status; second, the issue should be viewed in the context of the relations between the mainland, the surrounding state, and the enclave itself; and, third, the enclave-specific vulnerability can be diminished through a process of integration of the mainland and the surrounding states.

2. Literature review

Enclaves and exclaves remain an underresearched area. The available scientific literature occupies itself mostly with studying separate enclave regions, making a very few attempts to do comparative studies or to come up with a theory concerning multiple aspects of enclaves' life. However, several authors made remarks on enclaves' political and economic uncertainty. Robinson (1959: 291) notices in his seminal article that it is normal for an exclave to be tied to the home country not only politically but economically as well. This calls for efficient communication between the two, whether by a corridor or by agreement. Nevertheless, there are several enclaves that have followed the opposite line of development and have become economically assimilated to their neighbors (i.e. German Büsingen and the United States' Point Roberts).

Raton (1958) elaborates on the problem of transit noticing that the transit of passengers and cargo is the most important issue for an enclave. The ultimate importance of the issue is caused by the smallness of the enclaves that does not allow them being self-sufficient. The blockage of an enclave by the surrounding state may cause severe disruption of life subsistence as well as the proper governance. It may well ruin the economy, too. Catudal predicts inevitable tensions stemming from 'the exclave problem' that, in his opinion, consists in the conflicting desires of the mainland state, which wants to maintain normal communication and administration of the enclave, and of the surrounding state, which wants to include the enclave within the purview of its economic and civil administration (1979: 2). In the recent time, the most important contributions belonged to Brendan Whyte (2002) and Susanne Nies (2003a: 398-402, 2003b: 116-120). Nies enumerates the following fields of uncertainty that are typical to the enclaves. First, the uncertainty of access. Second, classical fields of internal policy, such as transportation, post, medical services or education, are often transformed into the problems of foreign politics by the mere existence of an enclave. The central government does not always conceive the problems of its detached territory clearly. However, the former has to deal with them on the level of foreign politics. The constant fear of losing an exclave on the side of the state further complicates the governance of an enclave. Third, the political and economic uncertainty and the long transit routes as factors contribute to the economic complexity of an enclave situation. There is also a phenomenon of the re-orientation of trade flows from the mainland to the surrounding states, which can effectuate a

political danger of the weakening ties between the exclave and the mainland. Fourth, the uncertainty on the future prospects of an enclave causes low immigration and high migration, leaving an enclave with a senescent population.

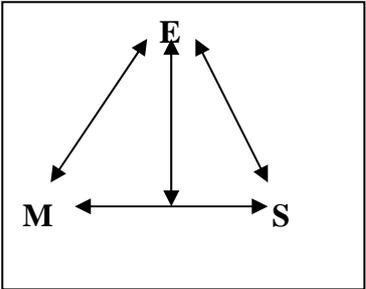
There exists a vast body of literature on the Kaliningrad Region. The problem of uncertainty and vulnerability is treated primarily in the economic context and geopolitical contexts. Wellmann (2000) and the papers collected in Baxendale, Dewar, and Gowan (2000) represented early attempts to place in the context of the EU-Russian relations in terms of hard and soft security. Smorodinskaya (2001) and Smorodinskaya, Zhukov (2003) contributed to the understanding of the economic vulnerability of the region, based on its worrisome dependence on the preferences of the Special Economic Zone (SEZ). Bilchak, Samson, Fedorov, (2000), Samson et al. (2000), the Kiel international ad-hoc group of experts on Kaliningrad (2002) led by Alexey Ignatyev, Lamande, Vinokurov (2003), Samson, Lamande, Vinokurov (2004), and Vinokurov (2004a) search for the ways and means to create an industrial and trade specialization that would be more stable and sustainable in the long term. Klemeshev and Fedorov (2004) argue that the Russian Federation should undertake additional steps to ensure Kaliningrad's life support to prevent the danger of Kaliningrad turning into a depressive and isolated region surrounded by the developing European Union. Finally, Gareev, Zhdanov, and Fedorov (2005) conclude that the economic prospects might be favorable in case of a thoughtful Russian federal policy.

The common approach employed in the literature takes up Kaliningrad as an isolated case. The enclave is treated as a unique problem to be handled by Russia alone or by the EU and Russia together. In the light of the existing Kaliningrad-related literature, the purpose of the present paper is to utilize the framework of the theory of enclaves to acquire a new look at the nature of Kaliningrad's vulnerability. To do this, I analyze the political and economic aspects from the viewpoint of the two pivotal axes, the mainland-enclave and the mainland-surrounding state relations. The main conceptual tool is the mainland-enclave-surrounding state triangle.

3. Conceptual framework: the mainland-enclave-surrounding state triangle

Enclaves do not exist in a vacuum. They exist in an environment full of players and powers with sometimes similar but often contravening interests. The two powers that have most to do with an enclave are the mainland state and the surrounding state. These two sides and an enclave itself compose the mainland-enclave-surrounding triangle, which I will later refer to as the MES triangle. It will serve as the main conceptual framework for our exploration of enclaves.

Figure 1. The MES triangle.



Note: E – an enclave/exclave, M – a mainland state, S – a surrounding state.

The MES triangle is composed of four axes. These are, first, mainland-enclave relations; second, enclave-surrounding state relations; third, mainland – surrounding state relations on general issues; fourth, mainland –surrounding state relations on the enclave issue. The arrows comprising the triangle are double-sided. This reflects the mutual impact rendered by the parties. The impact is not necessarily of equal strength. It is but natural that the mainland exerts decisive impact upon enclaves’ fate and fortune. Likewise, the general context of the mainland-surrounding state relations is the context in which an enclave must find its place and to which it should adapt its vital activities. Further, the impact of the surrounding state’s economy and politics is immeasurably larger than the reverse side. Nevertheless, it is remarkable that, however small and insignificant an enclave is, it can exert a significant impact its mainland, the surrounding state, and the mainland-surrounding state bilateral relations in a variety of ways.

I will characterize the relations along all four axes:

1. Mainland-enclave (M-E) relations. From the point of view of the enclave, this is the most important axis that usually determines its politics and economics. Since the enclave is an inherent part of the mainland state, it is guided by the mainland's national politics and legal system. The mainland exerts powerful influence over the enclave and determines its economic and political regime. On the economic side, in particular, the mainland may or may not furnish the enclave with a special economic regime responding to the latter's specificity. On the political side, the mainland is often concerned about the issue of sovereignty over the enclave. This concern is likely to have serious implications on the policies employed by the mainland. For example, direct governance and some restriction of local democracy is likely to happen in order to ensure the mainland's full sovereignty. In other words, there are negative and positive stimuli for the mainland to assign heavier weight to the enclave that it would have deserved based on the sheer 'weight' of its population and territory. First, the central government in the mainland is in many cases worried of a potential secession of an enclave. This is the stimulus of negative nature for the mainland to care of the enclave. Second, there are certain strategic/military/geopolitical considerations that give enclaves more weight in the eyes of the central government. They form the positive stimuli. These two factors combined appear to have enough weight to determine the central government's wish to pay its price in order to hold the enclave and to use its strategic advantages. Often this price is giving the enclave certain economic privileges that are unthinkable for other regions on the mainland.

2. Enclave – surrounding state (E-S) relations. Despite the mainland being the decisive power from the enclave's perspective, the surrounding state is a pivotal actor that exerts a powerful impact on the enclave's affairs. This impact may be exerted actively and willingly or not. It is not to exclude that the surrounding state would want to exert active influence on the enclave considering the latter to be within its own sphere of political and economic interests. In doing this, the surrounding state is restricted by the fact that the enclave is under the foreign sovereignty and may normally rely on the support of the mainland. An enclave can be perceived as an annoying splitter in the body of the state or a 'stone in the shoe'. It may cause some military-strategic concerns due to its geographical location. It may cause also some economic problems based on the differences of legal regimes, the opportunities for smuggling, the costs for sustaining the proper border regimes, etc. Shall the surrounding state's policies be neutral or even benevolent, it nevertheless exerts powerful economic and political influence due to the very fact of surrounding the enclave.

3. Mainland – surrounding state (M-S) relations on general issues. Much of the enclave's well-being and order depends on the general state of the M-S relations. Shall the relations be disturbed, even for some matters not related to the enclave, the negative impact on enclave will tend to be significant. On the other hand, peaceful and friendly M-S relations create a positive political framework for the enclave. One step further, a deep and comprehensive integration between the mainland and the surrounding state is able to remove most of the enclave-specific problems altogether. At the same time, some of the economic opportunities – from smuggling to cross-border shopping – may be removed as well. The balance is however undoubtedly positive.

4. Mainland – surrounding state relation on the enclave issues. The fourth axis might not be as evident as the previous ones. However, it is of special importance. Just as any of the four axes, it composed of two sub-arrows. First, there are the M-S relations on the specific matters caused by the enclave's existence that have a profound impact on the latter. Second,

vice versa, it is an enclave that in turn can render a significant impact on the M-S relations. The fact that not only the nature of M-S relations influences an enclave but also an enclave (its mere existence and specific constellations, needs and events) can influence the M-S relations is of vital importance for understanding the enclaves' specifics. It helps reveal the role of enclaves in the bilateral relations of states as well as in the international politics of conflict and cooperation. Besides, it helps reconstruct the frameworks for a political and economic life of enclaves. On the other, already in national politics, enclaves are given unproportionate attention compared to their population and territorial weight. To a somewhat lesser degree, but still, the same is true for the external politics of the surrounding state. My idea is not that enclaves are simply "very important" but that, while being small, they weigh in international economy and especially politics disproportionately to the size of population and territory.

The impact of the enclave on the M-S relations appears to be often negative and almost never positive. If there exist any territorial claims over the enclave (like in the cases of Gibraltar, Ceuta and Melilla, Macau, Hong Kong, Mount Scopus, and several Armenian and Azerbaijani enclaves), the general S-M relations can worsen significantly, up to the point of a military conflict. If the enclave's belongingness is not disputed, there are several options, the positive impact of the enclaves on the M-S relations is theoretically possible (for instance, as a model region for economic and political cooperation or a connecting chain in the strained relations) but seldom and blurred in practice.

One might ask a clearly reasonable question: why do we restrain ourselves to the mainland and the surrounding state only within the framework of the MES triangle, leaving aside the rest of the world, its great powers and supranational organizations? The explanation lies in the remarkable feature of enclave politics and economics. The impact that the mainland, the surrounding state and their bilateral relations exert on the enclave far exceeds any possible impact of the rest of the world. The importance of the mainland and the surrounding state is thus decisive. Even if there is a certain influence, it is usually channeled through either the mainland or the surrounding state. The only noticeable exception was West Berlin - up to the point where one could say that it was an enclave of the Western bloc in the Eastern bloc (with the blocs assuming the roles of the mainland and the surrounding state). The sensitivity of the enclave issue within the triangle normally prevents outside powers from directly intervening. Consider Gibraltar. Its strategic location and fact that both Great Britain and Spain are members of the European Union and NATO have led to the situation when several influential actors (EU, NATO, UN, U.S.A.) share concernment over the Rock. Nevertheless, none of them intervenes directly, as they prefer to leave this thorny issue to the Anglo-Spanish bilateral relations. A similar situation exists around Ceuta and Melilla. As Spain is the

member of both NATO and the EU, it would be natural to expect for the enclaves to be “within” these organizations. However, it is only partially the case. Both enclaves are explicitly excluded off the defense responsibility of NATO, as the Alliance did not want to be involved on the African coast. Again, the disputed issue of belongingness of the enclaves is left to the bilateral relations of the mainland, Spain, and the surrounding state Morocco. As for the EU, Ceuta and Melilla, just like Gibraltar, form part of it, but the enclaves are not the part of the customs territory. They are not subjects to the Common Agricultural Policy nor the EU fisheries and trade policies, either. May be it is only the United Nations that have traditionally been active on the enclave issue, mostly in the context of colonialism, but, in most cases, their influence was restricted to multiplying resolutions and was not substantial as such.

4. Enclaves and conflicts in the MES triangle

It is not a coincidence that there are so many conflicts connected to the existence of the enclaves. Enclaves are potential conflict points. They can cause tensions between the mainland and the surrounding state that tend to escalate into the serious conflicts or even full-scale wars (for example, Gibraltar in the 1960s, the 1970s, and 1999; Cooch Behar in 1992; Portuguese Dadra and Nagar-Aveli in India in 1954; Nagorno Karabakh; West Berlin in 1948-49 and 1961; East Prussia). While analyzing the international conflicts around enclaves, it is important to understand that an enclave is formally not a party in a conflict (except the rare cases (East Pakistan in 1971; Cabinda since 1975) of an enclave struggling for independence). These are disputes between the surrounding state and the mainland caused by the existence of an enclave.

The conflicts over enclaves are of three types:

1. **Disputes of sovereignty.** The conflicts of this type arise when the surrounding state contests the mainland state’s sovereign rights over the enclave. The disputes of the first kind have the highest conflict potential.
2. **Conflicts over enclave-specific matters.** If the sovereignty of the mainland state is recognized by the surrounding state, tensions may nevertheless emerge on a smaller scale. The very existence and geographical location of an enclave may cause numerous problems that also tend to persist. If there had not been an enclave, the ground for the conflict would not have existed. The border settlement can take decades to complete while causing frictions between the mainland and the surrounding state. There is also a number of soft-security

issues, such as immigration, smuggling, enclave's acting as a haven for criminals, or pollution (that is, negative externalities). An enclave usually depends on the surrounding state in a multitude of ways: first, for access, second, economically (trade, export markets), and, third, for essential supplies (or transit of supplies) of food, water, electricity, waste disposal, etc. The surrounding state possesses powerful instruments with which it can easily apply pressure on the enclave. The Chinese recognized this situation early in the seventeenth century regarding Macau, as the officials governing the adjoining province said: 'the Macau's inhabitants depend on us for their daily rations. Should they have a single malicious thought, we can put a knife on their throats in no time' (Ptak, Haberzettl 1990: 13).

3. Representative, or substituting, conflicts form the third type. Conflicts and tensions around enclaves may substitute for a confrontation on a larger scale between the mainland and the surrounding state or between the blocs that they represent. Such conflict has normally something to do with the enclave; however, the real principal reason is to be found beyond that. By applying pressure at the enclave, the surrounding state can in fact aim at the mainland. This moment is important since the pressure applied at the enclave is often targeted not at the enclave dwellers themselves but at the mainland. For example, conflicts on the illegal immigration in Ceuta and Melilla serve as representative conflicts for the whole of the larger problem that exists in the relations of Spain and Morocco, or even between the EU and the Magreb countries. The blockade of West Berlin in 1948-49, the construction of the Wall in 1961, and the Bundestag sessions in West Berlin at the end of the 1960s had to do with the global East-West opposition.

5. Kaliningrad and the mainland-exclave communication: the vulnerability of access

Since the Russian sovereignty over the Kaliningrad Region does not form a matter of dispute, this conflict of the first kind mentioned earlier is not present currently and highly unlikely to be so in the future. A closer look at the EU-Russian relations does not allow revealing distinct traces of any major representative conflicts either. There were only minor incidents of that sort. For instance, Poland hardened the border regime with Kaliningrad unofficially after the Polish president was not invited to celebrate the 750th anniversary of Königsberg/Kaliningrad (which was at its turn probably caused by the cool Russian-Polish relations after the Orange revolution). At the same time, Kaliningrad stays in the focus of several enclave-specific conflicts and tensions. These are, first, the transit issue, which became the stumbling block in the EU-Russian relations in 2002-2003; second, the soft-security issues of illegal immigration and smuggling; and, third, the EU concerns over the negative externalities of pollution in the Baltic Sea. This paper treats only the first issue out of the three.

The problem of mainland-exclave communication, also shortly referred to as the problem of access or transit, is the central one on the mainland-exclave vector of the MES triangle. It is deeply rooted in the nature of an enclave, since the embeddedness in the surrounding state and its detachness from the mainland makes an enclave/exclave what it is. The communication has three vital components: first, the movement of goods and services; second, the movement of people; and, third, the movement of military and police forces as well as state officials.

As soon as an enclave emerges, it faces the problem of communication with the mainland. If the arrangements are made by the mainland and the surrounding state, the problem can be dealt with and mitigated at an early stage. As soon as an enclave emerges in the turmoil of international politics, tensions, and military conflicts, the problem can be severe from the very beginning. It comes as an additional shock and impedes the prospects of the economic and societal recovery. Specifically for Kaliningrad, the problem of access was mitigated by the visa-free regime with Lithuania and Poland in the 1990s. It came as a shock later on, as both states introduced visa regimes in 2003.

Is there any difference in the scope of the problem of access between various types of enclaves? Brendan Whyte comes up with the idea that the significance of one surrounding state lies in the ability of the enclave to negotiate access, and economic and political rights. If the enclave is surrounded by more than one state, it has increased leverage in such negotiations, while if it has only a single stubborn host state, it is totally at the host's mercy (Whyte 2002: 2). This explanation equals to the hypothesis that can be generalized and formulated as the following: *ceteris paribus*, the problem of access is more severe in true enclaves surrounded by just one state than in other outliers, mere exclaves in particular. The experience of Kaliningrad and other enclaves and exclaves does not confirm this hypothesis. Kaliningrad is a mere exclave with access to sea: the region is sandwiched between Poland on the south and Lithuania on the north; besides, it has a convenient access to the Baltic sea on the west. Theoretically, there is a variety of ways for the communication with the Russian proper: land routes via Lithuania and Belarus, via Lithuania and Latvia, via Poland and Belarus; air transportation; and the maritime route to St. Petersburg. Despite the seemingly wide choice of options, the economic expediency largely narrows the choice to the route Kaliningrad-Lithuania-Belarus-Russian proper. All major railway tracks and roads as well as pipelines and power lines have been laid through Lithuania in the Soviet times so that an

access through Poland is not economically justified now. The possibility of sea connection with Saint Petersburg is largely devalued by economic logic as well. Since 80-90 per cent of inflows come from Central Russia, Volga region, and Siberia, while 80 per cent of Kaliningrad's outflows are heading for Central Russia (Vinokurov 2004a), St. Petersburg and North-West Russia are just minor trade partners for Kaliningrad. A ferry on the line Kaliningrad-St. Petersburg was opened due to political considerations. It is so far unprofitable and must be subsidized by the state. Businesses just do not use it since it is cheaper to use existing direct land links through Lithuania and Belarus. Therefore, despite the theoretically greatest possible latitude for choosing ways and routes to communicate with Russia proper, Russia had to fight hard for a special transit regime through Lithuania. The economic reasoning makes Kaliningrad a quasi true enclave as concerns communication with the mainland.

Let us turn to the transit agreements implemented for the passenger transit from the Kaliningrad region to the Russian mainland in 2003. These decisions led to the implementation of a special regime for the facilitated passenger transit through Lithuania. The decisions of 2004 for cargo transit, on the contrary, did not establish a specific legal regime for a corridor-like movement of goods through the Lithuanian territory. They rather confirmed that the Kaliningrad case fell under the general transit regulations of the EU.

Before 1 July 2003, transit via the territory of Lithuania was visa-free. Moreover, there was a special regulation for the residents of Kaliningrad allowing them to visit Lithuania itself visa-free. The Russian authorities have estimated that in 2001 the total number of crossings between Kaliningrad and the rest of Russia were 960,000 by train and 620,000 by car. By comparison, the population of Kaliningrad is about 955,000.

The "Joint Statement on Transit between the Kaliningrad Region and the Rest of the Russian Federation" was adopted at the 10th EU-Russia Summit in November 2002 (EU and Russia 2002). In this document, the parties acknowledged 'the unique situation of the Kaliningrad Region as part of the Russian Federation but separated from the rest of the Federation by other states'. The parties agreed to pursue a comprehensive package of measures to facilitate the easy passage of borders, and in particular to create a 'Facilitated Transit Document' scheme. Trilateral negotiations Russia-Lithuania-EU – a new format that enriched the European-Russian dialogue – took place on the basis on the Summit's decisions. The

negotiations ended in spring 2003 with a set of decisions for the implementation of facilitated transit schemes. They came into operation on the 1 July 2003. The Facilitated Transit Document (FTD) and the Facilitated Railway Transit Document (FRTD) were introduced to facilitate the passenger transit by train, bus, and car. A person must be in possession of an FTD in order to cross Lithuania by car or bus. The FTD is issued by Lithuanian consulates in Russia for the period of one year. It is free of charge for all Russian citizens. This notwithstanding, the procedures for acquiring an FTD are much like normal visa procedures. In contrast, the FRTD is issued for persons going through Lithuania on a Russian transit train. When buying his ticket, a traveler must submit his/her basic passport data, which is then transferred to the Lithuanian consular authorities electronically (see Vinokurov 2004c for details).

Two years into existence, the facilitated railway transit document's scheme functions quite well. It takes almost no extra time for a passenger to undergo the necessary procedures. After several incidents at the very beginning, the system functions smoothly. One has however to spend many hours in the queues in front of the Lithuanian consulate in order to obtain the Lithuanian visa or an FTD. In contrast, the cargo transit between the Russian mainland and Kaliningrad remain a problem. The negotiations on the cargo transit led by the sides in 2003-2004 did not result in a special facilitated regime. The standard EU transit regulations are applied after Lithuania joined the European Union in 2004. It resulted in higher costs of transportation between the mainland and the exclave.

The problem of access is enclave-specific – it just would not exist in case of a typical region on the mainland. It consists of two parts: first, an exclave is separated by the mere distance; second, it is separated by the territory of a foreign state or states. While the first element is present also for islands, the second element is unique for exclaves. The complexity of the issue of the mainland-exclave access stems primarily from the latter element, that is, its detachness from the mainland and embeddedness in the surrounding state. It makes an exclave increasingly vulnerable even to minor changes in policies by the surrounding state but also to the overall state of the mainland-surrounding state relations. The solution reached so far for the problem of Kaliningrad passenger and cargo transit is only partial. It illustrates well the vulnerability of Kaliningrad stemming from its detachness from the mainland and embeddedness in the EU, and its ensuing dependence of the arrangements to be met between the European Union and Russia.

6. Regional economy: high vulnerability to external shocks

Enclaves' economies are highly vulnerable. Their vulnerability stems not only from the small size, but also largely from their detachness and insularity, that is, enclave-specific factors. Let us go through several crucial factors:

- Normally, enclaves are small. The small size of the local economy is not able to support the industry. If an industry is established, it has to look for markets elsewhere.
- The insularity of an enclave impedes both exports and outflows to the mainland. From the point of view of economic geography, the surrounding state could form a convenient proximity market. However, this market is protected by numerous tariff and non-tariff barriers making the enclave's products uncompetitive against the surrounding state's own producers. Furthermore, the sheer distance and the cost of transit complicate the access to the potential markets of the mainland state. If an enclave does not possess a unique competitive advantage, it becomes economically incapable in view of its isolation.
- Another aspect connected to the smallness is that an enclave has to specialize in a very few industries or sectors. As enterprises can relocate, an enclave faces the task to tie up the enterprises to the home base. Thus, an enclave can only support a very few sustainable and competitive industries. On the other hand, there is a vicious circle since the narrow specialization makes them even more vulnerable against economic shocks and cycles.

The economic incapability combined with increased vulnerability explains why the special economic regimes are established so often in the enclaves. A special economic regime can make an enclave viable in the situation where its natural assets do not suffice to survive. Two approaches can be employed:

- 1) The compensatory approach is employed when a special regime is introduced to compensate for the detachment from the mainland.
- 2) Alternatively, the mainland may choose to liberalize the enclave toward the surrounding state and the rest of the world, thus mitigating the enclave's isolation.

