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**Kaliningrad Exclave:
Prospects for Transformation Into a Pilot Region**

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The Author's Address

To politicians, policymakers, to influential business people in Russia and Europe, who are not indifferent to the future of our continent and some of its historically unique spots

A unique disposition of Kaliningrad inside the unified European space, to which Russia itself doesn't belong so far, makes the region a natural Russia's interface in the EU. For this very reason, and not on the ground of how typical or atypical Kaliningrad looks to the whole of Russia and to the entire Russia's North-West, this territory can be regarded as a pilot region for EU-Russian cooperation in the 21st century.

The idea to turn Kaliningrad into a pilot region is not mine. It is an official initiative of Russia, offered in her Strategy for Developing Relations with EU till 2010. And as for me, I strongly believe that this initiative may fairly make up a real breakthrough of Russia towards Europe, a timely step for introduction of new security thinking.

After all, is it worthwhile pouring water through a sieve named "the Kaliningrad Factor", manifesting devotion to best values instead of realising these values in action, in order to cope with the task of economic modernisation at least in one of the Russian provinces, which has strategic location, and to do it vigorously, in a realistic and civilised way for the benefit of our common European Home?

1. What is Unique about the RF Kaliningrad Region?

Kaliningrad Region of the Russian Federation, a territory of 15.100 square kilometres, with a population of 948.5 thousand, belongs to the North-Western District in the Russian administrative division. By its constitutional and loyal status, this is an ordinary province, no different from the other 88 member-states of the Russian Federation, as well as from the other nine units of the North-Western District. However, because of its unusual economic setting and imputed functions that it is performing, it is unique in many respects, not only to Russia but also to the whole world.

We can identify at least five specific features of Kaliningrad, which determine its present and future development. They are:

- ***Exceptional geopolitical location.*** This region is Russia's exclave in the Baltic area of Europe, the only unit of the Russian Federation that is separated from the rest of Russia with land frontiers of foreign countries (transit goes either through Lithuania and Latvia or through Lithuania and Byelorussia) and with international waters. In this respect, there is nothing like the Kaliningrad exclave anywhere in the world.

To the extent that Kaliningrad is of top importance to Russia's security in the Baltic area and in Europe in general, this exceptional location of the region in the centre of Europe can become a source of political and strategic military problems of international scale.

- ***Unique geo-economic location.*** With the EU enlargement, particularly as soon as Poland and Lithuania join the EU, the region will become a Russian enclave in the united Europe. This will make

Kaliningrad an economic periphery in a double sense: a marginal site of Russia, remote from the mainland (a Baltic exclave of Russia) and an outside edge of the nearby Europe (an alien enclave in Europe).

- **Exclusive economic regime.** This is the only region in Russia, which enjoys a right to conduct free trade with the rest of the world: for eight years since January 1993 it has been paying neither custom duties nor VAT and excises. This right was given to the region exclusively on the ground that in September 1991 it was granted the status of a free economic zone “Yantar” (“Amber”) by a special decree of Russian Cabinet, and it was confirmed in January 1996, when the region became a Special Economic Zone (SEZ) by a separate federal law.

It is believed that Russian authorities granted Kaliningrad this exclusive privilege as a compensation for its economic disadvantage of becoming an exclave part of Russia. However, this is only partially true: the issue of establishment of a SEZ in Kaliningrad emerged even before disintegration of the USSR, and it was extremely politicised from the outset, as well as the whole free zones story in the Post-Soviet Russia¹. Today, the Kaliningrad SEZ can be regarded as a unique economic experiment not only by Russian standards, but also internationally: there is no other country in the world, where such a large, industrially developed and densely populated part of a national territory is exterritorial in terms of its customs regime.