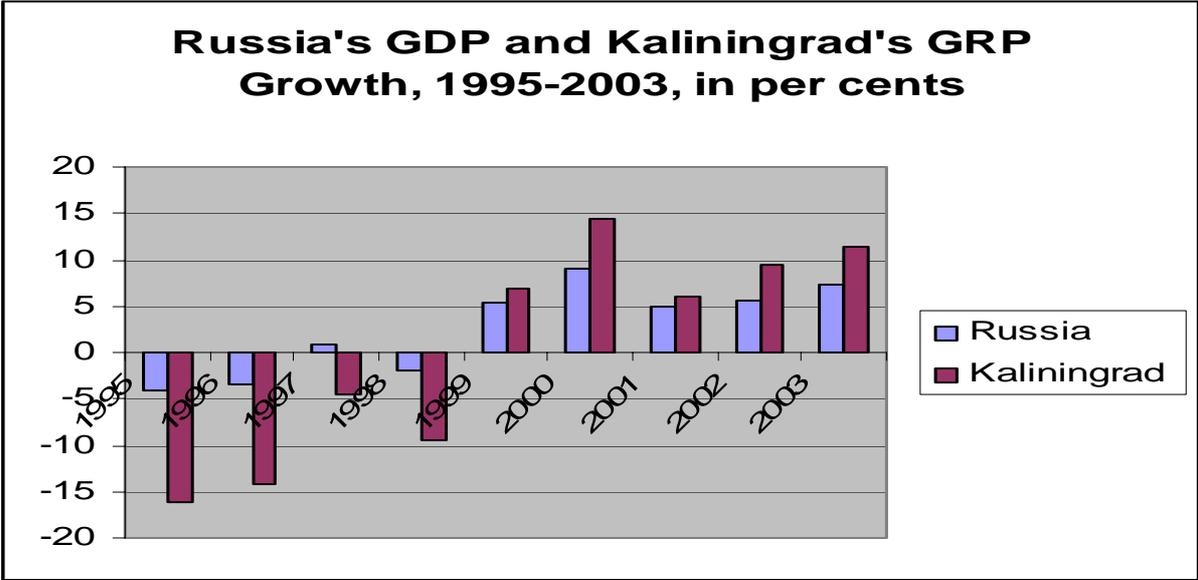
When the Kaliningrad Special Economic Zone (SEZ) was created, the Russian mode of thinking toward Kaliningrad was clearly along the first line. The idea was to compensate the region for its detachness, for longer and more expensive transport routes, and for the comprehensive de-militarization. The Russian economic crisis of the 1990s had severe consequences for Kaliningrad. By 1999, industrial production fell by 62 per cent compared with 1990, as old patterns of production and trade were eroded. Since then, however, the economy has been growing with impressive speed. New trade and production specializations have evolved over time. Much of the region's economic development is attributed to the existence of the Special Economic Zone (SEZ), which forms the backbone of the regional

economy. The SEZ regime encouraged the industries that re-worked imports targeting the Russian internal market. Several new industries evolved, such as food processing, assembly lines for household appliances and consumer electronics, and furniture. All of them target the Russian market. The market structure for the furniture industry is typical: only 7 per cent of the production is sold within the region and 10 per cent are exported, while 83 per cent are shipped to the mainland. The SEZ regime, working at expense of the federal budget and the competitors in other Russian regions, became vital for the regional economy.

Table 1. Russia's GDP and Kaliningrad Region's GRP in 1995-2003, annual change - %

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Russia	-4.1	-3.4	0.9	-1.9	5.4	9.0	5.0	5.6	7.3
Kaliningrad	-16.2	-14.2	-4.5	-9.5	6.8	14.4	6.0	9.5	11.5

Figure 3. Higher amplitude of the Kaliningrad regional economy



Source: Kaliningrad Regional Committee for Statistics (2002, 2004).

The Kaliningrad regional economy has repeated the all-Russia economic trend since the beginning of the 1990s. When the Russian economy was declining until, so was the regional economy. As growth commenced in 1999, Kaliningrad became to grow, too. There is one important peculiarity, though. The Kaliningrad economy react to the external economic factors with much greater amplitude that the Russian economy on the whole. The economic crisis of the 1990s was more severe in Kaliningrad, as the 1998 GRP made up 30 per cent of the 1990 level, compared with 50 per cent for Russia. Then, the regional economy grows by

greater speed. While the Russian economy grew by 6.5 per cent annually, Kaliningrad's GRP added 9.8 per cent every year in 1999-2003. The higher amplitude of the economic development is the direct consequence of Kaliningrad's dependence on external factors and on the SEZ regime upon which the recent growth was based.

Table 2. Comparative Dynamics of Kaliningrad Foreign and Interregional Trade, USD mln

Year	Exports	Imports	Outflow to the Russian mainland	Inflow from the Russian mainland
1996	415.8	1001.6		
1997	389.8	1209.3		
1998	351.3	1148.9		
1999	287.7	875.2		
2000	452.9	887.9	424.4 (432.2)	(468.9)
2001	401.4	1009.9	618.7	
2002	408.6	1578.9	...	
2003	555.4	2138.1	1117.9	
2004	1089.4	3006.8	1802.0	

Source: North-West Customs Office (2001, 2004), author's calculations⁴⁷.

There exists a very positive trend in the regional trade with mainland Russia. The volumes of trade have rapidly and constantly risen since the crisis of the year 1998. The outflows to mainland Russia have more than quadrupled in four years from 2000 until 2004. Overall, Kaliningrad takes an intermediate position in Russian-European trade. About 80 per cents of the foreign trade of the region are realized with the enlarged EU, the bigger part with Poland, Lithuania, and Germany. The intermediate trade position of the Oblast is specific. Kaliningrad exports predominantly raw materials and goods with low value-added and imports more processed goods. The region get its supplies of raw materials from Russian regions (from fuel, petrochemicals, and energy to wood and metals) and sells processed outputs mainly of the food processing industry, furniture industry, and the assembly plants for consumer electronics and household appliances. The regional comparative advantage in these industries is based however on the existence of the SEZ regime and, to a lesser degree, on the factors of industrial endowments. As exports are composed of primary (oil) and semi-

⁴⁷ The statistical methodologies of the State Committee for Statistics and of the Customs Office slightly differ. The figures for inflows and for outflows (in brackets) were calculated according to the methodology described in details in Vinokurov (2004a, appendix I); see also Samson, Lamande, Vinokurov (2004). Other figures for the outflows to the Russian mainland represent the data provided by the Customs Office under the IM40OEZ and 40XX35 procedures, which count for the absolute majority of goods produced in the SEZ Kaliningrad and transported to the mainland Russia.

finished goods (pulp and paper), virtually all of the industrial outflows are produced by the enterprises that rely on the SEZ privileges.

There is a wide consensus that the existing regime is sustainable neither from the point of view of the federal interests nor considering the eventual Russia's WTO accession. The new SEZ law is to be adopted at the end of 2005. According to the draft, the old regime is to be replaced by the new regime, which main elements are the tax preferences for big investors (RUR 150 million threshold, that is, about EUR 4.5 million) combined with the duty-free imports. This design corresponds to the normal SEZ design practiced throughout the world. Contrary to the old law, the new legislation shall not pose any WTO-related legal issues. At the same time, the new regime would co-exist with the old one during the transition period of ten year when the SEZ residents would be able to choose either one.

7. Overcoming political and economic enclavity and vulnerability

I have so far revised the intermingled issues of access and economic development. Kaliningrad's political and economic vulnerability is inherent. It is intrinsically connected to its enclave/exclave status. Had Kaliningrad not been detached from the mainland Russia and simultaneously surrounded by the EU member states, most of its problems would not have existed. Kaliningrad's enclavity and exclavity determine the scope and scale of the problems that the enclave and the Russian Federation, but also the European Union, have to deal with.

The issues of access and economic development illustrate the inherent vulnerability of an enclave. Is it possible to mitigate the situation and to place an enclave in a more stable framework? It is logical to assume that, just as the enclave-specific factors contribute to higher political and economic vulnerability, the *washing out* of the enclavity might make an enclave less vulnerable to the external shocks. Enclaves are made by the borders. The border in this context means not a physical phenomenon but rather an obstacle to the communication and the flow of people, goods, services, capital, and labor. When borders become more penetrable, the part of the enclavity/exclavity disappears.

It can be attained by reaching such a level of integration between the mainland state and the surrounding state that is sufficient to provide a smooth passage of people and goods between the mainland and the exclave. In other words, a deep and comprehensive integration between the mainland and the surrounding state is able to remove the problem of exclave-mainland transit altogether. In this respect, the most important factor is probably the level of integration reached between the surrounding state and the mainland. If they are integrated enough (movement of goods, movement of people) then communication between the mainland and their exclaves would not represent an aggravating problem. In fact, transit is not the only problem that can be substantially eased by the M-S integration. The M-S integration is able to solve many other problems stemming from enclavity/exclavity. The integration damps down, if not eradicates altogether, the enclave-specific conflict potential based on contradictory interests and an enclave being a trouble spot in the bilateral relations. A deep economic integration can greatly diminish the economic problems of an enclave. Besides, it eases up the people's interaction diminishing potential for opposition.

The best examples of the most positive impact of the M-S integration are the small enclaves inside the European Union: Baarle, Llivia, Jungholz⁴⁸, etc. However, it is not necessary for the mainland and the surrounding state to reach the integration level of the European Union. Campione and Büsingen profit from the EU-Swiss integration based on sectoral agreements despite the fact that the EU-Swiss integration is limited. In North America, Alaska as well as the small pene-enclaves on the U.S.-Canadian border benefit from the historically close relationships of the mainland state with Canada (visa-free regime etc.). The establishment of NAFTA in 1992 had further positive effects on the flow of goods, including transit. There are certain essentially important elements of political and economic integration, the presence of which is pivotal for the enclaves. It is enough when the surrounding state and the mainland states possess:

1. a visa-free regime making possible the free movement of people;
2. a certain degree of the free trade in goods, preferably supplemented by the free flows of services and capital;
3. and the free movement of labor.

These three components shall be supplemented by the general friendly M-S relations, which are usually the case between the states that have been able to reach such a level of integration.

⁴⁸ Baarle is an enclave complex comprising 22 Belgian enclaves in the Netherlands as well as seven Dutch counter-enclaves (that is, enclaves within enclaves) and one further Dutch enclave in Belgium. Llivia is a Spanish enclave in France. Jungholz is an Austrian enclave in Germany.

Although the attainment of all three elements mentioned above leads to the most relaxed and beneficial regime, even a partial progress in one of the fields can greatly benefit the enclave, surpassing by far the positive impact of integration on the other regions of the same state. In case of Kaliningrad, the problems of both passenger and cargo transit arise exactly because the relations between Russia and the EU (or its member states Poland and Lithuania) did not reach any of these conditions.

To conclude, Kaliningrad's inherent political and economic vulnerability should be viewed and can be mitigated only in the framework of the MES triangle, i.e. taking into account both the Russian federal policy and the state of the EU-Russian relations. The freedom of movement of, first, people, and, second, goods and services are essential in this context. It is therefore helpful and indeed necessary to view the Kaliningrad problem in the framework of the EU-Russian Common Spaces, the Common Economic Space (Vinokurov 2004d) and the Common Space for Freedom, Security and Justice in particular.

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Modern terms and future competitiveness of the Kaliningrad Region's economy

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The idea of free entrepreneurship – future Special (free) Economic Zone in the Kaliningrad Region rose even before the collapse of the Soviet Union, and originally it was not any way connected with the exclave situation of the region. At the period of market economy formation, the performance task of faster development of small business stipulated by customs and tax exemptions at the territories of special economic zones was formulated.

On July 14th 1990, the Supreme Soviet of the Russian Soviet Socialist Federal Republic declared the Kaliningrad Region as a zone of free entrepreneurship. On July 3rd 1991, the Chairman of the Supreme Soviet of the Russian Soviet Socialist Federal Republic issued an order “On the economical status of Free Economic Zone of the Kaliningrad Region”. The order of the Council of Ministers of the Russian Soviet Socialist Federal Republic as of September 25th 1991 No. 497 approved the “Regulation on Free Economic Zone in the Kaliningrad Region (FEZ Yantar)”.

However after the collapse of the Soviet Union and formation of several independent states instead of former Soviet republics the Kaliningrad Region turned out to be territorially separated from the mainland of the Russian Federation. The airline distance from the Kaliningrad Region's border to other Russian region – Pskov Oblast – is more than 370 km. Travel by land from Kaliningrad to Moscow you have to cross the territories of two independent states – Lithuania and Byelorussia.

Such a territorial separation of the region objectively caused economic losses for enterprises and inhabitants of the region. These losses were stipulated by breach of cooperation ties, customs and border barriers. It resulted in an immediate decline of production and the

destruction of industrial potential. In the Kaliningrad Region, these processes were more avalanche than in other Russian regions.

According to the world practice, states apply special compensational mechanisms for such separated territories: state donations and subsidies, tax exemptions, customs preferences. States define and support task-oriented specialization of the exclave territory within the national economic system and its local integration with the neighboring countries. The powers of state authorities are redistributed and the powers vested in the local governing are enlarged.

Regarding the Kaliningrad Region during several years the federal authorities consequently applied compensation measures based on customs preferences granted. Originally this mechanism was described in the Regulation on the FEZ Yantar, later on – in the federal law “*On Special Economic Zone in the Kaliningrad Region*” No. 13-FZ as of 22.01.1996. This law considerably increased the status of legal documents regulating economic activities in the region.

The federal law defines legal and economic principles for establishing and functioning of the Special Economic Zone (SEZ) in the Kaliningrad Region taking into consideration its special geopolitical situation and importance for Russian national interests. The law is targeted at the creation of favorable conditions for social-economic development of the Russian Federation and the Kaliningrad Region.

According to the law, all territory of the Kaliningrad Region is a Special Economic Zone, except military objects and the regional administration governs the functioning of the SEZ.

Primarily, the law regulates export and import operations within the regime of *free customs zone*. It is envisaged that at the territory of the SEZ customs duties and other customs fees are not paid for the commodities.

First of all, for commodities produced in the SEZ with considerable level of processing and exported to other countries and the Russia mainland (including the territory of the customs union).

Secondly, for the commodities imported from other countries for the consumption within the region or for their export to other countries (both processed or not).

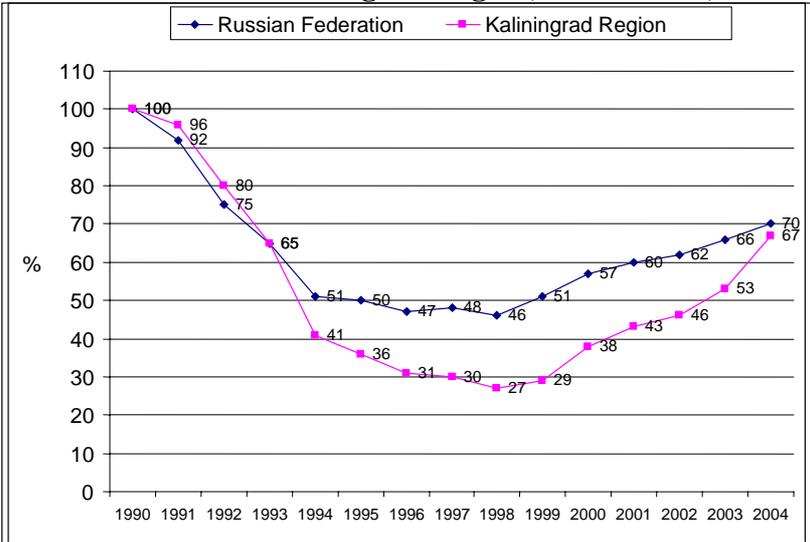
The majority of commodities to be delivered to the main land of Russia should gain at least 30 per cent of value added after the processing by regional enterprises. Even now it is much higher than the rates of customs duties for correspondent commodities.

At the beginning of 2003, the customs duties for poultry accounted for 25 per cent, for other goods – 20 per cent (carpets, furniture, sausages, meat cans) or 15 per cent (cattle meat, canned fish). Besides meat is included into the list of products, duty-free import of which is limited (quotas). For sophisticated household devices and consumer electronics the value added should exceed 15 per cent. These very duties are paid for imported household devices, for TV sets – value added is 20 per cent.

Starting from the 1990’s, two phases of economic development of the Kaliningrad region can be defined. They differ from each other by the impact of zone mechanism on the structure and rates of economic development: *before and after the financing crises as of August 17th 1998*.

Chart 1 demonstrates the comparative dynamics of industrial production in 1990-2004, two phases of Kaliningrad Region industry development are obvious: deep crisis (1991-1998) and sharp rise (1999-2004).

Chart 1. Comparative dynamics of the industrial production in the Russian Federation and the Kaliningrad Region, 1990—2004, %



The first phase is characterized by sharp decline in production. In 1998, the industrial production in the Kaliningrad Region accounted only for 29 per cent of the production in 1990 (in Russian Federation 46%), agriculture 48 per cent (in Russian Federation 56%), retail turnover 42 per cent (in Russian Federation 86%). The capital construction declined 6-fold (in Russian Federation 4,5 times).

Additionally to typical Russian factors the Kaliningrad Region was negatively impacted by high percentage of economic branches with sharp decline of production, as well as exclave situation of the region hindering the work of economic actors in united economic space of the country.

This phase is also characterized by intensive processes of structural reorganization, forming prerequisites for further development of real sector. That time the market infrastructure was forming, as well as necessary economic ties between the economic actors inside of the region with Russian and foreign partners. First export-oriented and import-saving producing companies started to operate.

In 1999, the second phase of economic development started, it was characterized by intensive growth of production. After a long lasting depression there was a fast growth of domestic investments to capital assets (see Table 1). The material basis for economic growth was formed; old enterprises were modernized, new ones were established, oriented on processing of imported raw materials for further shipment to domestic market.

And herein the regime of the SEZ became one of the factors for import-saving productions growth, the key role for the development and enlargement of those belonged to increasing consumer demand in allover Russia. In 1996-1998, the same zone mechanism was functioning, but production for domestic market was developing slowly.

From my point of view, not only customs preferences of the SEZ and low labor costs became the reasons for accelerated development of import-saving productions, but also simplified procedures of commodities shipped to the Russian market (due to production by the Russian standards and also by the demands of the Russian consumers).

Another important factor of economic growth was a favorable situation of the region regarding the main importing districts of our country, well-built logistic system and convenient transport infrastructure with the raw materials and semi-finished products supplied abroad.

Since 2000, the growth rate of industrial production in the Kaliningrad Region has been much higher than the average figures for the Russian Federation and many regions of the North-West federal district.

Table 1. Indexes of investment to the capital assets and physical volume of industrial production in the North-West federal district regions in 1999-2004, % to previous year

Region	Year						Total, for the whole period
	1999	2000	2001	2002	2003	2004	
<i>Investments to the capital assets</i>							
Karelia Republic	140	160	124	95	93	113	245
Komi Republic	94	180	108	92	105	197	177
Arhangelsk Region	98	180	123	117	120	96	305
Vologda Region	102	98	121	109	111	2-fold	146
Kaliningrad Region	122	165	103	122	156	115	454
Leningrad Region	158	114	126	63	136	121	194
Murmansk Region	189	125	130	82	124	96	312
Novgorod Region	153	87	147	57	163	78	182
Pskov Region	120	118	121	94	106	91	170
Saint-Petersburg	122	80	119	105	111	111	135
<i>Russian Federation</i>	105	117	110	103	113	111	174
<i>Physical volume of industrial production</i>							
Karelia Republic	122	108	100	103	101	109	149
Komi Republic	102	106	107	98	103	104	122
Arhangelsk Region	122	130	106	101	119	138	279
Vologda Region	109	110	99	104	103	106	135
Kaliningrad Region	104	132	113	110	115	130	255
Leningrad Region	107	127	110	136	121	110	271
Murmansk Region	108	109	102	98	103	102	158
Novgorod Region	115	108	118	108	103	108	176
Pskov Region	120	111	108	107	104	106	170
Saint-Petersburg	106	127	101	131	106	114	215
<i>Russian Federation</i>	111	112	105	104	107	106	154

Last years considerable investments came to the region. The analysis shows that investment processes are quicker in the region than in average in the whole country (the share of the region regarding investments to the capital assets is 0,5 per cent, in industrial production only

0,35%). But still the share of domestic and foreign investments per capita is much lower than the average figures in Russia.

At the present moment small business sector is pretty well developed in the Kaliningrad Region: 7600 small enterprises are registered, i.e. 8 ones per 1000 inhabitants, that is 1,4 times higher the average figure for Russia (third place after Moscow and Saint Petersburg). In total 91,000 small businesses operate in the region, including 5800 farms and 77,500 individual entrepreneurs without a legal identity of its own. In general, 148,000 people work in small enterprises (36% of those are engaged in economics). The share of small businesses in gross regional product accounts for 20 per cent.

The most important result of the regional development starting from the 1990's is a formation of new economic structure, with prevailing service sector (in particular transport, trade and tourism). In 2002, the ratio of services regarding employment was 62 per cent and 53 per cent of gross regional product (GRP).

In 2003, GRP rose by 11,5 per cent; in 2004 by 12,3 per cent, that is higher than average figures in Russia.

The comparison of the GRP dynamics in the Baltic Sea region for the period after the financial crisis of 1998 demonstrates that the Russian economy has become the leader concerning growth rate (Table 2).

Table 2. The growth of gross regional product in the Baltic Sea region for 1995-2004.

Countries / regions	Growth rate of GDP / DRP, year-in-year:										Average growth rate for the following periods	
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	1995-2004	1999-2004
EU15	2,4	1,6	2,5	2,9	2,9	3,6	1,7	1,0	0,8	2,2	2,2	2,0
Estonia	4,5	4,5	10,5	5,2	-0,1	«7,8	6,4	7,2	5,1	5,9	5,7	5,4
Latvia	-0,9	3,8	8,3	4,7	3,3	6,9	8,0	6,4	7,5	7,5	5,6	6,6
Lithuania	3,3	4,7	7,0	7,3	-1,7	3,9	6,4	6,8	9,7	7,1	5,5	5,4
Poland	2,7	6,0	6,8	4,8	4,1	4,0	1,0	1,4	3,8	5,8	4,0	...
Denmark	2,8	2,5	3,0	2,5	2,6	2,8	1,6	1,0	0,4	2,3	2,2	1,8
Germany	1,7	0,8	1,4	2,0	2,0	2,9	0,8	0,1	-0,1	1,7	1,3	1,2
Finland	3,4	3,9	6,3	5,0	3,4	5,1	1,1	2,3	2,0	3,0	3,6	2,8
Netherlands	3,0	3,0	3,8	4,3	4,0	3,5	1,4	0,6	-0,9	1,4	2,4	1,7
Norway	4,4	5,3	5,2	2,6	2,1	2,8	2,7	1,4	0,4	2,8	3,0	2,0
Sweden	4,1	1,3	2,4	3,6	4,6	4,3	1,0	2,0	1,5	3,7	2,9	2,9
Russian Federation	-4,1	-3,4	0,9	-4,9	6,4	10,0	5,1	4,7	7,3	7,1	2,9	6,8
Including GRP of the Kaliningrad Region of the Russian Federation	-16,2	-14,2	-4,5	-9,5	6,8	15,2	3,4	9,5	11,5	12,3	1,4	9,8

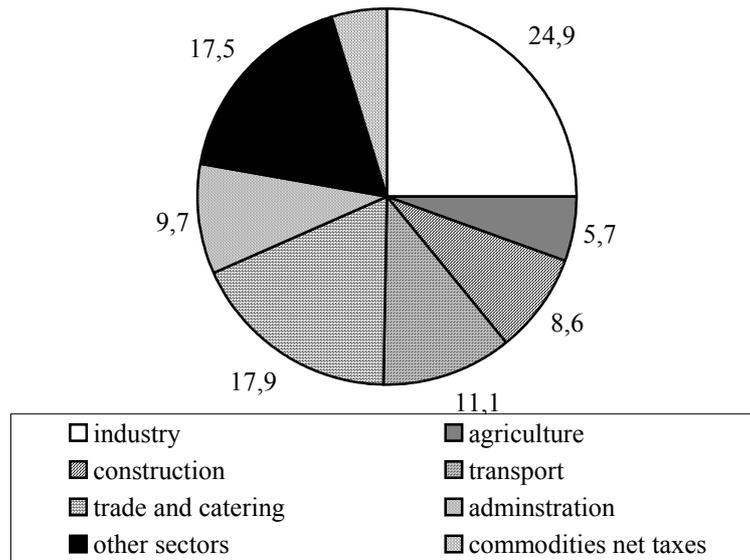
Besides the GRP growth rate for the Kaliningrad Region is especially impressive: during 5 years its volume grew 1,7-fold. The structural changes of GRP for recent years are demonstrated in the Table 3.

Table 3. Changes of sectoral structure of GRP in the Kaliningrad Region

Constituents of GRP	2000	2003	Changes (+/-)
Commodities production, total	53,8	40,1	-25,5 %
Including:			
Industry	38,3	24,9	-35,0 %
Agriculture	7,7	5,7	-26,0 %
Construction	6,9	8,6	+24,6 %
Other sectors	0,9	0,9	0,0 %
Services production, total	41,0	55,3	+34,9 %
Including:			
Transport	7,7	8,8	+14,3
Communication	2,4	2,3	-4,2 %
Trade and catering	11,1	17,9	+61,3 %
Administration	4,8	9,7	2-fold growth
Other sectors	15,0	16,6	+10,7 %
Commodities net taxes	5,2	4,6	-11,5 %

The basis of the Kaliningrad Region economy is still an industry, constituting 24,9 per cent of GRP. The share of the most important producing branches – agriculture and construction – is respectively 5,7 per cent and 8,6 per cent. During the past years, the service sector started to play a more important role. The second position is taken by trade and catering (17,9%) in terms of the GRP share, and the third transport and communication (11,1%). As a whole, the share of service sector in GRP in 2003 constituted 55,3 per cent (Chart 2).

Chart 2. The gross regional production in 2003, %



The sectoral structure of processing industry has been drastically changed. The production of finished goods has increased considerably. The quality of finished goods has also sharply improved. Finished goods became competitive in the regional and the federal markets, and now the majority of regionally-produced commodities are exported. The qualitative changes in the regional industry lie in such spheres as renewal of assortment and higher quality of products, changed sources of raw materials and markets. About 60 per cent of produced commodities (this share is even higher in import-saving sector) constitute new ones (not produced earlier).

It is obvious that the selection between “favorable” and “unfavorable” production is carried out very quickly. Thus, more than 1400 cars of the class which was not produced 10 years ago are monthly assembled in the region. Furthermore, about 250,000 TV sets are produced every month. The Kaliningrad-produced commodities differ from imported ones less and less, and sometimes they are even better. They are stably demanded in the regional and the mainland markets. The scale of production is expanded which proves the role of the region specializing on import-saving strategy.

Table 4. The share of commodities produced in the main sectors of the regional industry, %

Sector	Year		Structural change
	1998	2004	
Industry, in total	100,0	100,0	—
Including:			
Electric energy	18,3	5,8	3,16-times decline
Fuel industry	8,9	10,2	Growth by 14,6%
Iron industry	3,0	0,5	6-fold decline
Chemical and petrochemical industries	0,8	1,0	Growth by 25,0%
Mechanical engineering and metalwork	13,3	37,1	2,8-fold growth
Forestry, wood-processing, pulp and paper industries	9,2	7,4	Decline by 19,6%
Construction material industry	1,6	2,7	1,7-fold growth
Light industry	2,0	1,7	Decline by 15,0%
Foodstuff industry	38,0	31,7	Decline by 16,6%
Of those:			
Meat industry	2,1	5,5	2,6-fold growth
Oil production and dairy products	1,9	3,4	1,8-fold growth
Fishery	20,1	12,5	1,6-fold decline
Flour-and cereals and mixed feed industries	2,0	0,9	2,2-fold decline
Printing industry	0,8	0,4	2-fold decline
Other industrial sectors	2,1	1,5	Decline by 28,6%

Note: from 1998 till 2004 the production volumes in the Kaliningrad Region grew 2,5 times.

The following sectors made the most important input into the industrial growth in 1999-2004: mechanical engineering and metalwork industries (4,4-fold growth), light industry (3,6-fold growth), construction materials (3,2-fold growth), and electric energy (2,9-fold growth).

Besides, the production in fuel industry rose only by 3,8 per cent and in the chemical industry it declined by 38 per cent. The volume of investments (more than 3,5-times growth), transport shipments, services related with export-import transactions, domestic and foreign tourism grew in the Kaliningrad Region faster than in Russia in general.

Positive trends continue in 2005. In first six months of 2005, the volume of industrial output rose by 27,5 per cent, construction by 44,4 per cent, transport throughput by 6,5 per cent. Retail trade turnover increased by 13,1 per cent, services to inhabitants by 9,6 per cent. Real value of incomes rose by 15,8 per cent, and average monthly wages by 21,7 per cent.

The region is leading among the Russian regions regarding the industrial production of some commodities. In 2004, a half of TV sets produced in Russia and 2/3 of vacuum cleaners were made in the Kaliningrad Region. Besides, 16 per cent of canned meat, 37 per cent of canned fish, 11 per cent of fish and marine products, 6 per cent of furniture, 5 per cent of cellulose, 2,7 per cent of vodka and alcoholic beverages are manufactured in the Kaliningrad Region. In 2004, 26 per cent of vodka exported from Russia was produced in Kaliningrad.

Due to the enlargement of assortment and the introduction of modern technologies, based upon foreign cooperation and investments, goods produced in Kaliningrad have advantages compared to many domestic and foreign goods in terms of price and quality. In 2004, the export of Kaliningrad goods to the mainland of Russia reached \$ 1802 million. In 2002, the export was \$ 759 million, in 2001 only \$ 424 million. During the first six months of 2005, the value of goods produced in the Kaliningrad Region and sold to the Russian mainland was \$ 1048 million. TV sets account for 20,9 per cent, cars 15,4 per cent, processed meat 16,3 per cent, fish and canned fish 7,3 per cent, vehicles and cranes 5,1 per cent, carpets and floor covering 2,3 per cent of Kaliningrad's sales to the mainland Russia.

Import substitution specialization of the region is stimulated by grown demand in the Russian market, favorable geographical situation of the region and the SEZ regime. On the other hand, the main weak point is a necessity to cross the territory of Lithuania and Byelorussia that causes additional transport and transaction expenses and time losses.

More rapid growth of Kaliningrad compared with other Russian regions proves that during the past years, the SEZ regime has been successfully operating, stimulating dynamic development of regional economy and increasing inhabitants' standard of living. At the same time, many experts mention the drawbacks of the SEZ, such as customs privileges resulting losses in the federal budget, large grey economy, intensive non-legal cross-border trade (mainly based on very limited goods, such as alcohol, cigarettes and petrol), dependency of the regional economy on the SEZ. But all these drawbacks can be somehow justified.

The federal law- FZ No. 13-96 "On Special Economic Zone in the Kaliningrad Region" in force for last 10 years allowed the Kaliningrad Region to solve the problem of restructuring the regional economy. As the situation significantly changed in the Russian Federation, it

stipulated the necessity to pass a new federal law “On Special Economic Zone in the Kaliningrad Region”.

During the past three years, the work aimed at the perfection of the SEZ regime in the Kaliningrad Region was systematically maintained. A large input into the perfection of the current SEZ regime in the Kaliningrad Region was made by the Commission chaired by Mr. Shuvalov. This Commission was established by the presidential administration of Vladimir Putin.

The four main principles to improve the SEZ law in the Kaliningrad region are:

- Compatibility of the SEZ regime in the Kaliningrad region and common international practice;
 - Continuity of current and new mechanisms of SEZ;
 - Change of focus from customs preferences to tax privileges for new participants of SEZ;
- and
- Maximum removal of administrative barriers.

This work resulted in the development of the conception of the regime and mechanisms of SEZ, combining the interests of state, business and the Kaliningrad citizens. On June 9th 2005, a new version of the federal law on SEZ in the Kaliningrad Region was enforced by the State Duma at the first hearing. Now the suggestions are actively analyzed and prepared for the second hearing of the law in the State Duma, approximately in October 2005.

Tax privileges envisaged in the new version of the SEZ law in the Kaliningrad region **stimulate establishing of new capital-intensive industries in several sectors of a regional economy, previously not stimulated by customs free regime.**

An enforcement of a new version of the law on SEZ will allow us to activate considerably long-term advantages of the Kaliningrad region, including:

- Russian Federation identity (attention on the federal level);
- Common domestic market;
- Low cost of labor forces, energy, common economical space with other countries;
- Very favorable geographical location;
- Ice-free ports;

- Proximity to some European cities and sales markets, developed transport logistics;
- Mobile and educated inhabitants mostly sharing European mentality; and
- Rich historical heritage, mild climate, and attractive nature.

As far as I am concerned, the enforcement of a new law on the SEZ will be primarily established in the following sectors of the Kaliningrad economy:

Transport complex:

Construction and modernization of key objects, including:

- port facilities, ferry transportation, specialized terminals, port factories, consignment storehouses;
- aviation complex, aerostation, terminals, air transport forces, airport facilities;
- multimodal transportation; and
- suburban traffic, bus stations, and rolling stock.

Agriculture complex:

Foundation and development of large agricultural complexes, including:

- vertically-integrated agricultural complexes;
- fishing and fish processing complexes;
- fur-farming, poultry breeding; and
- gardening.

Construction industry:

Development of the following fields:

- industrial and civil engineering activities; and
- production of construction materials with the use of local raw materials (bricks, ceramics, woodworking, etc.).

Tourism and recreation complex:

Development of industry including construction and modernization of:

- hotels;
- network of small hotels, agro-tourism facilities;
- conference centers, offices;
- constructions in cultural and historical zones;
- maritime and boat tourism;
- sanatorium-resort complexes specializing in medical maintenance and recreation;
- networks of catering and entertainment facilities; and
- sport complexes.

Energy:

Regional energy independence is based upon:

- construction of small hydro energy stations and heat power plants; and
- use of alternative types of fuel.

Housing and utility services:

Improvement of environment by construction of treatment plants, introduction of new technologies for removal and utilization of wastes.

Construction of blocks of flats:

Solving of housing problem via the development of the mortgage system.

It can be estimated that until 2015, the number of investment project in the Kaliningrad region will reach 150, including 60 large projects.

The preservation of **“transparency period” for enterprises functioning under the federal law No. 13-96 will allow in middle-term period to pay back the investments and change the specialization** of business meeting the demands of other economic regimes of SEZ.

After the enforcement of the law, the annual flow of investments to the Kaliningrad region will increase 1,5 times, the volumes of industrial production will rise by 25 per cent, cargo shipment by 30 per cent, volumes of industrial and civil engineering activities by 20 per cent.

The attractiveness of investments to regional agriculture, hospitality sphere, transport and logistics complexes of the Kaliningrad region will significantly increase.

It is obvious that by the result of investment growth there will be an “outflow” of qualified staff from small and medium-sized businesses to new jobs, the recruiting of foreign staff will rise. Besides, the collection of income tax will increase and business activity will considerably rise.

Eventually, the stimulation of import-saving productions in the Kaliningrad region will lead to supply of their outputs not only to Russian, but also to foreign markets. A special program of export-oriented productions stimulation might be also implemented in the region. The measures of their encouragement envisage to be implemented in line with the Russian policy, possibly by formation of local free economic zones at the territory of the region (supplementing currently functioning mechanism of the SEZ), by granting income tax exemptions for prioritized investment projects. But at the present moment from my point of view it is more relevant to use and modernized existing capacities of import-saving productions.

Further perfection of regional legislation, as well as federal target program “Development of the Kaliningrad region for the period until 2010” is to play an important role in investment stimulation. The federal program is already creating conditions for investments attraction and export-orientation production stimulation. The funds allocated by this program have not only social, but also stimulating economic importance (appropriation) for creating conditions necessary for successful regional development (primarily industrial and social infrastructures), as well as for support to modernize leading sectors of regional economy.

Due to poorly developed regional financial infrastructure, incapable to attract and ensure sufficient investment inflows, it is relevant to study the issues regarding stimulation of this infrastructure establishing by founding international investment and financial corporation. Its founders might become the Russian Government, EU structures, the regional administration, large Russian and foreign investment banks. This corporation might facilitate enterprises in development and expertise projects, promote a transfer to international standards, allocate financing for the projects and control their implementation, promote enterprises’ in their entering European financial markets.

Due to the imminent membership of Russia in the WTO, possible sanctions of this organization regarding economic support to the Kaliningrad region provided within the framework of the Federal target program “Development of the Kaliningrad region for the period until 2010” are to be prevented. By the preliminary calculations based on official statistics on the development level the Kaliningrad region can be considered as unfavorable region according to Article 8 of the “Agreement on subsidies and compensation measures of WTO”. In this case, the subsidy program can be applied for the Kaliningrad Region. This program will be based on the principles of SEZ and take into account the strategy of the regional development for medium-term perspective.

A key factor defining the economic future of the region is an economic situation in Russia in whole: as the situation is improving, the regional development rate will be higher than the average figures for Russia, in case of recession the industrial decline in the region will be more drastic. The geographical situation of the region creates favorable prerequisites for facilities to coordinate Russian foreign trade activities, to develop both export-oriented and import-saving productions. The terms of regional successful development are the following:

(1) preservation and perfection of mechanisms of the Special Economic Zone and (2) enlargement of economic cooperation between Russia and EU.

Other important factor is a development of relations between Russia and European Union. It is necessary to stimulate the foreign trade activities in the Kaliningrad Region, to make a pilot region at this Russian territory to work out integration mechanisms of Russia and EU interaction within the strategy of social-economic development of the Kaliningrad Region as a region of cooperation.

Taking into consideration a variety of problems surrounding the Kaliningrad region from my point of view, it is relevant to study the possibility to develop a larger document providing the Kaliningrad Region of the Russian Federation with a special status, justifying this status by the territorial isolation from the mainland. Such status should on the one hand guarantee a strong federal power in the region, on the other hand it increases a role of local governance, independence of the region while making decisions on its social-economic development. The considerations on regional status were firstly announced at the beginning of the 1990's, and now when the Russian economy has overcome its recession, these issues have all necessary prerequisites to be solved.

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Kaliningrad after the EU enlargement but before the legislative change concerning its special economic zone ⁴⁹

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1. The main objectives of the study

The rapid economic transition of the Baltic States and Poland along with their recent EU memberships raises the question, has the Kaliningrad region⁵⁰ benefited from the EU coming to its borders or has the region suffered from the EU enlargement? In this short report, the author aims at answering the question, *what is the socio-economic impact of the EU's latest enlargement upon the Kaliningrad region?*

The study focuses on analysing change in the region's foreign trade and foreign investment, due to the fact that the region's external economic relations are likely to experience changes earlier than the rest of the economy. Here, one should keep in mind that major changes in economic behaviour do not occur overnight, and hence, one is only able to analyse the immediate impact of the Union's expansion on Kaliningrad. One should not forget that some immediate reactions to the enlargement are probably only temporary ones. Furthermore, it is extremely important to keep in mind that just a year has passed since the enlargement occurred, and therefore, all the necessary statistical data is not available yet.

Secondly, one may ask *what are the possible economic consequences of the legislative change concerning the special economic zone to the Kaliningrad economy?*

⁴⁹ This article is based on the report prepared for the Russian-European Centre for Economic Policy (RECEP). The author gratefully acknowledges the contribution of the interviews, discussions and meetings, which took place during the expert period. The author wishes to thank all the persons involved in the research process. Special thanks go to Marina Cherkovets (RECEP), Sergey Prihodko (Institute for the Economy in Transition), Christer Pursiainen (RECEP), and Vitaly Zhdanov (the Administration of the Kaliningrad region). The views expressed in the article do not necessarily represent those of the RECEP, its funding organisation or opinions of those persons, who were interviewed, discussed or met.

⁵⁰ In the report, the terms 'the Kaliningrad region' and 'Kaliningrad' are used interchangeably.

In time of writing this article, only the first reading of the act on the Kaliningrad special economic zone (SEZ)⁵¹ has taken place in the State Duma. Therefore, the analyses have to be carried out on the basis of the draft law. Major changes in the final law may invalidate the analyses made in this paper⁵².

Before one is able to deal with the two aforementioned research objectives, one should have a look at the economic potential of the Kaliningrad region prior to the EU expansion. An overview of the region's economic potential is necessary to comprehend the true impact of the EU enlargement and to better estimate the economic consequences which change in the SEZ legislation may cause to the Kaliningrad region.

2. An overview of the Kaliningrad region's economy

2.1. The economic potential of the Kaliningrad region prior to the EU enlargement

Russia's economic slowdown in the 1990s had major consequences for Kaliningrad. By 1999, the region's industrial production fell by over 60 per cent compared with 1990, as old production and trade relations were eroded. Since then the Kaliningrad region has rapidly started to recover.

During the past three years, the Kaliningrad region has grown considerably faster than the Russian Federation as a whole. Annual GDP growth rates in Kaliningrad have exceeded 10 per cent during the period 2001-04, whereas economic growth in Russia has remained between 4-7 per cent. If the Kaliningrad region manages to maintain such a high growth rate, the region is able to meet the ambitious goal of doubling its economic size in 10 years⁵³. Should the growth of the 2001-04 continue, Kaliningrad is already able to double its regional GDP by the end of this decade. However, in order to maintain such a high growth rate, the

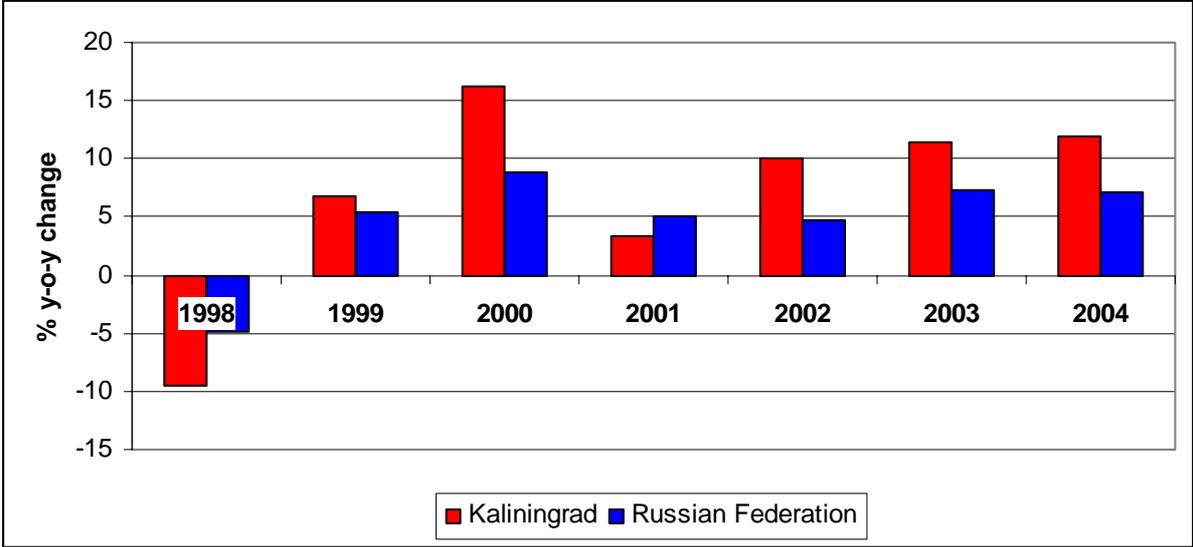
⁵¹ The companies operating under the current SEZ may sell the imported goods to the Russian mainland without paying custom duties if 30 per cent of the product's value is added in the region plus change in the Tariff Nomenclature code's 4th digit. In electronics and household appliances, 15 per cent value added is required plus change in the Tariff Nomenclature code's 5th digit. The companies operating in the SEZ are also exempted from export tariffs.

⁵² The second reading is scheduled to take place in the State Duma on the 24th of November. The third reading is expected to take place before the end of 2005, thus the law could be in force already in the beginning of 2006.

⁵³ Note: an annual growth rate of 7.2% is required to double the GDP in 10 years.

regional companies need more energy, since energy bottlenecks are already currently slowing down the economic growth (see Table 1)⁵⁴.

Table 1. Annual GDP change in Kaliningrad and Russia, % y-o-y



Source: Pan-European Institute (2002-2005a)

Despite Kaliningrad’s impressive growth, some statistics produced by the Russian statistical service (Rosstat) suggest that the living standard in Kaliningrad is lower than in Russia on average. For instance, Kaliningrad’s average monetary income in June 2005 was RUR 6571 (€ 187), approximately 85 per cent of the Russian average. The passenger car intensity and meat consumption per person, however, give an opposing picture of the region’s living standard. When using these material wellbeing indicators, Kaliningrad outperforms many Russian regions. Furthermore, the author’s own observations in various Russian regions lead him to think that the Rosstat data is not fully able to describe the true picture of wellbeing in Kaliningrad, probably due to a large chunk of unrecorded economy, and therefore, the real living standard in Kaliningrad is most likely higher than in Russia on average (Liuhto et al., 2004; 2005).

⁵⁴ The planned North European Gas Pipeline may aid the energy shortage of Kaliningrad. The planned capacity of the two-string pipeline is 55 bn cubic metres per year, and the first 27.5 bn cubic metre string is to be commissioned in 2010. The over 1200 km long pipe will cost approximately USD 4 billion. Offshoots might be built to link the pipeline with Kaliningrad. The timetable of the plan seems ambitious, though not unrealistic. Even prior to the accomplishment of the planned pipe, the growing energy needs of the Kaliningrad companies must be met in one way or another. Here one should stress that the energy producing units of Kaliningrad should not export energy if it results in energy shortages in the region.

Kaliningrad ranks as the 37th among 89 Russian regions⁵⁵ in terms of its investment potential. The region's infrastructure, its transport infrastructure in particular, is highly developed by Russian standards. For example, Kaliningrad has Russia's only ice-free ports on the Baltic Sea shore. In addition, the Pan-European Transport Corridors 1A and 9D go through the region. Therefore, it is not surprising that Kaliningrad ranks 3rd after St. Petersburg and Moscow in terms of its infrastructure potential. On the other hand, the region's labour, financial, production, innovation, and consumption potentials are somewhat lower than the Russian average (see Table 2).

Table 2. The investment potential of Kaliningrad among Russia's 89 regions

Investment potential 2003-2004	37
Change from previous year (a deterioration of 2 positions)	-2
Infrastructure potential	3
Institutional potential	29
Natural resource potential	40
Labour potential	52
Financial potential	52
Production potential	53
Innovation potential	54
Consumption potential	58
Investment risk 2003-2004	22

Source: Expert 2004

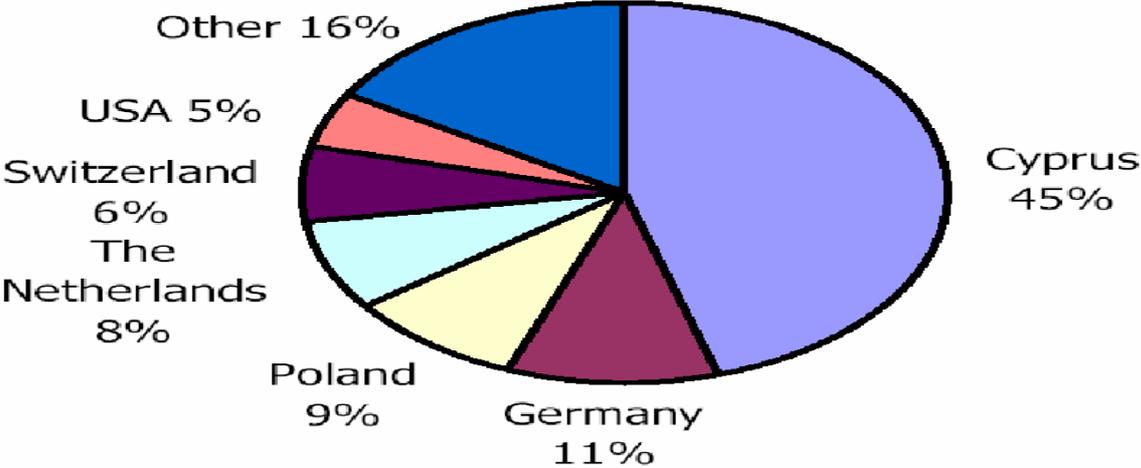
Relatively low investment potential is one of the reasons why the amount of foreign investment in Kaliningrad is relatively modest. The region accounts for not more than 0.2 per cent of the foreign investment stock of the Russian Federation. The aforementioned stake is even lower than Kaliningrad's share in the Russian GDP, 0.4 per cent. This indicator suggests that Kaliningrad does not perform as well as the country as a whole in attracting foreign investment. This implies that Kaliningrad has not succeeded in putting to full use its geographical proximity to the EU or the SEZ to attract foreign investments there.

Kaliningrad's accumulative foreign investment inflow amounted to nearly USD 300 million by the end of 2003. In 2003, Cyprus, with a 45-per cent share, was the largest investor in the region, indicating that the major part of 'foreign' investment originates from Russia. If one

⁵⁵ The number of the regions in Russia has been reduced since this ranking was conducted.

excludes ‘Cyp-Rus’ investment from the foreign investment stock, the major foreign investors come from Germany, Poland and the Netherlands. The active presence of Cyprus, Germany and the Netherlands in Kaliningrad is not a surprise, since they are also among the leading investors in the Russian Federation as a whole (Pelto et al., 2004). Similarly, Poland’s presence in Kaliningrad is anything but unexpected due to her geographical proximity. Lithuania’s absence from the list of the main investors in Kaliningrad indicates that Lithuanian firms have concentrated more on less-capital intensive business operations, mainly on trade and services, rather than on industrial production, as the number of Lithuanian firms in Kaliningrad is noteworthy. Here, one has to remember that companies based in the neighbouring countries may utilise the opportunities of the target region without investing there, which may also explain the modest investments of Lithuanian firms in Kaliningrad (see Table 3).

Table 3. Foreign investment inflow to Kaliningrad in 2003 by country



Source: Pan-European Institute 2005a

Here, one should not forget that Lithuania and Poland are not major capital-exporting countries. Their combined outward foreign direct investment stock is less than USD 2 billion, i.e. Lithuanian firms have invested abroad only USD 0.1 billion and their Polish counterparts USD 1.8 billion. The outward investments of Lithuania and Poland are clearly smaller than those of the Nordic countries. Denmark, Finland and Sweden have invested USD 77 billion abroad, USD 69 billion and USD 189 billion respectively. Russia’s own investments abroad amount to over USD 50 billion (UNCTAD, 2004; Vahtra & Liuhto, 2004).

Kaliningrad's foreign trade has developed extremely positively. In 1992, Kaliningrad's foreign trade amounted to not more than USD 0.14 billion. In 2003, their turnover has become nearly 20 times larger. In 2003, the region's imports were valued at USD 2.1 billion and the exports USD 0.6 billion. The sales of Kaliningrad to the Russian mainland amounted to USD 1.1 billion. Then, Kaliningrad's sales to the Russian mainland were over a half, compared with the region's imports. The aforementioned ratio stresses the great importance of the SEZ in boosting Kaliningrad's sales to the Russian mainland⁵⁶. The region's import structure and the list of the main importers confirm the above conclusion (see Table 4).