¹ Yuri Matochkin, former Governor of Kaliningrad Region, gives an outright confirmation in his book that efforts he then made to lobby for putting his total region under tax-free trade regime had no economic grounds at all. His endeavour was merely an attempt to politically utilise conditions of an exclave and growing separatist mood in his domain to get a higher administrative and legal status for the region. See: *Yuri Matochkin. «Na izlome» («Breaking Loose»), Kaliningrad: Yantarniy skaz, 1999, p. 58*

- **Irregular pattern of development.** The region’s economic system is a combination of a military base with a free trade zone. Prospects for its further development are still largely determined by the presence of a troop concentration and strategic military installations on its land. This factor places an extra fiscal burden on the region, creates excessive consumer demand, and expands low-income social strata, which are engaged in shadow businesses. Another side of the problem is that strategic investors and humanitarian cooperation projects are facing extra high risks here.

- **Ambiguous status as an agent of international relations.** Western community regards Kaliningrad as a nearly “full-fledged” subject of international relations, because it is located in the centre of Europe, closely to future members of the EU. So, administration of the region is facing a mandatory but doubtful task: it has to play a role of an independent agent of foreign policy without having any independent policy line. This matter is a clear source of trouble for Kaliningrad at international talks, a disincentive for making optimal managerial decisions, a factor to weaken competitive edge of the region against its neighbours, which are sovereign states.

Kaliningrad as an Archetype of Russian Reality

With all peculiarities, Kaliningrad remains a subordinate in the game of economic federalism, as it is taking shape in the new Russia, and an indivisible part of the Russian economic landscape, as it has been shaped in the age of reforms. What is more, there is much evidence that Kaliningrad is not only closely related to “continental” Russia (to Moscow and St. Petersburg in particular), but is also a certain archetype of the mess of Russian reality. Enjoying exclusive foreign trade favours and other individual benefits of a Special Economic Zone, it shapes out some typical distortions in Russian economy, which owe their origin to

the still prevailing in Russia rent-seeking style of behaviour of business enterprises, state bureaucracy and regional elite.

Generally speaking, the experience of the Kaliningrad SEZ vividly illustrates how liberal policies can induce monopolistic pressures when being “embedded” in the Post-Soviet social context with its historically inherited networks and rules of the game.

2. Outcome of the Last Ten Years: Why Has the Regime of Privileges Failed?

The regime of free trading has produced on Kaliningrad development an *ambivalent effect*.

On the one hand, foreign trade privileges have moderated, to some extent, the acuteness of Kaliningrad problems resulting from its exclave position, and worked as a kind of social shock absorber. They allowed to cover local demand with rather cheap tax-free imported foods, to lower costs of imported industrial inputs, to slow down consumer price inflation (in 1996-1999 rate of price increase in Kaliningrad was the lowest in Russia), and to keep from 45 to 60 % of working population afloat (mainly in shadow businesses).

On the other hand, all the last ten years the region went on a passive drift, avoiding reasonable structural transformation, and in spite of its privileges (or maybe, owing to their presence), arrived at extremely low results, even against the generally discouraging national indicators of that period.

Indicators calculated at constant prices show that up to the end of 1999, volumes of output were on steady decline in all sectors of Kaliningrad economy, except foreign trade, with annual decreases being greater than on the average in Russia. This drove the region down from its pre-reform conditions of 1990, and increased its negative deviations from the trends, which were observed in the 90-s generally in Russia and particularly in the North-Western District (*see Table 1*).

By the end of last decade, GDP of Kaliningrad has declined by 55% (in Russia and in the North-Western District - by 42%); the region’s share in GDP of Russia and in consolidated gross regional product of the North-Western District declined by 21%. In terms of per capita gross regional product (\$4400), the region was the second worst among ten areas of the North-Western District, next to Pskov region. Moreover, in the decade of its privileged status, Kaliningrad managed to attract, in total, not more than \$70 million of foreign direct investment, a meagre one seventh of the sum of capital inflows into the unprivileged neighbouring Novgorod region.

Why hasn’t the regime of zonal privileges worked?

Here are some reasons of general and specific nature.

1. A Technological Fault. The worldwide practice of creating free economic zones has developed some common principles of their typical design against which the Kaliningrad SEZ model maintains an original technological fault. Free trade regime, which is usually applied either to local sites (not more than several hectares) or to deserted areas, has been extended in the Kaliningrad case to cover the entire industrially developed and densely populated territory of a member-state of Federation. As a result, distortions in the region’s economy got worse, both in its industrial and institutional structures, and the region ended in a direct “drug dependence” on federal benefits².