Table 4. The largest importers of the Kaliningrad region in 2003

Rank	Company	Field of operation	Share of region's total imports
1.	Telebalt	Electronics	5.9%
2.	Avtotor	Automobiles	5.2%
3.	Promexportimport	Household appliances	2.6%
4.	Interfood	Foodstuffs	2.4%
5.	Lukoil-Kaliningradmorneft ⁵⁷	Oil business	2.3%
6.	Agerratum	Foodstuffs	1.7%
7.	Stella Plus	Electronics	1.4%
8.	Sodruzhestvo Kargo	Material for fodder	1.3%
9.	Podonit Plus	Black metallurgy	1.1%
10.	Produkty Pitanya	Foodstuffs	1.0%
Total of 10 major importers			24.9%

Source: Liuhto et al. 2005

Kaliningrad plays an important role in the Russian Federation's foreign trade, especially in the country's imports. The region accounts for 4 per cent of the country's total imports, though the population of the region covers only less than 1 per cent of the federation's population and less than a half percentage of the country's GDP.

It is natural that the foreign trade intensity of a small economy, especially when it is geographically located apart from the mainland, becomes high⁵⁸. However, Kaliningrad's current SEZ, based on customs privileges, is a more important factor than its exclave⁵⁹

⁵⁶ One of the peculiarities of the Kaliningrad SEZ is the imposition of regional import quotas. Beginning in 1998, about 35 categories of goods are subjected to import quotas (Vinokurov, 2004a).

⁵⁷ Lukoil is at the moment Russia's largest oil producer. In August 2005, it produced 1.76 million barrels per day. The volume of Lukoil-Kaliningradmorneft's oil production constitutes 0.7-0.75 million tonnes per year. Most of its production is exported.

⁵⁸ The ratio of Kaliningrad's foreign trade over its GDP was 160% already in 2003 (Usanov et al., 2005).

⁵⁹ Kaliningrad is a semi-enclave of the EU as it is not fully surrounded by the Union because Kaliningrad has access to the Baltic Sea.

position or small economic size in explaining the region’s high import intensity⁶⁰. The aforementioned argument can easily be explained by comparing the region’s proportion of the Russian Federation’s total imports and exports.

The region accounts for 4.0 per cent of the Russian Federation’s imports, whilst merely 0.4 per cent of the country’s exports. Such a high import share cannot only be explained by the exclave position or the small size of the regional market. Correspondingly, the region’s export share corresponds to its GDP share, suggesting that Kaliningrad is not a particularly export intensive region. The low export intensity refers to the relatively weak competitiveness of Kaliningrad-based goods abroad. Here, one should not forget that improving the external competitiveness of goods via the SEZ is a much more demanding task than that of improving their internal competitiveness, i.e. the competitiveness of Kaliningrad-produced goods inside Russia (see Table 5).

Table 5. The Kaliningrad region in the Russian economy

Kaliningrad’s share of the Russian total	
Basic facts	
Area	0.1%
Population	0.6%
Economy	
Gross domestic product	0.4%
Industrial production	0.5%
Retail trade	0.5%
Enterprise population	0.9%
External economic relations	
Exports	0.4%
Imports	4.0%
Foreign investment	0.2%
Number of companies with a status of “a firm with foreign capital”	2.0%

Source: Rosstat 2004

⁶⁰ The non-CIS imports per person are clearly higher in Kaliningrad than in any other Russian region (Liuhto et al., 2004).

2.2. Kaliningrad in international comparison

Kaliningrad's economic recovery seems less glorious when compared to Poland or particularly to the Baltic States, which belonged to the same country less than 15 years ago. The table below shows that the GDP per capita in Kaliningrad is less than a half of that in Latvia, which has the lowest living standard amongst the Baltic States.

Kaliningrad succeeds better with its external economic relations. Its exports per capita are already two thirds of that of the Latvians, and its imports per capita are higher than in Latvia and Poland. When analysing Kaliningrad's high import intensity, one should naturally remember that a great part of the region's imports are finally targeted to the Russian mainland, which distorts the aforementioned comparison.

The weak performance of the Kaliningrad region becomes more obvious, when analysing the region's attractiveness in the eyes of foreign investors. The FDI stock per capita in Latvia, Lithuania, and Poland is 5 times that of Kaliningrad. The gap between Estonia and Kaliningrad is even wider – 20 times (see Table 6)⁶¹.

Table 6. A comparison of the Kaliningrad economy with its neighbourhood in 2004 (at current prices)

	Kaliningrad	Poland	Estonia	Latvia	Lithuania
GDP (€ billion)	1.9	195.2	9.0	11.0	17.9
Exports (€ billion)	0.9	60.0	4.7	3.2	7.5
Imports (€ billion)	2.5	71.6	6.7	5.6	9.9
FDI stock 2003 (€ billion)	0.2	42.6	5.3	2.7	4.1
Population (million)	0.945	38.174	1.351	2.319	3.446
GDP per capita (€)	2011	5113	6662	4743	5194
Exports per capita (€)	952	1572	3479	1380	2176
Imports per capita (€)	2646	1876	4959	2415	2873
FDI stock per capita 2003 (€)	212	1116	3923	1164	1190

Sources: UNCTAD 2004; Eurostat 2005; Statistics Lithuania 2005; Pan-European Institute 2005b

⁶¹ The FDI figure for Kaliningrad contains all foreign investments, including foreign loans and portfolio investments, in the Kaliningrad region. In addition, one has to remember that a great part of the 'foreign' investments are Russian by origin. This naturally distorts the comparison of Kaliningrad with its neighbouring countries, as it exaggerates Kaliningrad's FDI attractiveness.

The gap between the Kaliningrad region and its neighbours becomes narrower when Kaliningrad is compared with the Lithuanian or Polish regions bordering it. This is mainly due to the fact these Lithuanian and Polish regions do not generally perform as well as other regions in these countries. GDP per capita in Warminsko-mazurskie and Podlaskie, the Polish regions bordering Kaliningrad, is ‘only’ double that of Kaliningrad. Correspondingly, the Lithuanian regions bordering Kaliningrad – Klaipeda, Marijampole and Taurage – have a GDP per capita 25-150 per cent higher than in Kaliningrad.

Though Kaliningrad’s GDP per capita is lower than in the surrounding regions, the official employment situation in Kaliningrad is better. The unemployment rate in Kaliningrad is only 6.2 per cent, measured by the ILO standards, whereas the unemployment rate of Warminsko-mazurskie and Podlaskie is clearly over 15 per cent. Lithuania’s regions bordering Kaliningrad have lower unemployment rates, 6.9-12.7 per cent, than Poland’s eastern parts. Kaliningrad’s narrow labour potential, together with these relatively high unemployment rates in the surrounding regions, has created a rather interesting phenomenon, i.e. a labour movement from Lithuania and Poland to Kaliningrad. Kaliningrad companies, particularly those in electronics and other advanced fields, search for qualified experts abroad (see Table 7).

Table 7. A comparison of wellbeing in Kaliningrad and its surrounding regions

	Kaliningrad	Warminsko -mazurskie (Poland)	Podlaskie (Poland)	Klaipeda (Lithuania)	Marijampole (Lithuania)	Taurage (Lithuania)
GDP / capita (€) 2011 (2004)		3871 (2002)	3992 (2002)	5039 (2003)	3186 (2003)	2520 (2003)
Unemployment (2004)	6.2%	19.7%	16.4%	12.7%	6.9%	8.9%

Such a wide gap between Kaliningrad and its bordering regions underlines the fact that the economic activities across the border are below their potential due to the barriers hampering cross-border business activities from taking place. To put it differently, Kaliningrad would definitely benefit from lowering the economic border between Kaliningrad and its surrounding areas.

To sum up, when comparing Kaliningrad with its neighbours, one should take into account methodological differences in producing statistics between the EU and Russia, the large size

of the unrecorded economy in Kaliningrad and the exchange rate issues, which prevent one from producing a precise comparison. The author's own experience in travelling in Kaliningrad and its bordering regions in Lithuania and Poland suggests that the real living standard gap is perhaps not as wide as the statistics may indicate.

3. Kaliningrad's new challenges

3.1. The external economic relations of Kaliningrad after the EU enlargement

In 2004, the trade between the EU and Russia increased substantially. Particularly the EU15 managed to increase its trade turnover with Russia by approximately USD 25.3 billion. The new members' trade growth was more modest, some USD 5.5 billion. The trade growth can mainly be explained by the high prices of natural resources and increasing consumption in Russia, which has kept Russia's imports going up since 1999. In 1999, Russian imports amounted to only USD 40 billion, whereas 5 years later they were almost 2.5 times higher. During 1999-2004, the country's exports have jumped from USD 75 billion to close to USD 185 billion. The volume growth in the EU-Russian trade and the structural change in trade have been much less impressive.

Even today fuel and metals cover over three quarters of Russia's exports. Machinery and equipment represent less than 5 per cent of the total exports. Correspondingly, consumer goods continue to dominate Russia's imports. Machinery and equipment already account for over 40 per cent of the total imports. Unfortunately, much of the machinery is not investment goods but consumer products, such as passenger cars and cellular phones. In fact, in the first quarter of 2005, the fastest growth was registered in car imports; the number of foreign cars imported into Russia jumped by almost 70 per cent.

In addition to an increase in the prices of natural resources, the enlargement per se has also had a direct impact on EU-Russian trade. The EU's share of Russian foreign trade jumped by more than 10 percentage points, as a result of their 10 new members. Last year, the EU covered approximately half of the country's foreign trade (see Table 8).

	Share before enlargement (% - 1-4/2004)	Share after enlargement (% - 5-12/2004)	Change in trade (USD mn - 2003/2004)
Austria	0,9	0,7	213
Belgium	1,1	1,2	980
Cyprus	2,8	2,0	1198
Czech Republic	1,3	1,2	461
Denmark	0,4	0,5	406
Estonia	0,7	0,7	181
Finland	3,6	3,0	1984
France	2,9	2,9	1659
Germany	9,3	9,3	5342
Greece	0,6	0,5	339
Hungary	1,6	1,5	543
Ireland	0,6	0,3	-261
Italy	5,7	6,0	4354
Latvia	0,7	0,6	325
Lithuania	1,4	1,3	800
Luxemburg	0,0	0,1	99
Malta	0,1	0,0	43
Netherlands	6,6	6,4	6691
Poland	3,3	3,1	1675
Portugal	0,2	0,3	582
Slovakia	1,0	1,1	229
Slovenia	0,3	0,2	58
Spain	0,8	1,1	551
Sweden	1,2	1,3	1033
United Kingdom	2,8	3,1	1342
EU15	36,7	36,7	25315
EU25	(49,9)	48,4	30827
CIS	17,9	18,5	13471
China (excl. Taiwan)	6,5	5,7	3283
Japan	2,9	2,9	3059
USA	3,2	4,0	2605
TOTAL	100	100	66120

Source: Customs Russia 2005

Russia is the fifth largest trading partner for the Union, with a share of 7.6 per cent of the Union's imports and 4.4 per cent of exports (Karaganov, 2005). The enlargement did not cause a strategic change in the geographical division of the EU's foreign trade, since the foreign trade of the 10 new members with Russia is rather modest. Poland with her 3-per cent share in Russian foreign trade is clearly the main partner among the new members. In this context, it is necessary to mention that the share of the EU15 in Russia's foreign trade has remained unchanged after EU enlargement, but the share of the new members has diminished from 13.2 per cent to 11.7 per cent. All in all, despite the strong growth in EU-Russian

foreign trade, one should not argue that an immediate strategic shift would have taken place in the trade between the EU and Russia.

The foreign trade of the Kaliningrad region developed very positively last year. Kaliningrad's foreign trade turnover reached in 2004, nearly USD 4.5 billion, a growth of over 60 per cent compared to 2003. The first half of this year shows that the strong growth continues. During the first six months of 2005, the foreign trade turnover of Kaliningrad has increased by nearly 60 per cent. Particularly, Kaliningrad's exports have skyrocketed. In 2004, they doubled and extremely fast growth seems to continue. Imports are growing at a lower pace. In the first half of 2005, they increased by some 35 per cent (see Table 9)

Table 9. The trade flows of the Kaliningrad region, USD million

	2000	2001	2002	2003	2004	1H/2005
Exports of goods (A)	475	455	471	574	1264	884
Imports of goods (B)	875	1047	1610	2142	3198	1710
Sales of Kaliningrad goods to the Russian mainland (C)	424	619	759	1118	1802	1048
Ratio A/C	1.12	0.74	0.62	0.51	0.70	0.84
Ratio B/A	1.84	2.30	3.42	3.73	2.53	1.93
Ratio C/B	0.48	0.59	0.47	0.52	0.56	0.61

Sources: Pan-European Institute 2005a, Kaliningrad Statistics 2005

The high peak in exports is not directly linked with the EU enlargement. The growth in exports in 2004 was mainly due to the large increase in the export of oil and oil products (by 2.8 times) and machinery (by 2.2 times). This was chiefly due to companies from other regions in Russia channelling their exports through Kaliningrad so that they were registered as Kaliningrad's exports. The proportion of Kaliningrad's own firms in the value of exports was approximately 50 per cent. One should keep in mind that energy and machinery account for over 60 per cent of the region's exports⁶².

The use of the Kaliningrad region in minimising export taxes and duties casts some shadow over the new SEZ, as it suggests that the artificial exploitation of tax breaks may continue, if the SEZ is not controlled carefully. On the other hand, the impressive growth in machinery

⁶² A further study on the development of Kaliningrad's machinery exports should be carried out, since it might reveal, how some Kaliningrad-based companies have succeeded in upgrading their exports, while the Russian exports as a whole suffers from the overwhelming dependency on the exports of natural resources. Kaliningrad's success could be copied also elsewhere in Russia

exports is a very encouraging fact, as Kaliningrad may show the rest of the Russian Federation a way how to decrease the natural resource dependency in exports.

In 2004, Kaliningrad's imports increased by USD 1 billion, a growth of nearly 50 per cent. Such a tremendous jump is not a novelty in the Kaliningrad region, since the annual growth of imports has remained between 20 and 54 per cent during the whole decade. The EU enlargement has not changed the structure of the region's imports. In 2004, materials linked with machine building and foodstuffs accounted for two thirds of the region's total imports. The structure was practically the same a year earlier.

Last year, Kaliningrad's sales to the Russian mainland reached the record high, USD 1.8 billion, being almost over 60 per cent higher than a year earlier. The sales to the mainland are very concentrated. Three products – TV's, meat and fish products – account for 40 per cent of these sales. It is important to notice that sales to the mainland have increased faster than imports to the region. Therefore, the ratio between the mainland sales and the region's imports reached a record high in the first half of 2005. The aforementioned ratio illustrates the 'old' SEZ is not only a transit region to the Russian mainland, but an increasing amount of value adding takes place in the region.

One should also notice that the region's imports were double the exports in the first half of 2005. In 2003, imports exceeded exports by almost four times. In other words, Kaliningrad's external trade has become more export-oriented. In addition, one should notice that the exports have rapidly caught up with that of sales to the Russian mainland. The ratio between their real exports and 'the mainland exports' is over 80 per cent. This is a great achievement, since in 2003 this ratio was barely over 50 per cent. Though the 'old' SEZ has contributed positively to the increase in the region's exports (e.g. subcontracting with foreign firms in electronics), the SEZ is not the major explanatory variable for increasing exports but rather the increase in energy prices.

Kaliningrad's foreign trade is understandably more orientated to the EU than that of the Russian Federation. Clearly over two thirds of Kaliningrad's foreign trade is conducted with the EU, whereas the EU covers a half of the foreign trade of whole Russia. The geography of Kaliningrad's foreign trade has not significantly changed when one compares the years 2003 and 2004. The leading troika have kept their places, i.e. Germany, Poland and Lithuania were

still the region's main trading partners in 2004. Together they formed 37 per cent of the region's foreign trade. A year earlier, their combined stake was three percentage points higher. Last year, France became Kaliningrad's fourth largest trading partner, as its trade with Kaliningrad increased by an impressive 500 per cent. Kaliningrad's trade with the Netherlands, the region's 5th largest trade partner, almost tripled, probably due to high oil prices. Despite the EU enlargement, the Kaliningrad region's foreign trade with Belarus jumped from USD 120 million to nearly 150 million, making Belarus the 6th largest trade partner for Kaliningrad. Sweden's trade with Kaliningrad collapsed in 2004 when compared to 2003, from USD 140 million to USD 60 million respectively. The collapse has probably nothing to do with the enlargement per se. The trade value of the 8th largest trade partner (nearly USD 50 mn), Denmark, remained practically unchanged in 2004, compared to a year earlier.

Non-legal foreign trade activity across the Kaliningrad border, i.e. shuttle trading, was vivid prior to the enlargement. Vinokurov (2004a, 15) wrote prior to the enlargement as follows: *“since Polish and Lithuanian borders have become external borders of the Union, stricter customs regimes will most probably cause lower volumes of black and grey trade on the borders. Certainly, as long as heavy price imbalances exist, this kind of border trade (cigarettes, vodka, spirit, gasoline) will not vanish entirely, but their volume must shrink considerably. In the long run this may be judged to be a positive phenomenon, but in the short and medium term, it will create enormous difficulties for an estimated 20,000 to 40,000 families in the region that currently make a living on shuttle trading. This would create an extremely serious structural problem at the regional level because a disproportionate part of these families live in smaller border towns where other employment possibilities are severely limited.”*

Even if no statistics on shuttle trading exist, it seems obvious that the shuttle trading has decreased after the enlargement due to new regulations and stricter control at the borders⁶³. However, it is difficult to believe that the socio-economic impact of decreasing shuttle trading would have been as dramatic as has been indicated by Vinokurov, since the estimation that 20,000 to 40,000 families, i.e. 50,000 to 100,000 Kaliningrad citizens, would have been

⁶³ In mid-September, Itar-Tass (2005) reported that as of the beginning of the year, Kaliningrad frontier-guards have confiscated more than 200,000 packets of cigarettes to the total sum of two million roubles. The main part of them was to be smuggled into neighbouring Lithuania.

dependent on shuttle trading prior to the enlargement is indisputably too high. The aforementioned estimate would have meant that 5-10 per cent of the Kaliningrad population would have been involved in this non-legal trading. If this would have been the case, the unemployment rates of Kaliningrad would have skyrocketed after the enlargement. This has not happened, quite on the contrary, Kaliningrad's unemployment rate at the end of 2003 was 9.1 per cent, whereas a year later it was 6.2 per cent measured by the ILO standards.

Foreign investments in Kaliningrad increased over 90 per cent in 2002, by nearly 20 per cent in 2003, but only 10 per cent in 2004. The 2004 development indicates clearly that the EU enlargement has not started a foreign investment boom in Kaliningrad. The explanation for such a 'low' growth rate in 2004 is not the saturation of the Kaliningrad market, as foreign investments in the region are still extremely modest. The total foreign investment stock in the end of 2004 was less than USD 350 million.

During the year 2004, the Kaliningrad region was able to attract foreign investment of just some USD 60 million. In the first half of 2005, foreign investment inflow has been notably low, only USD 18 million. The slow growth of foreign investments in 2004 and in 2005 is due to the fact that some foreign companies, mainly the 'Cyp-Rus' ones, wait for the new SEZ law to be adopted. The adoption of the new SEZ will probably cause a temporary foreign investment boom in Kaliningrad, as it releases those investments which have been postponed (see Table 10).

Table 10. Annual foreign investment inflow into Kaliningrad, in USD million

	1994-99	2000	2001	2002	2003	2004	1H/2005
Total foreign investment of which	114	19.1	24.6	47.7	56.2	61.9	18.3
Direct investment	n.d.	6.6	3.2	5.9	14.0	22.4	8.2
Portfolio investment	n.d.	-	-	-	-	4.9	1.3
Other investments - trade credits and loans	n.d.	12.5	21.3	41.8	42.2	34.6	8.7

Sources: Pan-European Institute 2005a, Kaliningrad Statistics 2005

In January-September 2004, some 40 per cent of the foreign investment in Kaliningrad ended up in trade, nearly 20 per cent in communications, over 30 per cent in the paper industry, fuel

industry and foodstuffs⁶⁴. Presumably, the foreign investment structure and its geographical composition have not changed considerably due to the EU enlargement. The main change in the geographical division might be the lower share from Cyprus in the foreign investment statistics of 2004, since many of the Cypriot firms have postponed their investments as they await new SEZ legislation to take place. One must bear in mind that the majority of the Cypriot investment in Kaliningrad is Russian in origin. For these 'Cyp-Rus' investors, the enlargement has not been as an important motive to invest in Kaliningrad as the SEZ.

Due to a small amount of foreign investments, one cannot argue that foreign investments are the main driving force in Kaliningrad's economic development, but an important addition to the overall investment activity. The share of all foreign investments from the total investments into the fixed capital in the region was nearly 10 per cent in 2004. It is highly likely that the foreign investment inflow would grow and the role of foreign firms would become much more important in the regional development, when the implementation of the Common European Space begins.

Even if the EU enlargement has not resulted in major change in foreign investment flows into the Kaliningrad region, it has officially made the EU the main foreign investor in the Kaliningrad region due to the fact that Cyprus joined the Union.

Besides investments from the countries belonging into the EU, one should not forget the China phenomenon may be taking place in the Baltic Sea region. In other words, it is highly likely that Chinese companies will become more interested in investing in Russia and particularly in a new Kaliningrad SEZ. Those Chinese firms, whose business idea requires proximity to the European market, but nevertheless, which wish to maintain low cost levels, may find Kaliningrad an attractive investment place. Several company managers in Kaliningrad interviewed for this research expressed that the interest of Chinese companies has significantly grown towards the Kaliningrad region during the past 12 months.

Attracting more foreign investments into the region requires a more active investment promotion of the Kaliningrad region, since the possibilities provided by the Kaliningrad

⁶⁴ Kaliningrad's foreign investment division by sector is not dramatically different from that of the whole country. Trade accounted for 32%, industry (incl. fuel industry) 50%, and transport & communication 5% of Russia's all foreign investments gained in 2004 (Finpro, 2005a).

region are not familiar to the majority of foreign investors. Therefore, the activities of the Kaliningrad Regional Development Agency should be further supported or a separate unit, the Kaliningrad Investment Promotion ('KalinInPro') should be established sooner rather than later⁶⁵.

Despite the high importance of a foreign investment promotion agency for the Kaliningrad region, one has to keep in mind that larger foreign corporations may find Kaliningrad's labour potential too narrow to make major investments there. At this juncture, one should not forget the fact that in some industrial fields, foreign corporations have already encountered difficulties in finding a qualified labour force in the Baltic States⁶⁶. As Kaliningrad possesses an even smaller labour reserve than her Baltic neighbours, any labour bottlenecks will be reached surprisingly quickly. The narrow labour potential of the region would also create extra pressures to raise salaries at a faster tempo in Kaliningrad than in mainland Russia. Here, one should remember that the unemployment rate of Kaliningrad is already low at the moment, i.e. their unemployed persons do not create an extra labour reserve for industrial companies. In addition, one should keep in mind that the ageing of population and low birth rate negatively affect the future labour reserves of Kaliningrad. Therefore, it can be argued that the Kaliningrad region is able to accommodate only a limited number of major industrial producers.

In this context, one should bear in mind that the Kaliningrad companies, naturally, may use the labour force of close-by countries, such as Lithuania, Poland, Belarus and Ukraine. Even more distant alternatives can be considered. In fact, some of the Kaliningrad companies already at the moment use inexpensive and work-concentrated workers from China. However, their total number is presumably rather modest.

In order to produce a more detailed picture about change in the economic behaviour of Kaliningrad firms after the latest EU enlargement, one should conduct an empirical study among the companies in the region. Special emphasis should be placed on analysing changes in investment behaviour, and in particular, one should analyse whether new investments are linked with the mainland's growing potential or with their expansion aims abroad.

⁶⁵ In mid-June 2005, the Foreign Investor Association of the Kaliningrad region was founded. This association may have a positive impact on aiding new foreign companies to adapt to the regional business culture.

⁶⁶ The Estonian Investment Agency stopped trying to attract manufacturers years ago, favouring service-based investors instead (Sherwood, 2005).

Even if the author does not have statistics on the Kaliningrad companies' investments abroad, one may proffer an educated guess that the investment flows from Kaliningrad abroad are rather modest, as the capital accumulation in the region is not particularly notable⁶⁷. As a whole, one cannot completely exclude the possibility that some outflows of the Russian capital also take place via Kaliningrad. The EU enlargement per se has very little to do with these outflows, though a great part of these flows have traditionally ended up in Cyprus, now belonging to the EU (Vahtra & Liuhto, 2004).

Tourism is an important source of receiving foreign revenues in many neighbouring countries. The number of foreign tourists visiting Kaliningrad was just 70,000 in 2004, whereas the tourist flow into Estonia, with a comparable population size, is substantially higher. Approximately 960,000 foreign visitors were accommodated in the hotels of Tallinn alone. If one adds to the aforementioned figure one-day tourists from Finland, the total amount of tourists in Estonia can be measured in millions. Therefore, tourism and the shopping related to it contribute a significant stake for the Estonian GDP. This is not the case in today's Kaliningrad.

The development of tourism in Kaliningrad indicates that the number of Russian visitors has doubled in the period 1997-2004. During the same period, the amount of foreign tourists has increased from 50,000 to today's 70,000. On the basis of their tourism development, one cannot argue that foreign tourism, or even domestic tourism, would have significantly suffered from the EU enlargement. On the other hand, one cannot argue that the Kaliningrad region has managed to fully exploit the possibilities provided by its unique nature, history and geographical position.

Various issues slow down the building of the tourism industry in the region, such as undeveloped international transport connections, the small number of Western-standard hotels and visa requirements between the EU and Russia. Kaliningrad in particular would benefit from the visa-free zone between the EU and Russia⁶⁸. As the building of the visa-free zone

⁶⁷ Forbes (2005a/b) has named 27 billionaires in Russia. None of them lived in Kaliningrad. In fact, none of Russia's 100 richest persons was a citizen of Kaliningrad.

⁶⁸ According to Vinokurov (2004b, 1 and 11), *"it is feasible for Russia to introduce visa-free regime for the EU citizens in Kaliningrad Region. On the EU side, visa regime for Kaliningrad may be kept intact, if multi-entry Schengen visas with longer validity will be made available to the residents of Kaliningrad and visa procedures*

belongs to the road maps between the EU and Russia, their rapid implementation would support regional development in Kaliningrad (see Table 11).

Table 11. Tourism and border crossings in the Kaliningrad region

	1997	1998	1999	2000	2001	2002	2003	2004
Tourism (thousands)								
Foreign tourists	53	65	65	59	60	63	67	71
Russian visitors	112	117	144	164	182	212	224	240
Border crossings (millions) (entry plus exit)								
Persons	n.d.	n.d.	8.6	8.9	9.0	9.1	7.9	7.0
Vehicles	n.d.	n.d.	2.9	3.1	3.1	3.1	3.3	2.9

Source: Kaliningrad Statistics 2005

Though one should not explain the positive development in Kaliningrad's external economic relations by the enlargement per se, one can easily conclude that enlargement has not brought those negative consequences to Kaliningrad's economy which some researchers proposed prior to enlargement, i.e. Kaliningrad has not been economically trapped within the EU.

3.2. Kaliningrad and the expected new law on the special economic zone

Some views on the impact of the legislative change have been presented even earlier. In June 2005, the Pan-European Institute's monitoring report on the Kaliningrad region (2005a, 1) suggested that "*customs privileges of the regional Special Economic Zone (SEZ) continued to play a determining role in shaping the economic specialization of the region and in supporting its economic growth, which is based, first and foremost, on import substitution production. The Russian Government, after several years of discussions, approved a new draft law on the Kaliningrad SEZ and submitted it to the State Duma, where it is expected to be quickly adopted. The main idea of the new draft is gradually to replace the existing customs benefits, which are planned to remain intact for existing companies for the next 10 years, with tax breaks for large investors. The existence of the new draft creates some*

will be eased up. ... Opening Kaliningrad for Europeans, even if originally a unilateral move, would greatly facilitate doing business in Kaliningrad. It would provide tourism and hospitality business with numerous advantages, on the other hand, and provide investors with powerful incentives to come to the KO [Kaliningrad Oblast i.e. Kaliningrad region], on the other hand." Here one should note that only about a quarter of Kaliningrad residents had the external passport in 2004.

uncertainty regarding the new rules of play in the region, especially for investors who have already undertaken projects in the province. However, this uncertainty is not having a visible effect on the positive dynamics of the main macroeconomic indicators. On the contrary, many companies are seeking to establish a presence in the region in order to capitalize on customs privileges before the new law is enacted.”

In July 2005, **Sergei Yastrzhembsky**, the Russian presidential envoy to the European Union, stated as follows: *“investments in the Kaliningrad region has been insufficient in volume. This has to do with prospects for a Kaliningrad special economic zone that have been unclear until recently. One would expect that, with the adoption of the new law on the special economic zone, the problems that have in the past been slowing down the inflow of foreign investment into the region would be eliminated automatically. Both Russian and foreign investors will be much more active.”* (Interfax, 2005).

Should the law be adopted as suggested in the first draft, its core could be summarised as follows⁶⁹:

- The new law provides a full income tax relief for 6 years for new companies, which invest RUR 150 million (some € 4,25 mn) or more after the new SEZ law has been adopted. During the 7-12th year of operations, the income tax of the eligible company is lowered by 50 per cent.
- RUR 150 million or more has to be invested within 3 years. If the company fails to invest the minimum limit, it has to pay the taxes in full. An interesting legal case appears, if a company eligible for a tax break ceases to exist prior to the end of the third year.
- The following sectors are excluded from the tax break: 1) oil and natural gas production and the services related to them; 2) production of alcohol, tobacco and other goods under the excise (except passenger cars and motor bikes), 3) wholesale and retail trade; 4) repair of household goods; and 5) financial services. It is not clear to the author why the repair of household goods should be excluded from the tax break.
- The customs regime of the former SEZ is kept in place for 10 years. During the transition period the imports of goods are exempt from import taxes and duties. If 30 per cent value added takes place, these goods can be sold to the Russian mainland without paying import taxes and duties. Two major changes will take place. Firstly, companies operating in electronics also have to produce 30 per cent value added to be able to sell their goods to the Russian mainland without taxes and duties. Secondly, the companies operating under the ‘old’ SEZ are obliged to pay export tariffs and duties.

⁶⁹ Several experts interviewed for this research consider that the new Kaliningrad SEZ would be in line with the WTO criteria. On the other hand, some reports argue that the Kaliningrad SEZ would be against the WTO principles (Finpro, 2005b). Some Russian experts have expressed doubts whether Russia will sign the WTO agreement in December 2005.

- The new SEZ law is in force for a period of 25 years from its adoption.

As in time of writing this paper, it is not evident what will be the final form of the law and the date of its adoption, one can only speculate about the economic impact of the change. Though it is too early to predict all the economic consequences of this legislative exercise, several essential issues can be raised.

- 1) The era of two simultaneous SEZ regimes creates, at the beginning, a situation where three types of companies exist: (1) new companies entitled to a full tax break; (2) new companies not entitled to a tax break; and (3) old companies not entitled to a tax break but entitled to customs privileges. After the 6th year of the new SEZ, a further new category of companies appears, i.e. those that are eligible to cut their income tax only by 50 per cent. After the 10-year transition period, customs privileges are abolished, and hence, company category number 3 disappears.

History has shown that complicated administrative systems do not usually provide maximum benefit to the State, as companies tend to find loopholes in order to minimise their taxes. Empirical evidence also suggests that firms are faster in finding new loopholes in complex systems than the authorities are able to fill them.

Besides, it should not be forgotten that the two simultaneous SEZ systems require more administrative capacity and more control than the 'old' SEZ system. Complicated administrative systems do not aid in the battle against corruption, quite the contrary in fact.

- 2) The new system discriminates, at least in principle, against small companies, which do not possess enough financial resources to meet the investment limits required by the new law. Putting small firms into a less advantageous position is not in line with Russia's policy, which aims at supporting the development of small and medium-sized enterprises (SMEs), which are generally one of the main sources of economic flexibility and employment.

Although the new SEZ does not directly support employment creation via SMEs, it needs to be kept in mind that unemployment is not a substantial problem in Kaliningrad (6.2%). Kaliningrad's unemployment rate is lower than in Russia on average (7.6%). In fact, the unemployment rate in surrounding countries is even higher – in Lithuania (10.6%) and Poland (18.0%).

The new SEZ supports industrial production instead of services, as companies in the service sector seldom reach the investment limit mentioned in the law draft. In this context, one has to stress that the natural competitiveness of Kaliningrad does not presumably lie in industrial production with low labour costs but rather in sophisticated processes which are based on innovation, highly-qualified labour and proximity to the main European markets. In addition, one should not forget the rapid salary increase in the Baltic States, which has made some of their labour-intensive industries uncompetitive compared with their Asian competitors within a time frame of no more than 10 years. The same competitiveness trap may wait for the Kaliningrad industrialists, if their business idea is based on low labour costs.

Instead of turning Kaliningrad into a new production and industrial centre on the Baltic Sea shore, one should support the creation of various services which are based on wider trends in Europe, i.e. the ageing of the population (with a growing need for health-related services) and the increase of leisure time (tourism). It can be assumed that the future competitiveness of Kaliningrad will be based more on health tourism and the services related to it than upon conventional industry. Therefore, the region should support the strengthening of the service sector via a special policy targeted to the service sector.

- 3) Some foreign firms which already operate in the region may feel that the legislative change weakens their competitive position. We have to remember that the average foreign investment in Kaliningrad is substantially below the limit required by the proposed SEZ law. The legislative change may push these existing foreign firms to increase their investment or, in the longer run, force them to leave the market for larger players.

As the role of foreign investments in the Kaliningrad economy is not extremely large, the forthcoming legislative change is not to bring dramatic economic effect to the regional economy via existing foreign firms. One should not be too optimistic that tax breaks attract great amounts of new foreign capital into the region. International evidence has shown that tax reliefs are not the main motive for companies to invest abroad. One should keep in mind that the clear, free, fair and predictable business climate of the region is a much more important reason for potential new foreign companies to invest in Kaliningrad than the SEZ, based either on customs privileges or tax breaks. The foreign investment development of the Novgorod region is good proof of the aforementioned, underlining the role of the regional administration and the region's investment agency in attracting new foreign investments into the region⁷⁰.

- 4) Tax breaks provided by the Kaliningrad SEZ can theoretically be an additional attraction for some Russian capitalists to return their money to Russia and place it in Kaliningrad. However, the author is not very optimistic that a massive capital return would happen due to the change in Kaliningrad's SEZ legislation. Overall development and the predictability of the country's business climate are much more influential factors in attracting the Russian capital back home than tax breaks or other legislative measures.

- 5) If the tax reliefs decrease through time – six years of a full tax break, and thereafter, six years of half a break – it pushes entrepreneurs to establish temporary firms, not only to maximise their tax benefit but also to be in the same competitive position as new companies, which are eligible for a full tax privilege.

It seems highly likely that companies are established to operate for six years, and thereafter, their operations are closed and moved to new firms, which in practice carry out the same activities, and hence maintain the full tax break. Old firms might be forced to use such a reincarnation method to protect their business against newcomers.

⁷⁰ Moscow-born Georgy Boos, 42, was elected as the new governor of the Kaliningrad region in September, 2005.

The policy discriminating against old firms over new ones does not encourage long-term investments. Whatever controls are set in place to prevent such an artificial reincarnation, it is evident that the system is vulnerable to misuse.

- 6) It seems likely that Kaliningrad's tax breaks will lead to capital movements within the Russian Federation.

According to the positive scenario, change in Kaliningrad's SEZ legislation attracts companies from other Russian regions to move their operations to Kaliningrad, as they aim at minimising their taxes. Kaliningrad definitely benefits from such enterprise immigration and additional capital inflows. Also the Russian Federation as a whole benefits from capital movements to Kaliningrad, provided that these moves create new business activity instead of merely relocating them from one Russian region to Kaliningrad.

According to the negative scenario, the new SEZ may lead to the superficial registering of units in Kaliningrad, as the companies may aim at avoiding taxes by registering 'artificial' units in the region, i.e. the corporation may only move its headquarters instead of production into the region but still try to benefit from the tax break. Naturally, the State does not benefit from the superficial moves – quite the opposite.

It is impossible to predict what might be the extent of capital movements from other Russian regions to Kaliningrad. What ever the scenario takes place, one can be sure that the legislative change puts extra pressures on control.

- 7) The abolishment of the 'old' SEZ after the 10-year transition period may create some unexpected consequences. For instance, some food producers may find it to be more beneficial to locate their production elsewhere in Russia or in some nearby country, perhaps in Ukraine. Also the relative competitive position of the electronics producers in Kaliningrad worsens already during the transition period, and will continue to do

so, particularly after it. This may bring some negative impact to the Kaliningrad economy, when the 'old' SEZ will be terminated. A study concerning the socio-economic consequences of the termination of the 'old' SEZ should be carried out well in advance of its closure.

- 8) The overwhelming majority of the Kaliningrad businessmen interviewed for this research consider that the new SEZ law strengthens the economic stability of the region, since the new SEZ will be in force for 25 years. Earlier, the destiny of the 'old' SEZ was discussed annually in the State Duma, which created enormous problems for local businessmen in planning their future activities and created an extra investment risk.
- 9) Two SEZ systems operating simultaneously stresses the need to clearly define roles between federal and regional authorities. Unclear roles would probably lead to unclear rules and to an increase in unwanted bureaucracy, and hence, to a lower efficiency of firms due to time losses caused by the extra bureaucracy.
- 10) Despite the indisputably important role of the SEZ in the Kaliningrad economy, it should be stressed that all special administrative arrangements are counter to free competition and they break the economic unity of the Russian market. Although the Kaliningrad SEZ can, in the medium term, be justified, due to the region's exclave position, in the long-term all the actions aiming at the abolishment of the administrative privileges supports the overall market transition in Russia.

In other words, this special zone along with other special zones so designed at the moment break the economic unity of the Russian market, since giving privileges to some regions, which means a relative decline of competitiveness of those regions which have not been granted a special privilege. In that respect, special economic zones and other administrative privileges distort the natural competition within the Russian Federation.

Finally, one should emphasise that the SEZ creates an artificial competitiveness in Kaliningrad, which may, in the long run, distort the creation of natural, and hence sustainable, competitiveness in the region. Therefore, the operation of the SEZ should definitely be re-considered when the period of validity of the new SEZ expires. It is also extremely interesting to follow the future development of other special zones to be established in the country⁷¹.

To conclude, the Kaliningrad special economic zone has been and will be an important engine for the economic development of the Kaliningrad region. However, any possible delay of the new SEZ law should be avoided, since many local companies have postponed their investments whilst they wait for the new legislation to come into a force. If the new law will not be in force by January 2006, the Kaliningrad region will lose at least one year before the law can be put in place, due to Russia's taxation system. Should this happen, Kaliningrad's economic growth would definitely suffer from the postponement. Therefore, it is of the utmost importance to put this law into place already by the beginning of next year.

5. Summary

- 1) *The majority of the economic indicators suggest that the EU enlargement of 2004 has not caused a negative impact on the economy of the Kaliningrad region.*

Though the region's foreign trade has developed extremely positively after the enlargement, one should not argue that the enlargement per se has caused the positive development. The main explanation for growing imports in 2004 is the increase in

⁷¹ A law allowing the establishment of two special zones was adopted in Russia; 1) a manufacturing zone (not more than 10 sq km) and 2) a knowledge-intensive production zone (not more than 2 sq km). Manufacturing zones would enjoy accelerated depreciation, together with exemption from limitations on loss carry-forward, no property and land tax for 5 years and the waiving of import duties and VAT payments on goods carried inwards. Knowledge-intensive production zones would enjoy a low unified social tax (14%) and exemption from property and land tax for 5 years. Some experts estimate that 10-12 special zones are to be established in the first phase. The first new zones are to be chosen already during the year 2005. RUR 8 billion has been reserved in the federal budget of 2006 for establishing these new zones. The first new zones are expected to start their operations by the end of 2007. The aforementioned law does not have a direct impact on the special zones in Kaliningrad and Magadan. In addition to the 2 aforementioned zones, a law concerning the special zone specialising in tourism and leisure activities is perhaps adopted in September 2005 (Troika Dialog, 2005).

sales to the Russian mainland (*the transit effect towards the Russian mainland*). Correspondingly, the main explanation for growing exports is the increase in oil and machinery exports, which is, to a large extent, due to companies from other Russian regions channelling their exports through the Kaliningrad province (*the transit effect from the Russian mainland*). It is important to note that no dramatic change has occurred in terms of Kaliningrad's foreign trade structure or its geographical scope, though the EU's share has increased significantly, particularly due to the EU membership of Lithuania and Poland.

Despite no precise statistics existing, one may assume that the shuttle trading has considerably decreased between the Kaliningrad region and its surrounding countries after the EU enlargement. Even if the decrease in the shuttle trading has had a negative socio-economic impact on hundreds of families (not on tens of thousands of families) living in Kaliningrad, one should not forget that the abolishment of grey and black cross-border activities is beneficial to the regional budget. Furthermore, the abolishment of non-legal foreign trade activities between Kaliningrad and its neighbours supports legal competition in Kaliningrad, i.e. it supports market reform in the region, which is needed to build up the sustainable competitiveness of firms.

2) *The enlargement's immediate effect to the foreign investment inflow to Kaliningrad is modest.*

In 2004, the foreign investment inflow to Kaliningrad grew 'only' by 10 per cent. The growth rate of 2004 is lower than in 2002 and 2003. After the adoption of the new SEZ law, it is probable that the foreign investment inflow to Kaliningrad will pick up, as some existing foreign-owned companies release their investments, which they have postponed throughout the past 18 months. This naturally does not mean that the enlargement would be the major explanatory variable for increasing foreign investment inflow to Kaliningrad but rather the adoption of the new SEZ.

The EU became the major investor in Kaliningrad due to the EU membership of Cyprus. In reality, the investments from the aforementioned country could be re-spelt as Cyp-Rus, since the overwhelming part of the capital arriving from there is Russian in origin. One could not observe any strategic shift in foreign investment inflow or its

industrial division, which could be exclusively explained by the enlargement. Also the country division of Kaliningrad's foreign investment stock has not changed significantly, since the inflow of foreign investment in 2004 was not more than USD 60 million. In the first half of 2005, less than USD 20 million has floated as foreign investment into the Kaliningrad region, indicating that the foreign investment inflow in 2005 will be lower than a year earlier.

It is beneficial to bear in mind that the development of the investment climate in Kaliningrad and in Russia as a whole is a more important factor affecting foreign investment flows than the enlargement per se. Secondly, one should not forget that the role of the foreign investments in the overall investment activity of the region will become more important in the future. The enlargement and the intensifying relations between the EU and Russia, for instance via the Common Economic Space⁷², will most probably increase the movement of factors of production to and from Kaliningrad. Thirdly, *the Kaliningrad administration should be more active in attracting foreign investments into the region, for instance by establishing a special unit – 'the Kaliningrad Investment Promotion' – to carry out this task.*

- 3) *The new special economic zone in Kaliningrad will probably increase investment flows from other regions of Russia to Kaliningrad already in the short run.*

It is difficult to predict the extent of the investment inflows from other Russian regions, but nevertheless, these new investments will definitely aid the Kaliningrad region to develop its regional economy. There is less ground for optimism that the new SEZ would attract a great amount of new foreign investment (apart from those, which have been postponed throughout the past 18 months) or intensify the return of Russian capital from abroad into the region, at least not in the short term.

It is important for both the regional and federal governments that the new SEZ will not be used for tax evasion. This puts extra pressures upon control measures. Furthermore, it is essential that the new SEZ does not relocate the production already inside Russia but instead expands production, as otherwise the federal government and particularly

⁷² Vinokurov (2004c/d) deals in his articles with the concept of the Common Economic Space in great detail.

other regions, from where the companies move to Kaliningrad, would lose budget income.

The possible postponement of the new law would definitely slow down the investment activity of all companies, as they would further postpone their investments. Naturally, such investment behaviour would slow down the economic growth of the whole region. Therefore, it is of the utmost importance that the new law will be adopted prior to the beginning of the next year.

- 4) *The new SEZ and the gradual abolishment of the 'old' one will create a dual system, which may cause extra pressures for authorities to control it. It may also create surprising legislative loopholes, which some firms may try to misuse.*
- 5) *Lowering the income tax break after the 6th year of business operations may create the artificial termination of these companies after the 6th year and the shift of their operations to a new company owned by the same people or interest groups. This part of the new SEZ law seems extremely open to abuse. In addition, one should not forget that the policy discriminating against old firms over new ones does not encourage long-term investment.*

In order to avoid the likely misuse, the author strongly recommends that the SEZ will be organised as follows: a full tax break for the first 10 years (2006-2015) for all firms investing RUR 150 million or more, and thereafter, a 50-per cent reduction of corporate income tax until 2030. Such a system would be administratively much clearer and push the companies to invest as soon as possible to be able to use the tax benefit in full.

- 6) *Even if the new SEZ gives privileges to larger investors, and hence, theoretically discriminates against smaller ones, this will not be a major obstacle for the development of small and medium-sized enterprises in the region. By supporting larger investors the new SEZ simultaneously promotes industrial production, not the development of the service sector. As the future of the Kaliningrad region cannot solemnly rely on industrial production, services, particularly those related to health tourism, should be supported in the region's economic policies.*

7) *In the long run, the SEZ arrangements should be abolished in Russia and elsewhere in the world since they are chiefly based on administrative privileges, not on natural competitiveness.* Though the SEZ arrangement may aid in building new competitiveness, they may also distort the creation of sustainable competitiveness. Furthermore, the regional policy based on administrative privileges discriminates against other Russian regions, which do not possess such a privilege, and hence, it breaks the economic unity of the Russian market. On the other hand, the special economic zones may prove to be useful provided that they help some Russian regions to become regional growth centres.

Summa summarum, the immediate economic impact of the EU enlargement on Kaliningrad is relatively modest, though still a positive one. The new special economic zone will play an important role in the future development of the Kaliningrad economy. Similarly, the Kaliningrad region will play a special role in the future development of EU-Russian relations. It has been said that St. Petersburg is Russia's window towards Europe. Similarly, one may conclude that Kaliningrad is Europe's window toward Russia. Open windows are needed for creating a true partnership between Russia and the EU.

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Background interviews, discussions and meetings in chronological order

- Sergey Prihodko**, Executive Member of Board of Directors, Institute for the Economy in Transition, Kaliningrad 22.8.2005.
- Vladimir Mau**, Rector, Academy of National Economy, Kaliningrad 22.8.2005.
- Elena Chernetskaya**, President, Telebalt, Kaliningrad 23.8.2005.
- Yuri Zdanov**, Director, The Federal Agency of Special Economic Zones of the Russian Federation, Kaliningrad 24.8.2005.
- Marina Ovsyannikova**, Adviser to the Minister, Ministry of Economic Development and Trade, Kaliningrad 24.8.2005.
- Vladimir Egorov**, Governov, The Kaliningrad Region, Kaliningrad 24.8.2005.
- Mikhail Tsikel**, Vice-Governor, The Kaliningrad Region, Kaliningrad 24.8.2005.
- Stefan Valhovits**, President, Produkty Pitanye, Kaliningrad 24.8.2005.
- Daimir Imamovits**, Vice-President, Produkty Pitanye, Kaliningrad 24.8.2005.
- Mikhail Pluykhin**, Managing Director, Produkty Pitanye, Kaliningrad 24.8.2005.
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- Vitaly Zdanov**, Head, Department of Economic Development and Trade, The Kaliningrad Region, Kaliningrad 24.8.2005.
- Oleg Danovsky**, Deputy Head, Department of Economic Development and Trade, The Kaliningrad Region, Kaliningrad 25.8.2005.
- Igor Kolosnitsyn**, Vice-Director, Bureau of Economic Analysis, Moscow 12.9.2005.
- Vadim Nestrov**, Head, Publications office, Rosstat, Moscow 13.9.2005.
- Andrey Jakovlev**, Vice-Rector, Higher School of Economics, Moscow 13.9.2005
- Natalia Popova**, Ministry of Economic Development and Trade, Moscow 14.9.2005.
- Vladimir Sokolin**, President, Rosstat, Moscow 15.9.2005.
- Alexander Surinov**, Vice-President, Rosstat, Moscow 15.9.2005.
- Ruben Saakyan**, Head, Analytical Department, Federal Taxation Service of the Russian Federation, Moscow 15.9.2005.
- Leonid Gokhberg**, Vice-Rector, Higher School of Economics, Moscow 15.9.2005.
- Reijo Paasilinna**, Member of European Parliament, Bryssels 20.9.2005.

Future vision on the Kaliningrad economy in the Baltic Sea region

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1. Introduction

Kaliningrad Oblast is not a usual Russian region. Though it is one of the smallest administrative entities of the Russian Federation in terms of area (15,100 km²) and population (945,000 residents as of the beginning of 2005) it is unique in many other respects. It is the most western Russian territory and the youngest subject of the Russian Federation – it became a part of its territory only after the World War II. The oblast received status of a free economic zone in 1991 and it still has a specific federal legislation now under the name of a special economic zone (SEZ). Since May 1st, 2004 Kaliningrad Oblast has also become a Russian enclave⁷⁴ within the European Union.

This territory has a long economic history. In the ancient times it had extensive trading links with Rome and was known as the main supplier of fashionable (then as it is now) jewelry – amber. In the Middle Ages, Königsberg (or more exactly its three predecessors towns – Altstadt, Kneiphof and Löbenicht) was one of the Hansa trading hubs⁷⁵. Before the World War II it was also the main center in Germany for trading with the Soviet Union.