² Those not many large-scale free economic zones that exist in the world (in Brasilia, Argentina and some other countries), are either not densely populated territories, or not extraterritorial areas in terms of customs regime. And as regards the Chinese experience of the 80-s in establishing large-sized special zones with no customs duties, it is rather an exception, which the other time confirms common rules; in the 90-s, the Chinese leadership has revised its previous zone policies as inefficient in favor of localizing sites for free trading within the boundaries of large-sized special zones.

2. A Drive to Expand Imports for the Sake of Monopolistic Rent Extraction . An exclusive right for free trading gave Kaliningrad a monopolistic status among other Russian regions. Foreign trade, particularly imports have been much more lucrative here than in the rest of Russia. Any foreign purchases and trade intermediation gave the region a possibility of extracting substantial foreign currency rents, which were usually kept in shadow. For this reason, foreign trade transactions were bringing excessive commercial benefits over industrial activities, and the whole region was made to rush towards a large-scale expansion of cheap duty-free imports, and towards a massive development of the related trade-supply and intermediary services.

3. General Conditions of Market Transformation in Russia. The rouble was artificially overvalued under the federal policy of “currency anchor” in the 1990s, and it was kept too strong until devaluation in August 1998. In Kaliningrad, the rouble’s appreciation was combined with the duty-free regime, becoming another force to boost imports. The overvalued rouble was largely responsible for this massive expansion. As a result, Kaliningrad enjoyed unprecedented growth in foreign trade turnover (five-fold in 1994-1997) with its per capita imports leaving the average national figure far behind (it was 3 times higher than generally in Russia in the late 1990s); the region has got into a heavy dependence on deliveries of imported goods, especially on food imports (the latter covered in 1994-1997 from 60 to 80% of local consumption of food, as compared to 50% in Russia as a whole), and the ruining effect of imports on the real sector was much stronger than elsewhere in Russia.³

Prolonged expansion of imports (at an annual level of \$1.5 billion on the average) against the background of actually stagnant exports (at a level of \$340-370 million), converted a small-size negative trade balance

³ According to our estimations based on data by the RF Goskomstat, the RF Customs Statistics, the Kaliningrad regional Statistics Committee.

of the region into a huge deficit (from of \$180 million in 1994 to almost of \$1.5 billion by 1997) and made distortions in the industrial structure much deeper than generally in Russia (tertiary industries grew disproportionately at the expense of manufacturing and agriculture). What is more, it encouraged *an explosion of informal activities*.

To indicate the scale of the latter, let us remember that during the 1990s, Kaliningrad region was always a national champion in volume and rate of increase in unregistered personal incomes (by our evaluation based on Goskomstat data, average per capita excess of expenses over incomes of Kaliningradians has tripled in these years). There are many other facts showing the emergence of a powerful sector of shadow economy, which by the most optimistic estimates amounts to no less than 60% of gross regional product (in the rest of Russia, this indicator is between 25% to 50%).

Unregistered economy developed to a scale, which is comparable to the officially registered economy. This expansion undermined local finance and made it heavily dependent on the federal budget. With extra financial benefits as a Special Economic Zone⁴, Kaliningrad was suffering from growing shortage of revenues to balance its budget and to meet liabilities to the federal government. Today, unsettled official debts of the region amount to \$1.8 billion (about 43% of gross regional

⁴ Particularly, Kaliningrad has enjoyed the right to collect the proceedings from allocated oil exports in the regional foreign exchange account, a right to get favourable budget loans of the Federal Ministry of Finance, to accumulate funds from the Federal Special Programme for development of the Kaliningrad SEZ, to handle proceedings from auctioning quotas on imports of goods, and others.

product), and the Federal Government has no other way out but to increase expenditures to keep the social situation in the region stable.⁵

Devaluation of the rouble in August 1998 has diminished the scale of rent that the region was raising, lowered specific advantages of foreign trade intermediation, as well as benefits from expansion of imports. For this reason, devalued rouble gave to Kaliningrad a more strong incentive to contain imports and to replace it with locally produced goods than it gave to the rest of Russia. At the same time, soaring world oil prices brought about a boost in earnings from exports and in tax revenue, which in turn had a stimulating effect on local demand and industrial activity. As a result, by 2000, the recession that had been deeper in Kaliningrad than elsewhere in Russia changed to an upswing that is higher than elsewhere (as shown in *Table 1*, GRP grew by 8.7% against the average national figure of 7.2%).