After the WWII the German population of the region was deported and the region itself was closed for foreigners for more than 40 years. However, since 1990 it is again becoming a trading hub in the Baltic Rim region – Kaliningrad's foreign trade turnover has increased from USD 143 million in 1992 up to USD 4.1 billion in 2004 – an increase by a factor of 28 within 12 years! After the collapse of the Soviet Union the region has also become a recipient of massive immigration inflows – mainly from Central Asian states of the former Soviet

⁷³ Artur Usanov was a chief executive of the Regional Economic Development Agency until the end 2004.

⁷⁴ Technically the Kaliningrad oblast is a semi-enclave because it has access to the Baltic Sea.

⁷⁵ The Hansa or Hanseatic League was economic union of cities in the Nordic and Baltic region in 14th – early 17th century. It has its own body of law, a common set of measurements and standards facilitating trade.

Union. The total number of migrants that came to the region during 1990-1998 exceeded 400,000 people.

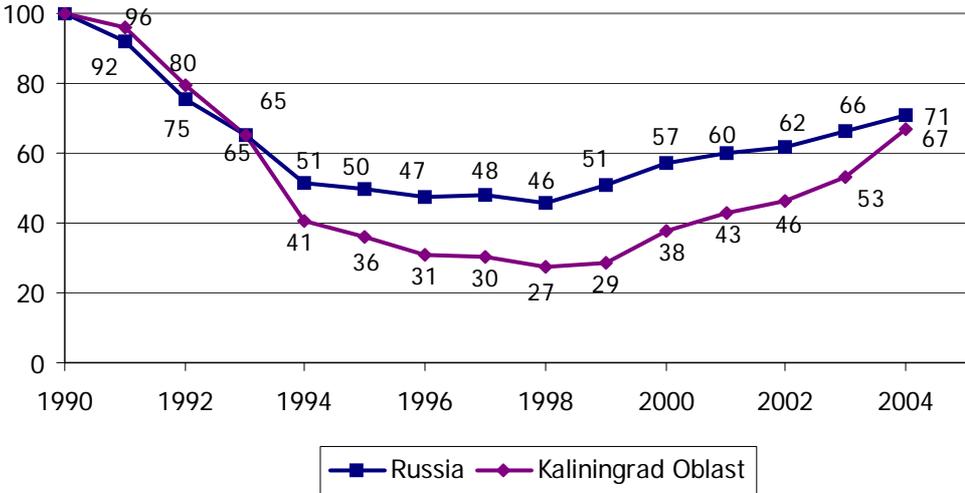
2. Kaliningrad's economic development: A recent history

Kaliningrad's economic development since 1991 was shaped by three main factors. One was Russia's transition process from a centrally planned economy to a market one that was accompanied by a deep economic crisis. The other factors were specific for Kaliningrad. In 1991 the region was granted a status of a free economic zone (FEZ) that was later consolidated by the federal law 'On the Special Economic Zone in Kaliningrad Oblast' in 1996. The SEZ has exempted companies located in the region from customs duties and import VAT and thus turned the region into essentially a free customs zone. Goods manufactured in the region and exported then to the rest of Russia were also exempted from customs duties (subject to the SEZ rules of origin).

In addition after the break-up of the Soviet Union Kaliningrad Oblast became separated from the mainland Russia by two independent states: Lithuania and Belarus. The exclave location of the region caused a significant increase in transportation cost and time for Kaliningrad's enterprises and consequently reduced their competitiveness on the Russian market.

All these factors, i.e. transition crisis, opening of the regional market to imports and increased transport cost brought a massive decline in industrial and agricultural production. At its minimal point in 1998 industrial production dropped by 73 per cent compared with 1990.

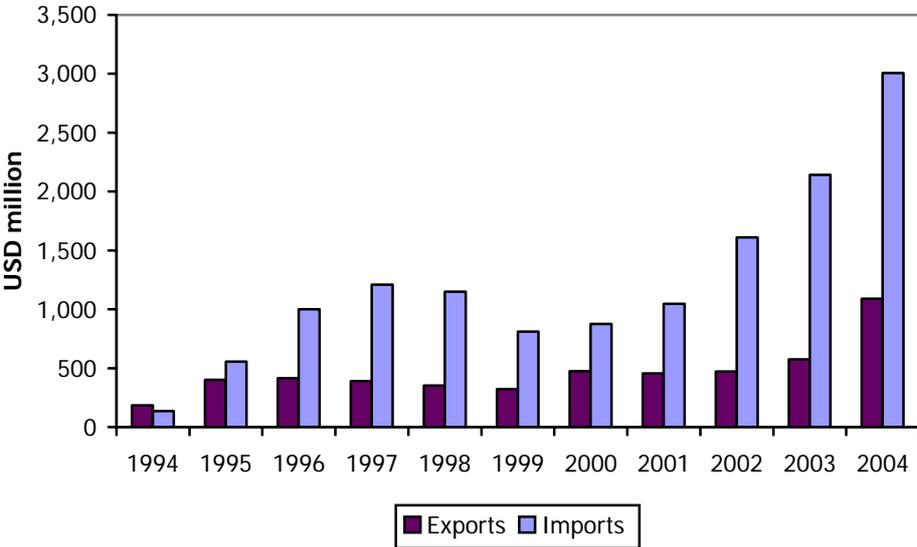
Figure 1. Industrial production in Russia and the Kaliningrad Oblast



Sources: RosStat, Kaliningrad oblkostat

At the same time the SEZ has created incentives for growth in foreign trade and development of retail trade and small businesses in the region.

Figure 2. Kaliningrad’s foreign trade

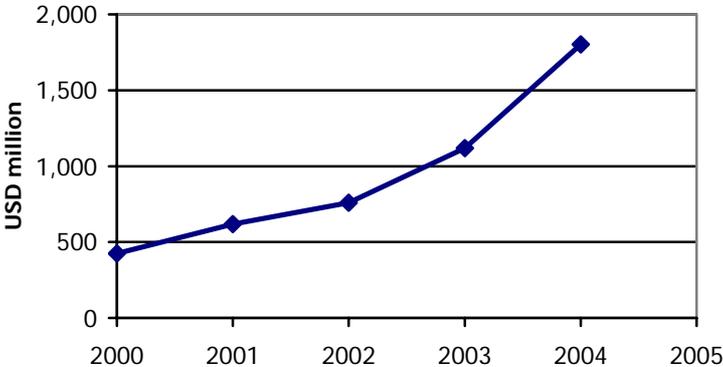


Source: Kaliningrad oblkostat

The region has also become an attractive location for industrial companies that produced final goods by assembling them from imported parts and components or by processing imported raw materials. Because the regional market is too small they all focused on the main Russian

market. After Russian economic crisis of 1998 these companies became one of the main engines of the Kaliningrad economic growth. Machine-building and food industry have become the main sectors where activities of these companies were most visible. Growth of import substitution industries oriented to the Russian market was remarkable. For example, compounded annual growth rate (CAGR) of production in machine building in 2000-2004 was 47 per cent and the volume of production has increased by seven times compared with 1999! It accounted for about two thirds of the total growth in the region’s industrial production in 2004. Two largest companies in machine-building – *Avtotor* that assembles BMW, General Motors and Kia cars, and *Telebalt* engaged in manufacturing of TV sets and vacuum cleaners – were responsible for a significant part of production in this sector. More general indicator of these industries’ growth is a sharp increase in ‘exports’ to the mainland Russia of goods produced under SEZ rules – CAGR of these exports in the last four years was 44 per cent (in USD). Growing consumer spending in Russia and real appreciation of the rouble have ensured seemingly insatiable demand for Kaliningrad-produced goods.

Figure 3. ‘Export’ of Kaliningrad-produced goods to the mainland Russia



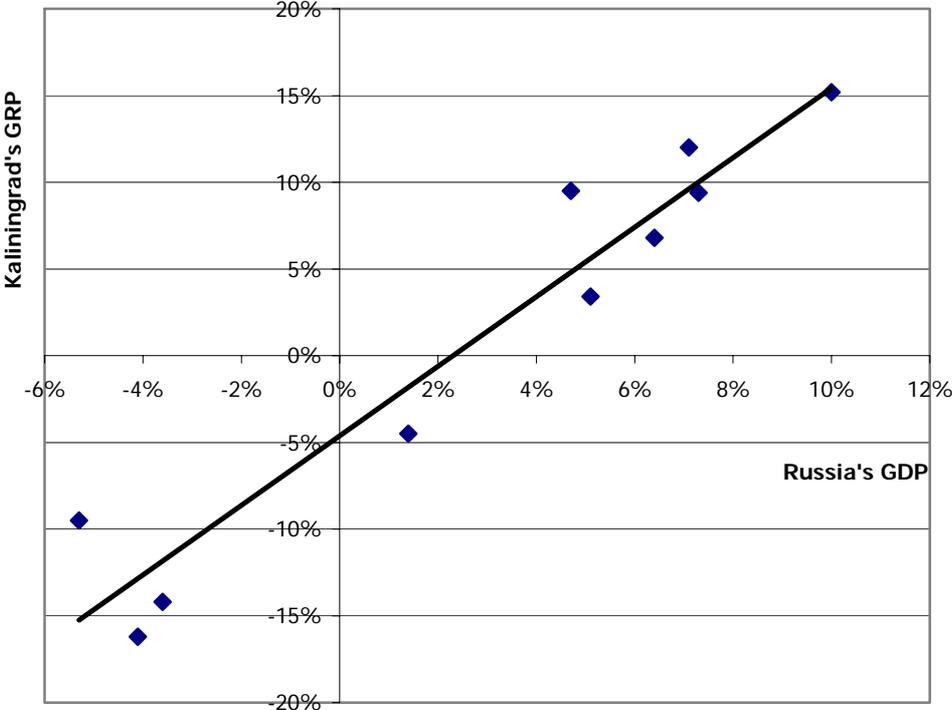
Source: Customs statistics

During these years Kaliningrad developed certain trade specialization. The main exports from the Kaliningrad Oblast are raw materials and goods with low added value: oil, cellulose, paper, and frozen fish. Most of them are produced by former state companies still using Soviet or even German assets. Manufactured goods and foodstuff dominate imports. This situation is typical for trade flows of developing countries in relation to more developed economies. In trade with other Russian regions the situation is totally different – Kaliningrad

receives raw products (energy, fuel, petrochemicals, timber, metals) and ‘exports’ finished goods – cars, home appliances, processed foods, furniture. Most of the goods for the Russian market is produced by new companies with no legacy from the Soviet times. Thus in relations to other Russian regions Kaliningrad plays the role of trade partner possessing a comparative advantage in industrial production though its advantage based mainly on the SEZ tax advantages (Vinokurov, 2004).

Growth of import substitution industries oriented to the Russian market was one of the main factors boosting output of the Kaliningrad’s economy. Other factors have included strong growth in oil export revenue due to high oil prices (Kaliningrad’s exports are dominated by oil even more than Russia’s) and increase in investment from the federal government and state-owned companies (i.e. RAO UES). All these factors closely related to the health of the Russian economy. Indeed simple regression analysis shows that performance of Kaliningrad’s economy was determined by changes in Russia’s GDP by about 90 per cent. Usually Kaliningrad’s economy closely follows changes in Russia’s economy with higher amplitude.

Figure 4. Changes in Kaliningrad’s GRP vs. changes in Russia’s GDP, 1995 - 2004



Sources: RosStat, Kaliningrad oblkostat

Last few years were very successful for the regional economy – CAGR of Kaliningrad GRP in the last six years (1999-2004) was 9.3 per cent and exceeds growth rates of Baltic countries, which are themselves the most dynamic in the EU, and Russia.

Table1. Changes in real GRP/GDP, %

	1999	2000	2001	2002	2003	2004	<i>Level of GDP/GRP in 2004 compared with 1998</i>
Kaliningrad Oblast	6.8	15.2	3.4	9.5	9.4	12.0*	170.7
Russia	6.4	10.0	5.1	4.7	7.3	7.2	148.1
Estonia	0.3	7.9	6.5	7.2	6.7	7.8	142.1
Latvia	3.3	6.9	8.0	6.4	7.2	8.3	147.3
Lithuania	-1.7	3.9	6.4	6.8	9.7	6.7	135.8
Poland	4.1	4.0	1.0	1.4	3.8	5.3	121.2

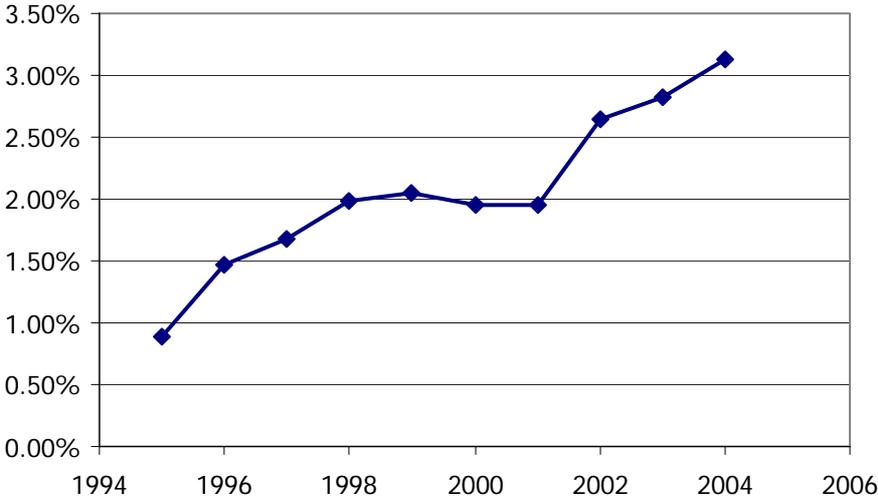
Sources: Eurostat, RoSstat

* - preliminary data

The SEZ law has undoubtedly played an instrumental role in ensuring current fast growth of Kaliningrad's economy. However, positive performance of the Kaliningrad economy and growing well-being of Kaliningrad population have paradoxically made many experts feel uneasy about the existing system of SEZ incentives. It seems that there is the following list of major problems that cause worry among economists and policy makers about the Kaliningrad SEZ.

- 1) Imports to the SEZ (including that for internal consumption) are exempt from import taxes: VAT and customs duties. It means that the Russian federal government indirectly subsidizes imports to the region by providing it a more favorable tax treatment compared with Russian goods (when a regional company 'imports' goods from other Russian regions it has to pay VAT). Therefore economic growth in the region that leads to the growth in imports means that the federal government at the same time has to increase its subsidies to the regional companies. It does not look like a sound economic policy. This subsidy was the main reason for the fast growth in imports to the SEZ and now absolute amount of Kaliningrad's imports seems out of proportion – in per capita terms it 4.5 times higher than the corresponding figure for Russia on average and Kaliningrad's share in Russia's imports is 6.4 times higher than its share in Russia's industrial production.

Figure 5. The share of Kaliningrad’s imports in Russia’s imports



Source: Kaliningrad oblkostat

Investment of companies that motivated primarily by this subsidy is likely to cause economic losses for the national economy as the whole and the SEZ in this case serves as an imperfect instrument of redistribution of wealth from other Russian regions to Kaliningrad through customs benefits.

In the international practice regime of a free customs zone is used for small trade or export-processing zones where there is no internal consumption or it is very limited. Policy makers have tried to remedy this problem by introducing a system of import quotas for duty free imports. But the system turned out to be inefficient and marred with corruption.

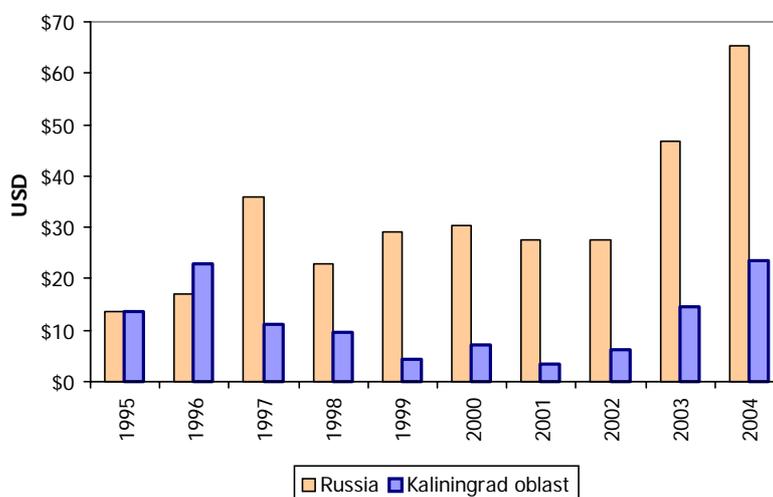
Shadow economy might also play an important role in explaining such high volumes of imports. Absence of import VAT creates strong incentive for tax avoidance through illegal schemes by sending goods imported to the SEZ duty free further to Russia (for example by masking them as goods produced in the SEZ). Some anecdotal evidence and statistical discrepancies⁷⁶ are signs that are pointing in this direction.

⁷⁶ Quick-and-dirty calculations can easily illustrate this thesis. Total industrial production in the region was approximately 1.9 billion USD in 2004. Total retail sales in the same year amounted to USD 1 billion. At the same time, the Kaliningrad companies imported goods in a free customs zone regime (without paying import taxes) with the total value of USD 2.5 billion. Even if we assume that industry and trade used only imported goods as inputs and average value-added was 20% then they could not consume more than USD 2.4 billion of imports.

- 2) Mild requirements of the SEZ rules of origin⁷⁷ lead to the fact that many companies that use the SEZ for import substitution production focus on simple assembly operations with low added value and their investment remains limited. For example, the share of machine-building in the industrial production was 36.5 per cent but its share in the capital investment it was only 7 per cent (for the first 9 months of 2004). It indicates that location of such companies in the Kaliningrad SEZ is determined by one main factor – ability to get tax advantage over their Russian competitors or direct importers by using the SEZ privileges. Thus impact of these companies on the regional economy is much lower than it could have been and continuation of their manufacturing operations in the region in the case of some unfavorable changes in the Russian legislation is doubtful.

- 3) When the Kaliningrad SEZ (initially FEZ) was established one of its aims was to attract foreign direct investment (FDI). However, the SEZ turned out to be a complete failure in this respect. FDI stock per capita in Baltic countries or Poland is higher than that in Kaliningrad by order of magnitude. For example, in Lithuania it was higher by a factor of 28 (in 2003). Gross FDI inflows to Kaliningrad was significantly behind even the average Russian level. Moreover, net FDI inflows were negative in 5 out of 8 last years. The SEZ rules themselves are not the reason behind the low FDI level in Kaliningrad. The main obstacles on the way of FDI have been unstable SEZ legislation, administrative barriers and poor investment climate in the region.

Figure 6. Foreign direct investment inflows per capita



Sources: RosStat, Kaliningrad oblkostat

Another fact that causes concern that customs statistics reported that good produced in the Kaliningrad SEZ for export (to foreign countries and to the rest of Russia) amounted to 2.1 billion. But according to the Kaliningrad statistical office all industrial production was only 1.9 billion. It might be that companies either underreport the figures to the statistical office or inflate their production volumes to the customs authorities to cover unprocessed imports.

⁷⁷ For electronics and household appliances the SEZ rules of origin require 15% value-added and for other goods – 30%. The EU rules of origin for Generalised System of Preferences are much more demanding and detailed.

- 4) The SEZ has not helped to develop a competitive export-oriented sector in the Kaliningrad's economy although it was also one of the aims for creating the SEZ in the first place. Kaliningrad's exports are dominated by raw materials and semi-processed goods and produced mainly by former state companies. Exports of Kaliningrad companies in 2003 were USD 557 million. In per capita terms Kaliningrad's exports (USD 590) are two times less than Russia's ones and 4.5 times less than that of Lithuania. Experience of the former socialist countries of Central and Eastern Europe demonstrates that successful development of the competitive export sector in manufacturing and service industries is closely connected with attraction of FDI as they bring new equipment and machinery, know-how and management techniques. For example, in Poland companies with foreign capital account for about 70 per cent of foreign trade [WERI, 2005].

These factors indicate that competitiveness of the Kaliningrad companies on the international market remains quite low and customs subsidies are not effective way to increase their competitiveness. It made the Federal Government to propose a new SEZ regime in a draft law that was approved in the first hearing by the Federal Duma in June 2005. The main idea of the new draft is to substitute existing customs privileges for investment tax breaks. The logic of the new draft is quite straightforward and clear – to attract to the region large investment from Russian and foreign companies to modernize its economy. The new law is described in detail in other parts of this book. I just like to mention that investment tax breaks as an incentive are definitely a step forward compared with the existing SEZ system. They have been used in many free economic zones around the world and sometimes with significant success.

Large tax breaks will almost surely attract significant investment if not from foreign but certainly from Russian companies. At the same time, the import substitution sector of the economy will likely to remain in the next few years significant locomotive of Kaliningrad economic growth because new law also envisages 10-year transition period when existing companies-residents of the SEZ can continue to import goods duty free. As a result GRP growth in Kaliningrad could stay around 10 per cent p.a. if Russia's economy continues to do well.

However, the new draft has its own problems including abundant opportunities for companies to minimize tax bill using transfer pricing, it leaves behind small- and medium-sized companies, it creates conditions for unequal competition between new investors enjoying tax breaks and existing companies. International experience also shows that tax incentives are rarely a decisive factor in determining investment location decisions of firms. A survey of 191

companies with plans to expand operations by Multilateral Investment Guaranty Agency (MIGA) found that only 18 per cent in manufacturing and 9 per cent in services considered grants and incentives to be influential in their choice of location (World Bank, 2004). Thus this new law might prove to be cost-ineffective way to deals with Kaliningrad situation. Its privileges cannot be generalized to the broader economy and in this sense its spillover effect will be limited.

3. Thinking about the future of the Kaliningrad's economy

Kaliningrad's economic future will be closely determined by its geographical and geopolitical location. The main feature of its location is of course its enclave position within the EU.

Discussion among the Russian experts whether the geographic location of Kaliningrad is advantage or disadvantage for its economic development is quite instructive. Some call Kaliningrad a “double periphery” (with the respect to the mainland Russia and the EU) and insist that its exclave location should be compensated through direct and indirect subsidies (such as tax breaks) from the federal budget⁷⁸. Others half-jokingly say that it is Kaliningrad that has to pay Russia for its location – mainly because it is close to rich European markets. What is interesting that this discussion reveals different views on the future development of the region.

On the one hand, if one considers the Kaliningrad's location within the framework of the existing economic model then Kaliningrad is definitely disadvantaged – mainly because almost all goods and passengers should go through Lithuania on their way to/from the mainland Russia and this increases transport cost and causes delays. On the other hand, as a location for export-processing companies it is probably the best place in Russia – it is close to prosperous Scandinavian and German markets, it has ice-free sea port and decent climate (not an excess in Russia). Thus it can be said that Kaliningrad's geographical location is neither good nor bad in itself. It is policies (of Russia as well as the EU) that make Kaliningrad's location either a good or bad thing. A well-thought and skillfully implemented policy will

⁷⁸ In many respects this proposition serves a foundation for existing the federal law 'On the Special Economic Zone in Kaliningrad Oblast' as well as for the new draft of the law.

offset geographical disadvantages and encourage companies to use the advantages to transform them into the real economic benefits.

There is a symbolic sign – if one draws a straight line between Moscow and Brussels on a map of Europe he/she will find Kaliningrad almost exactly in the middle of this line. It is a vivid illustration of the fact that Kaliningrad economic future closely depends on the state of economic and political relations between Russia and the EU and the region has a special place in these relations.

Who are not convinced by simple manipulations with a ruler on the map can consider some hard facts:

- Kaliningrad's exclave location means that the EU policies and decisions can have and do have a significant impact on the economic development of the region. Some examples of these policies include: goods and passenger transit, fishing, energy, sanitary and phyto-sanitary standards, visa policies, etc.
- Kaliningrad is geographically closer to many European capitals than to Moscow. Moscow is 1290 kilometers away from Kaliningrad and separated from it by two sovereign states. At the same time distance to Vilnius is just 350 km, to Warsaw – 400 km, to Berlin – 600 km, to Stockholm – 650 km.
- Kaliningrad foreign trade with the EU makes up almost 70 per cent of the region's total foreign trade.
- Kaliningrad citizens have more day-to-day exposure to the EU than citizens of any other Russian region. Many Kaliningraders more often travel to neighboring Poland and Lithuania than to the mainland Russian. Polish and Lithuanian consulates in Kaliningrad are among the busiest ones for these countries.

Given all these factors and history of the region Kaliningrad has good pre-conditions to become a transit hub for east-west trade, a conduit for EU investment to Russia and location for export-oriented manufacturing firms. On the whole it can develop into one of the centers of economic modernization in Russia.

The key way to achieve this vision and realize Kaliningrad's potential is economic openness – openness to trade and investment, openness to innovation, to new ideas and people. Experience of economic development in many countries suggests that openness is essential ingredient for economic growth. It is especially important for small countries or exclave territories. Openness will encourage new investment and foster competition in the region that will in turn increase efficiency of its economy. These ideas are not original in any case – the

first governor of the oblast Prof. Yuri Matochkin used slogan “Hong Kong of the Baltic Sea” to describe his vision of the Kaliningrad economic future.

Openness is also the most inexpensive way for the federal government to foster economic development of the region. It did understand that Kaliningrad requires non-standard approaches to its development and more openness than the other Russian regions back into beginning of 1990s. It established a free economic zone in the region, it negotiated on a reciprocal basis visa-free travel to Lithuania for citizens of Kaliningrad. At the same time the federal government never fully embraced economic openness as a basis of its policy towards the region – fears of regional separatism and security concerns have often pushed its decisions in the opposite direction. These fears are mostly counterproductive, share of Kaliningrad citizens that want full independence from Moscow hardly ever reached 10% since such polls have started.

In economic field openness should be implemented through better integration of the Kaliningrad’s economy into the EU market. Kaliningrad should become a pilot region in building the Common Economic Space (CES) between Russia and the EU. The overall objective of the CES is “an open and integrated market between the EU and Russia”⁷⁹. Thus Kaliningrad would be the place where parties can test their innovative forms of cooperation by opening markets, making steps towards institutional rapprochement, linking infrastructure networks. Being part of the Russian economic space and at the same time closely integrated into the single European market Kaliningrad could indeed become a Eurobridge, a Russian window into Europe and EU window into Russia. Openness should be supplemented (but not substituted for) by targeted financial support from the federal government that would include infrastructure investment and incentive packages for investors.

Enclave location of Kaliningrad within the EU has made problems related to this region one of the main issues in negotiations between Russia and the EU in the last few years. Negotiations related to Kaliningrad have so far focused the current and urgent problems of passenger and cargo transit, energy supply, visa issues etc. These negotiations were also accompanied by a feeling of mutual misunderstanding and Kaliningrad has to some extent

⁷⁹ *Road Map for the Common Economic Space*. Annex I to the Joint Statement of 15th EU-Russia summit (Moscow, May 10, 2005) available at http://europa.eu.int/comm/external_relations/russia/summit_05_05/finalroadmaps.pdf#ces

become a sore point in Russia-EU relations. However, the negotiations hardly touched the issues related to the long-term economic development of the region. Creating a working group or separate sub-committee on Kaliningrad will be a first step that will help both sides to consider long-term problems related to the economic development of the region that cannot be solved by Russia alone.

I briefly discuss below what steps could be taken besides the measures that are already taken by Russian authorities or envisaged in the new draft law on the Kaliningrad SEZ and how they can help to realize this vision and move forward in its implementation.

1. Free trade with the EU. The most essential step to ensure integration of the Kaliningrad economy into the EU single market and growth of the competitive export-oriented manufacturing sector in the region is to provide free access for Kaliningrad-produced goods to the EU single market (EU-Russia free trade zone in Kaliningrad). It should be noted that Kaliningrad market is already open to the EU goods (as well as goods from other countries) and it is important to keep it open. It means that foreign goods that imported to the SEZ should be exempt from customs duties but not from VAT. Import VAT just equalizes taxation for imported and domestic goods and introduction of import VAT will simply remove discrimination of domestic goods in the SEZ (EastWest Institute, 2003).

Unfortunately, the road map for the Common Economic Space between Russia and the EU approved at the EU-Russia summit in May 2005 in Moscow does not contain even words 'free trade'. However, creation of a free trade area (FTA) between Russia and the EU is envisaged in the Partnership and Cooperation Agreement (PCA) of 1997 – the legal basis for Russia-EU relations. Free trade with the EU is much more important for Kaliningrad than for Russia as a whole and will be an essential element for its development.

Some authors argue that the Kaliningrad economy will not benefit from such a step as it does not have many manufactured products that could be exported⁸⁰. There are several answers to this argument. First, Kaliningrad manufactured exports are growing (including ships, furniture, garments, etc). Second, a large portion of the Kaliningrad's (and Russian) potential exports is blocked by the EU through various means. Finally, free trade with the EU will

⁸⁰ S. Dewar. What is to be done?// Baxendale J., Dewar S., Gown D. (eds) The EU and Kaliningrad, Kaliningrad and the Impact of EU Enlargement. Federal Trust, 2000. P.231-264.

create incentive for foreign and Russian companies to locate their manufacturing operations in Kaliningrad to serve the EU market. Experience of Central and Eastern European (CEE) countries demonstrated that after signing the Europe agreement that opened the EU market for them their exports to the EU started to grow rapidly. Exports of the CEE countries to the EU increased by more than seven times between 1990 and 2000 (Havlik, 2001).

There is a myriad legal and technical problems on the way to such a free trade zone. However, it should be considered as a stage in creating a comprehensive free trade area between Russia and the EU that is mentioned in the PCA. In this case the FTZ in Kaliningrad becomes a testing ground for implementation of the relevant rules of origin, technical requirements, standards and certification, customs procedures, etc that will be required to set up the FTA. Legally it could be established by the Russia-EU agreement on Kaliningrad.

2. Liberalization of the Kaliningrad market for foreign investment. It was already mentioned that FDI is crucial for the development of export-oriented sector. The Russian government agreed to lift many restrictions on foreign investment as a part of the WTO accession negotiations. However, some restrictions will remain in financial and telecommunication services. The Russian government should consider opportunity to lift restrictions for foreign investors in these sectors in Kaliningrad. For example, because the Kaliningrad market is small it could allow foreign banks and insurance companies operate in Kaliningrad without creating a Russian legal entity – through their branches. To limit impact of their operations on the Russian financial system it could at the same time restrict their client base by companies-residents of the SEZ. Such a measure might bring significant benefits for local companies by lowering cost of funds, improving access to finance for SMEs and attracting FDI.

Liberalization is also urgently required in the energy sector – it is becoming a hindrance for new investment in Kaliningrad. Electricity tariffs of the local energy monopoly *Yantarenergo* are one of the highest in Russia and there is a lack of power for new projects. Kaliningrad should be integrated into the Baltic energy market by setting up relevant physical and institutional infrastructure and connecting the energy network with that of the surrounding states.

3. Visa-free travel to Kaliningrad for the EU citizens. Russia can introduce visa-free regime for the EU citizens traveling to the Kaliningrad region and staying there up to 30 (or 90) days. Because the region is an exclave territory security risks of this proposal (however they are seen) are minimal but it could bring important economic benefits for Kaliningrad and for Russia in general⁸¹. It will increase the number of European tourists visiting the region and thus create new jobs in the region and increase tourism revenue. It will greatly facilitate contacts between business people of Russia and the EU and will become a positive factor for attraction of FDI. Trade promotion activities in Kaliningrad such as international trade fairs and exhibitions will also get a boost. This experience will be useful for the Russian government if it decides to introduce a similar regime for the whole country. Finally, it will be a demonstration of goodwill from the Russian side and give a basis for progress towards a comprehensive agreement between Russia and the EU on mutual visa-free travel.

The existing draft law on the Kaliningrad SEZ envisages that employees of the companies–SEZ residents can get a visa at a border-crossing point. However, it can be predicted that such a measure will bring little benefit as requirements for getting such a visa will be too onerous. This why legislative proposal of the Kaliningrad Regional Duma for introduction of visa-free regime for the EU citizens should be supported.

4. Better investment climate. Kaliningrad is a part of Russia and all problems of the investment climate in Russia, i.e. unstable legislation, unclear property rights, selective law enforcement, corruption in the court system are present in Kaliningrad. However, even on this background the Kaliningrad oblast does not look good. Survey of business climate in Russian regions done in March 2005 by OPORA Russia – nongovernmental organization of small and medium-sized entrepreneurs – revealed that the Kaliningrad oblast was at bottom of the list in terms of conditions for entrepreneurship – 75th among 80 regions surveyed⁸². Low level of FDI is another indicator that investment climate in the region leaves much to be desired.

Without the attractive investment climate any laws and agreements will have limited effect on the economic development of the region. In many respects development of the better investment climate is responsibility of the regional authorities. Study of the Foreign

⁸¹ Such step, i.e. unilateral removal (or at least reduction) of visa barriers will be very useful for Russia as a whole, see *Vedomosti*, September 1, 2005

⁸² Available in English at <http://www.opora.ru/live/investigations.asp?id=38125>

Investment Advisory Service (FIAS) on the administrative barriers to investment in the region provided a good starting point for actions to improve in business climate. Important step in this direction would be the creation of one-stop shop for investors where they can get all the information and some permits and receive help in getting approvals from other agencies.

Another very useful step in attracting FDI would be to ease requirements for getting work permits foreign workers, especially for managers and technical specialists. Decision-making for these issues (within assigned quota) should be transferred to the relevant authority in Kaliningrad to improve response time and annual quota for foreign workers should be increased.

5. Use of the EU standards and certificates. The Kaliningrad oblast is a part of the Russian Federation and as such it is part of the Russian legislative space. Therefore use of the EU standards if they are not compatible with the Russian standards cannot be obligatory in Kaliningrad. However, it can be done on a voluntary basis. What is needed is information about the EU standards, training and technical assistance in implementation of the standards, and existence of the authorized bodies that could certify compliance and issue EU certificates in the region. This cannot be done without direct involvement of the European Commission – a program of technical assistance in this area from the EU would facilitate Kaliningrad trade with the EU, attract export-oriented companies and make cargo transit through Lithuania simpler.

6. Efficient border regime. Foreign trade and cargo transit make the lifeblood of the Kaliningrad economy. Therefore efficient operations of customs are very important for business climate in the region and for competitiveness of the regional economy. The CES road map contains several areas where Kaliningrad can become a pilot region for intensified cooperation between Russia and the EU customs authorities:

- Simplification of customs procedures.
- Introduction of compatible computer system and an integrated data transmission system.
- Harmonization of Russia and EU rules on customs and transit.
- Development of customs infrastructure.

Kaliningrad is already a testing ground for the customs computer system *Kaliningrad Transit* that is connected to the EU computer transit system (NCTS). This experience should be used not only for transit operations but also for trade operations between Russia and the EU.

7. Infrastructure development. To become a real center for east-west trade Kaliningrad transport infrastructure requires new investment. This investment should help to integrate Kaliningrad's road and rail networks into trans-European transport corridors, upgrade border crossing points, build new sea terminals and improve port facilities. Another target for investment is energy and housing infrastructure (water, sewage, waste, heating etc).

The Russian government significantly increased financing of projects in these areas after it adopted the Federal Target Program for Kaliningrad in 2001. However, to support economic growth in the region the federal and regional authorities should more actively involve international financial institutions, in particular EBRD, European Investment Bank, Nordic Investment Bank in financing such projects. Opportunities to set up a Kaliningrad Development Fund, which was informally proposed by the European Commission in 2002, or establish a joint Russia-EU investment program should be also explored.

8. Local special economic zones. The main problem of the existing SEZ law is that it extended regime that is normally used for compact economic zones to relatively large territory and results of this approach turned out to be mixed. Nevertheless local free economic zones can play a very important role in fostering economic developments and facilitating foreign trade and logistics operations. No wonder that they became so popular: in 2002 there were around 3,000 export-processing zones in 116 countries around the world with the total employment of 43 million workers (World Bank, 2004). Approval of the federal law on special economic zones in 2005 creates a legislative base to setting up such zones. Such zones can become primary location for export-oriented and technology companies. But to be attractive for investors they also will require up-front infrastructure investment from the government.

There are other opportunities for taking advantage of the Kaliningrad's isolated location. If Kaliningrad can offer a right package of incentives (tax breaks) it can become a financial center for back-office operations of banks or securities trading companies. For example, many Russian and foreign financial companies conduct their trading operations in Russian equities

and bonds through affiliated Cyprus companies mainly for tax reasons. If offered tax incentives they could move to Kaliningrad especially in the case of liberal visa policies for Kaliningrad.

9. Renaming the city. There is also one issue that is not directly related to the economic problems that is discussed in this paper. Nevertheless I believe that current name of the city is one of obstacles that hinder its economic development. Not many people will argue that M. Kalinin as one Stalin's aides deserves that the city with a long history and important role in Russia-Europe relations carried his name. Unfortunately, there is no public consensus or at least prevalent view what is appropriate name for the city. What is needed is a wide public discussion on this sensitive issue. There are many options. The natural one is to return the city its old name – Königsberg. It is already used in names of firms (everyone in Kaliningrad know *KenigAuto* – the former state coach company) and among young people (especially in its abbreviated variant – König). But this name is likely to be difficult to accept for older citizens. Another option is to use the old Russian name for German Königsberg – Korolevetc (that is also close to former Polish and Lithuanian names of the city). Acceptable for many might be idea to rename the city in honor of its greatest son – XXVIII century philosopher – Immanuel Kant (recently Kaliningrad State University was named after Kant). It is also possible to come up with neutral new name reflecting its geography. But in any case if we want to leave behind heritage of Stalinism and isolationism that marked city's history for 45 years the current name of the city it must be changed.

4. Conclusion

Kaliningrad is simultaneously a hostage to Russia-EU political and economic relations and catalyst for development of these relations. Currently it represents problems that worry both Russia and the EU but many of the problems cannot be solved by unilateral decisions of one of the parties. Thus it stimulates both sides to cooperate in their solutions, to come up with some ingenious and non-standard solutions. It is still not a showcase for Russia-EU relations but it could be. Kaliningrad provides a unique chance to advance Russia's integration to Europe and to miss this will be a big mistake.

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Kaliningrad as a Pilot Region in the EU-Russia relations: Scenario exercise

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1. Introduction and research objectives

Kaliningrad emerges as a key issue on the EU-Russia agenda. It is equally divisive and defining for the EU-Russia relations. Not only does it have a unique territorial format, a Russian exclave in the EU, but it also enjoys an exceptional economic regime, the Special Economic Zone. It is a peculiar globalization hub, and a test for the ability of Brussels and Moscow to find innovative solutions for the 21st century.

The present paper aims to analyze the Kaliningrad puzzle in the wider contexts of globalization and international relations. It outlines the future of the region not only from the local perspective, but from looking at the global forces at play. The principal goal of this research is to define a set of scenarios for the future of Kaliningrad, to single out the best-case/most desirable scenario (the “Pilot Region”), and to convert it into a policy project by outlining practical steps towards its implementation (the “Road Map”).

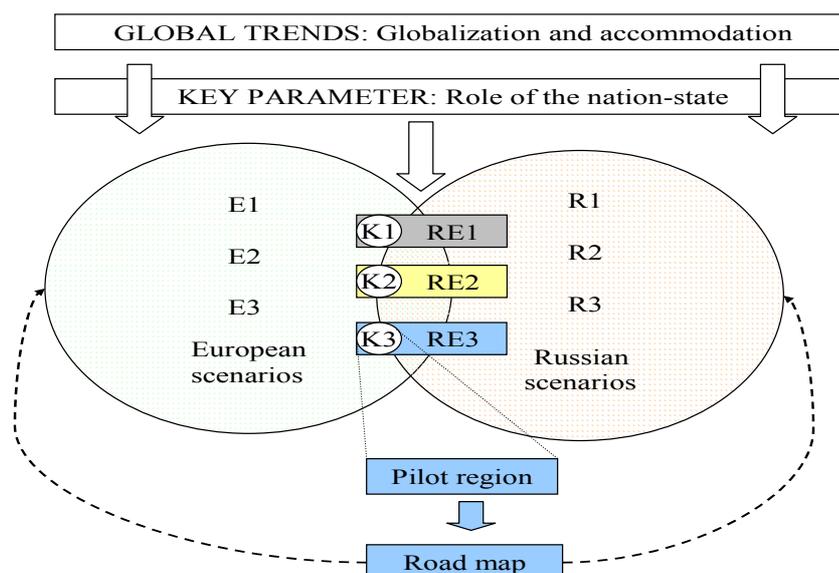
2. Research outline

The analysis proceeds in seven steps, starting from the high level of abstraction, and going down to the practical detail of EU-Russia cooperation and policy recommendations.

⁸³ Sergei Medvedev's contribution to this article is based on the study “*Towards the Kaliningrad Partnership in the EU-Russia relations*”, Moscow, RECEP, 2005.

- First, it defines key global trends that have a bearing on the EU-Russia relations and on Kaliningrad.
- Next, it singles out key variables/parameters to forecast the future of Russia-EU relations and of Kaliningrad. One such parameter is the role of the Nation-State in (a) the economy and (b) politics.
- Third, using the above variables, the analysis proceeds to define two sets of scenarios for Russia and the European Union. In each set, three basic scenarios are outlined. These are not accurate predictions of the future which will anyway be more complex, and will involve elements of different scenarios, but Weberian “ideal types”, analytical tools for understanding the developments in the EU and Russia.
- Fourth, the Russian and European scenarios are combined in a 3x3 matrix, producing 9 possible combinations of EU-Russia relations. These 9 combinations boil down to three basic scenarios:
 - “Cold peace”,
 - “Muddling through” and
 - “Full partnership.”
- Fifth, the three EU-Russia scenarios are applied to Kaliningrad, yielding three alternative futures:
 - “Outpost”
 - “Stagnation / growing dependence on preferences”
 - “Pilot Region”.
- Sixth, the “Pilot Region” is defined as the most desirable scenario for Kaliningrad, and the analysis turns from policy forecast to policy planning, and outlines practical steps for the implementation of the Pilot Region (a “Road Map”, complete with a timeline).
- Finally, the research examines the feedback loop: i.e. it explores how the Pilot Region concept and the Kaliningrad Road Map may influence the dynamics of the EU-Russia relations, and how they can promote certain developments/scenarios in Russia and in the European Union.

Figure 1. Outline of research



3. Global trends and variables

One of the key contradictions in today's world is defined by the tension between forces of globalization and forces of resistance to globalization. Almost any global development, from international terrorism to rising oil prices, from adoption of the EU Constitution to recent administrative reform in Russia, can be defined in these terms. Generally speaking, any globalizing trend is offset by adaptation strategies by the nation-states, indigenous cultures and resistance identities.

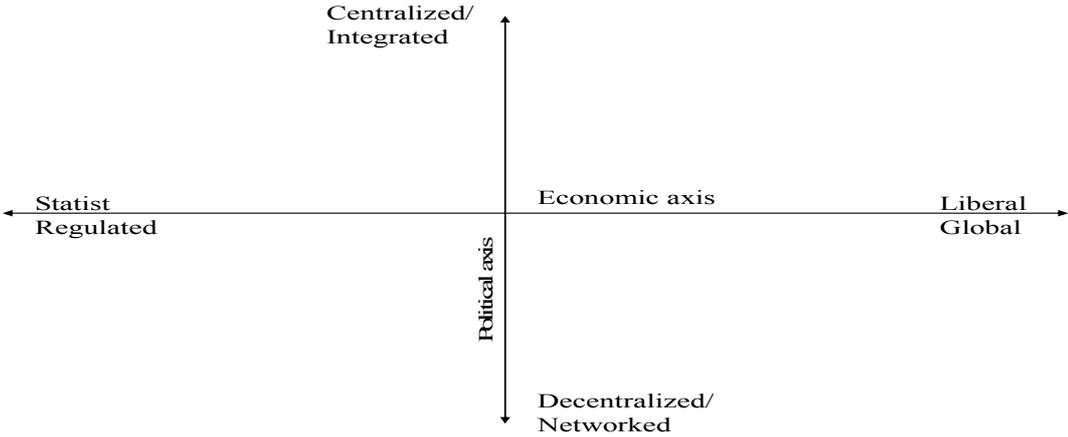
- De-nationalization, de-sovereignization and de-bordering is counterbalanced by re-nationalization, the comeback of the nation-state reclaiming its inherent monopoly on violence, security and borders;
- Integration (as manifested e.g. in the EU constitutional process) is counterbalanced by forces of fragmentation (e.g. in former Yugoslavia, or in Georgia);
- The global markets' strive towards homogeneity and the universal applicability of liberalism is offset by the re-emergence of the nation-state as an anchor of identity and the focal point of cultural resistance to globalization;
- The Americanization of global culture is met with increasing anti-Americanism;
- The rise and fall of the "New Economy" and the network enterprise is matched by the heavy weight of the Old Economy, and its main commodity, oil, which plays as strong a role, as it did in the 20th century, if not a stronger one;
- The rise of "liberal imperialism" of the West and promotion of the New World Order (as seen e.g. in Kosovo) is met with the increasing force of global terrorism and the threat of the New World Disorder, while regional instability emerges in Europe's turbulent neighborhoods.

Summing up, the key variable in understanding the forces of globalization and resistance/adaptation is the role of the nation-state. In the economy, it varies from the liberal, globalized, de-regulating role of the state to the statist, regulating, and protectionist role of the state aimed at the maximization of public goods. In politics, it varies from the decentralized, networked and confederal polity, to a centralized, hierarchical, unitary polity.

The nation-state variable can be visualized in a chart in which the horizontal axis represents the economy (varying from the statist/regulated to liberal/global), and the vertical axis politics (varying from the centralized/integrated to the decentralized/networked polity). See Figure 2. One important thing about this variable, it is universal enough to apply to such varying political organizations as the EU and Russia which go through very different stages of the Nation-State accommodation to the process of globalization. The EU is undergoing the process of sharing and pooling the sovereignty of the Nation-State, as underlined by the adoption of the EU Constitution. Russia, on the other hand, is re-defining the role of the

Nation-State with respect to globalization, as evident from President Putin’s statist project which follows the chaos of the 1990s.

Figure 2. Generic Chart

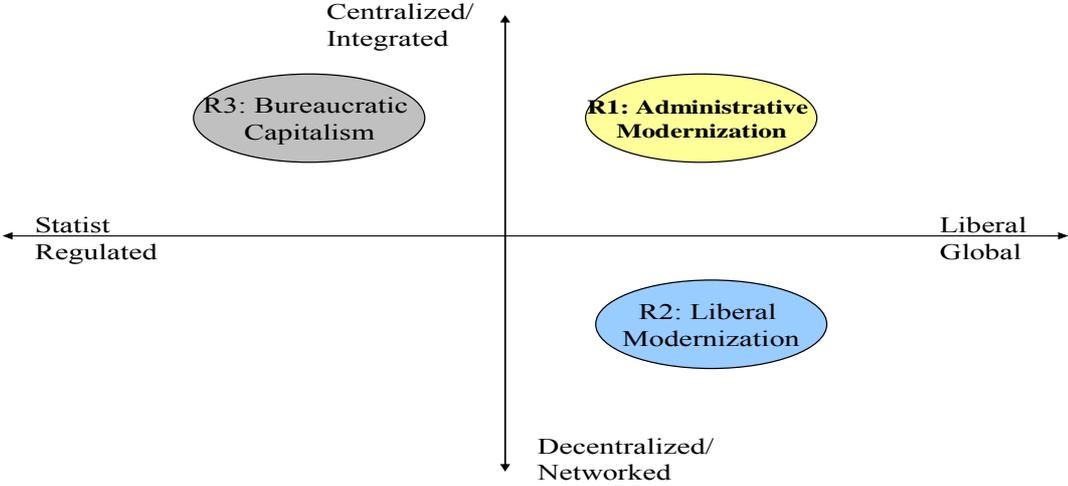


Using the generic chart, the paper proceeds to outline two sets of scenarios, one for Russia and one for the European Union.

4. Russian scenarios

Three basic options are outlined for Russia, two kinds of modernization (R1, “Administrative modernization” and R2, “Liberal modernization”), and one scenario of counter-modernization and stagnation (R3, “Bureaucratic capitalism”). The option of economic statism/regulation combined with political pluralism/decentralization does not seem feasible.

Figure 3. Russia's options



4.1. Administrative modernization

This scenario is based on the key outlines and ideas of President Putin’s first term in office: political centralization combined with a liberal economic and social agenda. In the political domain, the “administrative vertical” dominated by the executive is legitimized by the mechanisms of “managed democracy”, together with the tamed and compliant press. Increasing limits are put on federalism and local autonomy. In the meanwhile, a generally liberal economic agenda is pursued, based on the mechanisms of corporatism and re-distribution of Russia’s enormous resource rent and capital-intensive modernization projects. The paternalist social-security system inherited from the Soviet Union is dismantled through a series of painful social reforms, while Russia will eventually accede to the WTO, and will possibly seek OECD membership.

The historical template here could be South Korea in the 1960s and 1970s, under President Park Chung Hee, which combined a sweeping modernization agenda, a corporate state, and strict political control. The foreign policy implications of this scenario are generally pro-Western: Russia will retain her seat in the G8, and will enhance security cooperation with the

United States, especially during George W. Bush's second term in office. (One can even envisage Russia's military participation in Iraq, as improbable as it seems now). However, relations with the EU (as well as with the OSCE and the Council of Europe) will be tenser, complicated by such issues as the war in Chechnya, and the illiberal nature of Russian domestic regime. Russia will pursue a "liberal imperialist" strategy in the CIS, based on market penetration and economic domination, but will refrain from direct political intervention in the affairs of the neighboring states.

4.2. Liberal modernization

This scenario combines the best of both worlds: full economic liberalization and the opening of the political system, together with the decentralization of the decision-making. Russia will seek to overcome her over-dependence on the natural resources and oil exports, combined with the import of high value-added goods (the "Dutch disease"), and will diversify its economy. This will require the mechanisms of de-monopolization (including such monopolies as Gazprom and RAO UES), liberalizing the domestic energy markets, and supporting medium and small businesses. Politically, one can expect the re-emergence of a pluralistic scene, and of new liberal parties and projects, possibly supported by the Kremlin. Horizontal checks and balances, including a stronger legislative and the judicial, will be augmented by the vertical checks and balances, a stronger federalism, and the support to cross-border regionalism.

The foreign policy ramifications are the most positive here, including an enhanced dialogue with the EU which will be put on a solid normative and institutional basis. The role model here could be the liberal modernization in the nations of Central Europe (e.g. the Czech Republic) which eventually brought it into the EU fold. Still, one should not be overtly optimistic about this best-case scenario, as it looks fairly improbable in the short term.

4.3. Bureaucratic capitalism

A higher probability value can be attached to a less salutary scenario of continuation/deterioration of present trends in Russia. In the past year, the country has been evolving

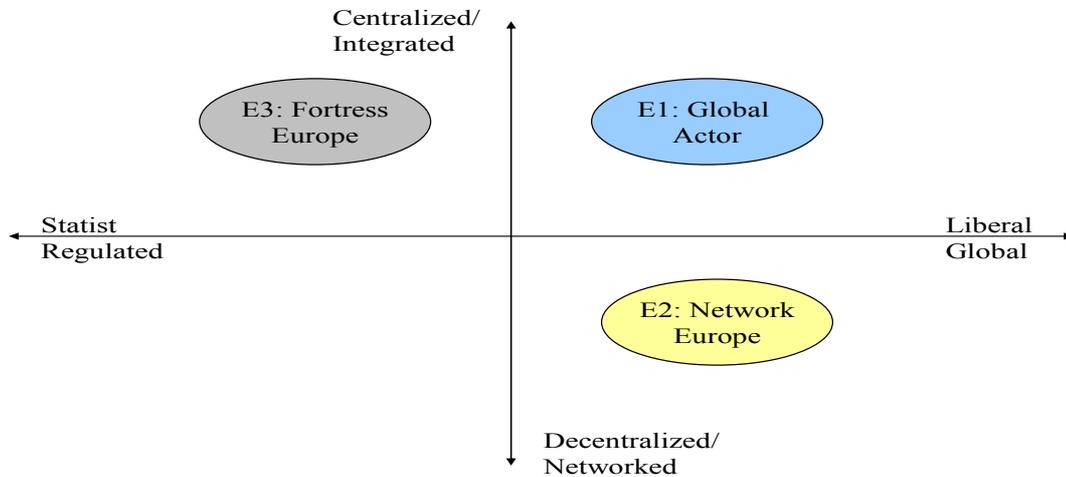
towards an informal state capitalism in which the corporations are private, but *de-facto* controlled by the state. It is marked by a high degree of ownership concentration (e.g. within Gazprom), matched by such examples as Suharto's Indonesia, or, more recently, Kazakhstan. The economic basis of this model is the huge dependence on natural resources, making Russia essentially a "petro-state." Being a "petro-state" as such does not say much about the nature of the political regime, as such states range from Nigeria to Norway, but the problem with Russia is that its political economy turns into the open struggle between major clans for the re-distribution of the resource rent, while much-needed structural reforms are indefinitely postponed.

Domestically, this scenario involves a drift from Russia's current illiberal democracy to a consolidated authoritarianism. It features the privileged role for the bureaucratic corporation, merged with the security elite, a one-party rule with the token opposition in the parliament (the role models are the Liberal-Democratic party in Japan or the Institutional Revolutionary Party in Mexico from the 1960s to the 1980s), and a unitary territorial structure. The foreign policy implications are grave, including Russia's neo-imperialism in the CIS and a "cold peace" with the West.

5. EU scenarios

The same generic chart is used for forecasting the future of the European Union. There are two scenarios with a higher integration/centralization value, E1, "Global Actor", in the benign globalization contingency, and E3, "Fortress Europe", in the malignant globalization case, and one ultra-liberal scenario, E2, "Network Europe", which involves EU decentralization and market forces roaming free. The scenario of political decentralization combined with the statist regulation of the economy was not deemed probable.

Figure 4. Europe's options



5.1. Global actor

This scenario presupposes the success of the national referenda on the EU Constitution and the completion of the institutional reform of the Union. The deepening of integration will be combined with its widening, as Turkey will begin accession talks, and inroads will be made further into the former USSR (e.g. opening talks with Ukraine).

The next round of enlargement will mean that, rather than being a global actor by default, the EU will become a global actor by design. This will involve developing a much more cohesive common foreign and security policy, the re-vitalization of the instrument of Common Strategies, the development of more concrete and diversified neighborhood policies, custom-tailored to each specific case, assuming a more ambitious out-of-the-area role, including peacekeeping and peacemaking, and developing a coordinated stance and common voice in the transatlantic relations.

In parallel to the globalization of the EU foreign policy, the Union will be increasingly exposed to the economic globalization and will continue to open up its markets. The key driver of this scenario is a relatively peaceful globalization, the containment of global

terrorism (since its total elimination does not seem feasible in the near future) and the concert of leading industrial nations with regard to the key problems of today's world.

5.2. Network Europe

The failure to ratify the Constitution and to implement the institutional reform may lead to the weakening of the central EU institutions, to the re-nationalization of economic and foreign policy and to the regionalization of Europe. In this contingency, one can envisage the emergence of a "core Europe" of rich nations, freezing the income divides between East, West and South, the marginalization and isolation of the European peripheries, and the proliferation of bilateralism in the international relations in Europe. The common EU foreign policy will collapse, as the Union will fail to develop a strategic vision and a global role. It will be a giant in terms of size, economic potential and human resources, yet one with a dwindling influence in the international affairs. Naturally, all sorts of common strategies, neighborhood policies and cross-border projects will not be able to take off the ground.

Rather than the regulated devolution and the vision of the "Europe of regions", this scenario will mean the proliferation of spontaneous networks and deregulated flows of goods, services, capital and people. This ultra-liberal scenario, though, lacking a political will, and leaving everything to the invisible hand of the free market, will leave many European regions and peripheries to their own devices and will eventually render them unsustainable. (This fully applies to Kaliningrad).

5.3. Fortress Europe

The powerful external variable for this scenario are the increasing problems of globalization: global terrorism and proliferation of the WMD, migration, environmental degradation, climate change, natural and man-made disasters, regional instability and state failure along the perimeters of Europe. The combination of some of the above factors is quite likely in the near future, and the challenge for Europe is to come up with a solution that will not seal it off from the outside world.

The alternative is the self-defeating, and eventually unsustainable, strategy of isolationism. The enlargement stops at the current 25 plus the candidates of Bulgaria, Romania and Croatia; Turkey is not allowed to join, and thus further alienated from Europe. The Constitution may still be ratified, but the institutional reform will be limited, with an impact on securitization (especially in the JHA) and on enhancing the powers and size of the bureaucracy. Some sort of political mobilization may take place at the national and European level, including tougher immigration and border controls, and the rise in xenophobia, racism and enemy-construction. In the economy, protectionism and state intervention will prevail, while foreign policy will feature isolationism, refraining from global commitments, and curtailing sub-regional and neighborhood projects.

6. EU-Russia scenarios

Building a 3x3 matrix, we obtain 9 alternatives of the Russia-EU relations which easily boil down to three options: “cold peace”, “muddling through” and “full partnership”. Scenario RE1, “Cold peace” is the outcome of isolationist scenarios on either side, “Bureaucratic capitalism” in Russia and “Fortress Europe” in the EU, or a combination of both. The mid-range scenarios like the “Administrative modernization” in Russia and the “Network Europe” in the EU are likely to yield the “Muddling through” outcome (RE2). Finally, the best-case scenario RE3, “Full partnership” for Russia and the EU, can only be achieved by a combination of EU’s “Global actor” scenario and Russia’s “Liberal modernization”.

Figure 5. EU-Russia scenario matrix

Russia	Liberal Modernization	Administrative Modernization	Bureaucratic Capitalism
Europe			
Global Actor	Full Partnership	Muddling Through	Cold Peace
Network Europe	Muddling Through	Muddling Through	Cold Peace
Fortress Europe	Cold Peace	Cold Peace	Cold Peace

6.1. Cold Peace

This is a combination of worst-case scenarios on both sides, and a product of a “globalization gone bad” contingency. In response to the global challenges like terrorism, migration and the environment, key global actors, like the US, the EU and Russia retort to isolationism, hostility and securitization (this move has been already partially accomplished in the United States, while Russia in the past year seems poised to follow suit).

In this contingency, the EU and Russia become increasingly alienated from each other; their hostility will be accentuated by divergences over such cases as Moldova, Ukraine, Belarus or South Caucasus, although the EU, bent on isolationism, is not likely to intervene, politically or otherwise, and will threaten, or apply, diplomatic and economic sanctions to Russia. Visa and border barriers will be erected which will hit hardest the regions sitting on the EU-Russian border – they will turn into the Cold war-type borderlands and militarized peripheries. In the meanwhile, EU-Russian trade disputes will multiply, on issues ranging from steel to domestic energy tariffs in Russia, which may eventually block Russia’s entry into the WTO. Although Russia will anyway likely drop its WTO application bid, overwhelmed by the domestic protectionist lobbies.

6.2. Muddling through

This scenario presupposes the continuation of the current ambiguous trends in the EU-Russian relations, and their deepening stagnation. All the current flaws of the EU-Russian dialogue will be multiplied and magnified: loose institutions, hollow summits (like the recent one in the Hague in November 2004), and bureaucratic squabbling. The EU policy towards Russia will lack cohesion, as competing visions of Russia will proliferate, from the traditional and highly personalized approaches of France, Germany and Italy, to the historical mistrust of Russia on the part of the new member states from Eastern Europe and the former Soviet Union. As a result, bilateral policies will come to the fore, to the detriment of a common EU approach, as exemplified by Italy’s approach during the previous EU presidency.

Russia, too, will be happy to explore the benefits of well-tested bilateralism, trying to exploit the internal EU differences, but also the differences between the EU and the US. Of the four

common spaces between Russia and the EU, some cooperation will remain only in the first space (the economy, underpinned by the old-style Russian energy exports) and the fourth one (humanitarian issues, although these will be dwindling, lacking an institutional and legal basis). Meanwhile, the second and third spaces (internal and external security) will increasingly become contention areas, with issues like visas, migration and re-admission, and EU-Russian rivalry in the CIS (Ukraine, Belarus, Moldova, and South Caucasus) coming to the fore.

6.3. Full partnership

This scenario is less a derivative of the observable trends, but more of a policy project, a desirable policy outcome. It implies the development of the EU-Russia dialogue beyond the old partnership format and the generic neighborhood policy (which is applied equally to e.g. Russia and Morocco, causing Russia to complain). Perhaps it shall entail a special partner status for Russia. On the Russian side, it will involve a significant institutional adaptation, gradual acceptance of a part of the *acquis communautaire*, and a partial legal harmonization with the EU.

The concept of the four common spaces will be exploited in full. In the economy, the EU will be able to fully participate in the modernization of Russia, not as much in the terms of FDI, but more in the terms of creating favorable institutional conditions for modernization, opening its own markets to Russia, and bringing the Russian markets up to speed. In foreign policy, the relations will evolve towards a model of cooperative security, emulating the positive experience of partnership that Russia has accumulated with NATO in the past decade. In internal security, visa-free travel will become an issue if practical implementation, not rhetorical speculation, will greatly enhance the dynamics of the fourth space, the humanitarian exchange.

7. Kaliningrad scenarios

There are two ways to envisage the future of Kaliningrad. On the one hand, one can mechanically extrapolate the EU-Russia scenarios. Thus, embedded in the three EU-Russia scenarios are three alternative futures for Kaliningrad:

- “Cold peace” between Russia and Europe will result in the scenario K1: the geopolitical vision of Kaliningrad as the Russia “Outpost” on the Baltic Sea, pitched against Europe.
- The “Muddling through” scenario of stagnation and bureaucratic incompetence will produce scenario K2: “Stagnation” of the region and the preservation of its drug dependence on trade preferences granted to Kaliningrad under the present status of the Special Economic Zone.
- Finally, it is only in the “Full partnership” scenario between Russia and the EU that Kaliningrad can turn into the “Pilot Region” of EU-Russia relations.

Figure 6. Kaliningrad scenarios: policy-taker approach

Russia	Liberal Modernization	Administrative Modernization	Bureaucratic Capitalism
Europe			
Global Actor	Pilot Region	Stagnation/ Preferences	Outpost
Network Europe	Stagnation/ Preferences	Stagnation/ Preferences	Outpost
Fortress Europe	Outpost	Outpost	Outpost

Another way of looking at the future of Kaliningrad is not just following the broad outlines of EU-Russia relations, assuming a passive role as a policy-taker, but shaping the future of Kaliningrad as a policy project, taking on the role of a policy-maker. Rather than a derivative of the Russian, European and EU-Russia scenarios, the Pilot Region, granted the political will, can develop independently of these contingencies – or, indeed, can shape them. The “Outpost” and “Muddling through” scenarios are briefly outlined below, while the alternative logic of the Pilot Region is presented in more detail in Section 8.

Figure 7. Kaliningrad scenarios: policy-maker approach

Russia	Liberal Modernization	Administrative Modernization	Bureaucratic Capitalism
Europe			
Global Actor	Pilot Region		Outpost
Network Europe			Outpost
Fortress Europe	Outpost	Outpost	Outpost

- “Outpost”: Although seemingly hypothetical at this stage of EU-Russia relations, it should still be counted as a number of external factors (which affect the development of Kaliningrad) may push Russia towards this path. This will bring the region to isolationism and an almost complete lack of market tools to stimulate economic growth.
- “Muddling through” or status quo: Kaliningrad’s current economic model based on the preferences of a free customs zone stipulated by the Law on the Special Economic Zone (SEZ) bears a strong resemblance to an upturned pyramid – it is equally unsteady in the long run. Kaliningrad’s economy is exposed to both internal factors (annulment or substantial revision of the Law on SEZ) and external ones (Russia’s accession to WTO will make the current preferences insufficient for Kaliningrad’s survival, not to mention its economic development). Furthermore, the region’s current growth by far surpasses the Russian average and will bring about two unpleasant consequences. Firstly, the current economic upsurge and growing imports will negatively affect the foreign trade balance of the whole country, not only Kaliningrad. This, in its turn, will result in a growing cost of preferences provided. At the same time more Kaliningrad domestic resources (power, land, workforce, etc.) will be employed thus considerably limiting the region’s overall investment attractiveness.

It is not difficult to predict what will happen when this pyramid falls down, as the productions substituting imports and making the basis of Kaliningrad’s economy nowadays will become uncompetitive for the same reasons. Then neither dozens, nor hundreds, but thousands of Kaliningraders will lose their jobs and the so-called ‘amber revolution’ will no longer seem far-fetched. Russia will be forced to react adversely and even to slide to the “Outpost” scenario, from which neither Russia nor the EU will benefit, since the Kaliningrad puzzle will transform from a smouldering issue into a burning one with further social, economic and political consequences hard to predict.

A solution to prevent such developments may be found in the third Kaliningrad scenario, namely, in the implementation of the project of a Pilot Region – a model of EU-Russian cooperation and partnership beneficial for all parties.

8. The logic of the Pilot Region

In essence, granted the political will in Russia and in the EU, the Pilot Region Concept can be realized not only in the “Full Partnership” EU-Russia scenario, but also under other, less favorable, contingencies, like the Administrative Modernization or, to some extent, Bureaucratic Capitalism in Russia, or Network Europe scenario in the EU. It is only in the most extreme cases of isolationism and confrontation that the Pilot Region would not work.

The change in mental attitude implies that Kaliningrad should not follow the state of the art of EU-Russia relations (which nowadays show disturbing signs of stagnation), but should develop a dynamics of its own. This is a change from a passive policy-taker approach to pro-active policy-making. Instead of being hostage to the complications and blocks in EU-Russia relations, the Pilot Region can overcome unfavorable EU-Russia trends and unblock contentious issues.

The Pilot Region Concept implies the use of a compact region of Russia surrounded by EU member-states (which Kaliningrad is), as a testing ground for EU-Russian cooperation and partnership. In other words, decisions, which for various reasons cannot be taken up in EU-Russian overall relations at this stage, can be practically implemented – and at an accelerated pace – in Kaliningrad for the benefit of its population as well as in Russia’s and the European Union’s best interests.

Thus, Kaliningrad as a Pilot Region may and should contribute to the formation of a new quality of EU-Russian relations. In programming terms, if Russia and the EU are two different operating systems then Kaliningrad may be not only a place to test their compliance, but also to develop and to fine-tune their interface.

It should be noted that *de facto* Kaliningrad has been playing this role urging both sides – Russia and the EU – to seek innovative solutions, to compromise and to take non-standard decisions. Examples range from visa and customs policies to the mechanisms to support Kaliningrad’s socio-economic development.

A successful implementation of the Pilot Region Concept implies that Russia and the EU will adhere to a number of fundamental principles of cooperation. Outlined below, these should find an adequate legislative support, primarily, in Russia’s Federal policy towards the Kaliningrad Region. Some of these principles are as follows:

- The parties should come to a common understanding of real threats and opportunities, which is essential not only for Kaliningrad-related issues, but for overall EU-Russian relations, as well as in the context of the current negative global trends. At the same time, both Russia and the EU should approach the Kaliningrad factor as a unique opportunity to bring their cooperation to a qualitatively new level of mutual trust and equal partnership rather than as a problem and a trouble-maker in EU-Russian relations.
- Of no less importance is the win-win principle, which presupposes that interests of none of the parties' – Russia, the EU, or Kaliningrad – are infringed on. Moreover, innovative ideas and approaches that could forestall European trends should be encouraged, launched and should receive all possible support. At the same time, certain efforts are needed to achieve the greatest possible transparency in procedures, decisions taken and mechanisms for their implementation.
- And, finally, Kaliningrad-related problems should be solved in an integrated and all-inclusive manner. Essentially, this implies that all parties should switch from considering the problems as they occur to preventively seeking solutions for Kaliningrad-related issues within the same overall context.

Practical implementation of the Pilot Region Concept for Kaliningrad, therefore, implies a need for a special institutional and legal framework, which comprises the following four key components:

- Fundamentals of the Russian Federal policy towards Kaliningrad, and primarily, **a status of Russia's overseas territory**, that should be granted to the region and would *de jure* acknowledge its unique geopolitical position of particular importance to the country as a whole in view of EU-Russian common spaces to be established. Unfortunately, this proposal caused much confusion and received a negative response from some Russian authorities. This response is based on a lack of understanding of the proposed innovations: the status of Kaliningrad as Russia's overseas territory (and this is critical) means strengthening, not weakening the power of federal authorities in the region, thus enhancing Russia's political sovereignty over its territory. It is only under this condition that implementation of the Concept can be deemed practically feasible.
- **EU-Russian negotiation mechanism** on joint development of Kaliningrad by Russia and the EU within the framework of bilateral relations. According to independent experts⁸⁴, such EU-Russian negotiating mechanism on Kaliningrad (for instance, working group or another dialogue format) should be granted a high-level status, which would allow discussing and approaching issues beyond the technical scope of cooperation of the current joint structures, while reaching critically important agreements.
- **An EU-Russian agreement between on a joint project** of transforming Kaliningrad into a Pilot Region of bilateral cooperation. This agreement should be elaborated and used in accordance with the above mentioned Federal policy.
- Finally, it is necessary to ensure a harmonious inclusion of the "Kaliningrad factor" into the EU-Russian common spaces to be established in accordance with the Road Maps, which were adopted at EU-Russian summit held in Moscow in May 2005. This primarily

⁸⁴ "Kaliningrad Region as a Pilot Region in Russian-EU Partnership" by a group of experts led by Artur Usanov. – Kaliningrad, 2003.

concerns the Common Economic Space, which implies ensuring all four fundamental freedoms: movement of persons, capital, goods, and services.

An active development of fundamentals of Russia's Federal policy towards Kaliningrad as a Pilot Region should be carried out in parallel with no less intensified cooperation with the EU on drawing up of a special "Road Map", which would reflect main stages of partnership-building, starting from defining mechanisms of decision-making (i.e. an official joint standing body) up to the development and implementation of a joint EU-Russian partnership program on/ for Kaliningrad – the Kaliningrad Pilot Partnership Program. Such a program based on principles of a genuine equal partnership could substitute the so-called technical assistance programs already in the midterm.

The Kaliningrad Pilot Partnership Program should fill EU-Russian cooperation on Kaliningrad with specific practical content, and in particular, cover solutions to most urgent issues related to further development of the region, including establishment of a special visa regime between the EU and Kaliningrad, introduction of an integrated approach to border management at the operational level, strengthening of civil society, establishment of Russian-European free trade zone and creation of a business-friendly climate. The Program should also comprise a number of non-profit infrastructure projects, which would target the development of facilities most topical for all parties concerned. Another important element of the Program could be harmonization of Russian and European legislation in Kaliningrad.

Kaliningrad as a Pilot Region has all the potential to play an important role in Russian domestic and foreign policies. Rather than being held hostage to EU-Russian relations with their ups and downs Kaliningrad could become a determinant of bilateral cooperation in some sense, enabling the parties to untie some of the most complicated knots. Implementation of the Pilot Region Concept could also considerably improve the current geopolitical situation in Europe after a double eastwards enlargement (NATO and the EU). It could also enable EU actors to shape a global, strategic thinking, and to implement the "Global Actor" European scenario beneficial not only for the EU, but also for Russia. As a result of the implementation of this scenario – with Russia's support and participation – a new centre of world integration and modernization could emerge, which is also in the EU's best interests.

In Russia, practical implementation of the Pilot Region idea could contribute to strengthening the positions of actors, seeking to promote the country's modernization, and could also facilitate the administrative reform. This would send a clear message of Russia's continued commitment to market reforms as well as of the country's openness to the rest of the world despite the current strengthening of administrative power and growing controversies with the West. In this respect, Kaliningrad could play the role of a testing ground for Russia's gradual and integrated incorporation into the globalized world.

Chances of the Pilot Region Concept implementation are high with Vladimir Putin's repeated support to the idea voiced in a number of his public speeches. During one of his visits to Kaliningrad in 2003 he particularly stated that: "*we should ... transform the Kaliningrad region into a model of cooperation of Russia with the enlarging Europe. This is not just our goal. This is a goal of the whole European Union*".

The European Union leaders made similar statements. At the EU-Russia Summit held in Moscow in May 2004, Romano Prodi, at the time the President of the European Commission, said that "*...it is in our shared interest to promote a prosperous and open Kaliningrad Region on the Baltic Sea. We are ready to work with you, perhaps in a joint working group, to work on a joint strategy to develop the region. The EU can bring considerable resources into play.*" These statements clearly testify the parties' political readiness to move towards practical implementation of the Pilot Region Concept.

9. Punching above its weight: Global reach of the Pilot Region

Despite its small size and a relatively minor economic impact, the Pilot Region can punch high above its weight and have an impact on the EU, Russia and the emerging European architecture, incommensurate with its size.

First, it can shape developments in the EU by promoting strategic thinking, global vision and innovative neighborhood policy of the Union. Development of the Union's common approach to Kaliningrad will foster cohesion in the lagging field of the Common European Security and Defence Identity. Ultimately, the success of the Pilot Region may promote the E1 scenario: the EU as the "Global Actor".

Second, the Pilot Region can help shape the developments in Russia by promoting liberal, networking and modernizing attitudes, breaking the corrupt practices of the regional and federal elites and the rentier behavior of the bureaucracy. By promoting the principle of territorial diversity, it can strengthen the principles of federalism in Russia and advance the R2 scenario of “Liberal Modernization”.

Finally, the Pilot Region can have an impact on the entire edifice of European security by improving the geopolitical situation in Europe after the double enlargement of the EU and NATO which touched on many Russia’s sensitivities. It can “de-securitize” the approaches of key actors, the EU, NATO and Russia; it can promote cooperative regionality and cross-border networks; it can diversify EU’s neighborhood and partnership policies, and promote the scenario RE3, “Full partnership” between Russia and the EU. Ultimately, the Pilot Region can become a test case for good governance and a successful globalization of Russia.

10. Closing remarks

The results of referendum on the European Constitution that took place in France in May 2005 and the Netherlands in June 2005 jeopardized the practical realization of the most favorable EU-Russian scenario – Full Partnership. According to classification of EU development options given above the present situation may be considered as the beginning of implementation of the “Network Europe” scenario in practice. Though this is not the least desirable path the EU might take, it however contributes to further “muddling through” in EU-Russian cooperation.

Yet, at the same time, recent developments do not turn down or discard the idea of Kaliningrad as a model of Russian-EU cooperation. On the contrary, considering mentioned potential of the Pilot Region to bring the EU and Russia closer to each other in building real partnership, its mission is becoming as timely and important as ever.