However, it must be clear that the upward trend will not last long, unless profound structural changes take place in the regional economy. If the devaluation effect fades out and world oil prices plunge, local economy can return to its old track, and import intermediation can become a lucrative business once again, putting the real sector at disadvantage and crippling productivity in general. And even in case industrial activity in Kaliningrad can be maintained at its present level, which would require substantial aid and compensation from the federal budget, this outcome will hardly change for the better the development prospects of the region.

A situation when economic vitality of the region depends on exclusive favours granted by the Federal Government, and on

⁵ For a more detailed account of relations between Kaliningrad and the federal government, see N. Smorodinskaya. Rent-seeking in the regions: the politics of economic privilege in Kaliningrad. – in: “Explaining Post-Soviet Patchworks: Pathways from the Past to Global” (ed. by K. Segbers, Institute for East European studies, Free University of Berlin), Aldershot, Ashgate, 2001

availability of monopolistic rents, can last under the enlargement of Europe for just a couple of years, while ending in degradation of local economy, society, and environment.

3. Kaliningrad in European Surrounding: Fundamentally Vulnerable

No other Russian province will receive as deep and direct impact from the EU enlargement as Kaliningrad region.

The enlargement will bring to Kaliningrad fundamental changes in conditions of economic activity and in prospects of development, particularly as soon as Poland and Lithuania join the EU. It will create well-known problems in the region, because crossing borders to visit neighbours will be regulated more strictly (according to the Amsterdam arrangement of 1999, all applicant countries will have to adopt the Schengen regulations in order to shift to a common visa regime with EU member countries within five years). The region will lose its free transit routes to Russia; will be put at risk of losing energy supply from Russia (Lithuania is going to leave the old Soviet energy system and to cut the transit of electric power); will face higher costs of ecological risks (the region has nine polluters threatening the entire Baltic area).

But the main point is that the enlargement will bring a *fundamental risk of rapidly growing gap in social and economic development of Kaliningrad with the European environment*.

For many political, geographical, structural, and institutional reasons, Kaliningrad has no obvious comparative advantage that can help it to adapt itself to the enlarging EU on its own will. The region is unable to attract independently the resources it needs, to modernise its technological set-up, and to rise its competitiveness to an adequate level. Moreover, the neighbouring Poland and Lithuania, natural rivals of

Kaliningrad in competition for trade advantages and investment resources, enjoy an incomparably better position from the starting point. They are sovereign states with essentially wider scope of authority, and they are candidate countries for joining the EU, enjoying its full-scale financial and organisational support.

The present social and economic situation in Kaliningrad is far from being first-rate even by average Russian standards. The region is still lagging behind the national level in terms of fixed capital investment (the national level is twice as high), living standards (the national standard is 1.4 times higher), and by per capita GDP (the Russian average is 1.5 times higher).

Compared with European neighbours, the regional GDP per head, an integral indicator of social welfare, is a half of that in new Baltic nations (Lithuania, Latvia and Estonia), a third of the figure in Poland, one fifth in Finland, Germany and Sweden, and one sixth in Norway and Denmark (see *Tables 2 and 3*). If, presumably, Kaliningrad economy grows by 5.5% a year on average in the next decade, or by 0.5% faster than it is projected by federal authorities for Russia in general, in 2010 per capita gross domestic product of the region will be no higher than \$7500. This will make 75% of the average Russian level, the same as it is today, 55% of the average for Baltic area, and only 30% of the expected welfare level in Finland and Germany (according to a forecast by Russian Institute of World Economy and International Relations). Moreover, the present EU support of applicants will just widen sharply the gap between the region and its neighbours.

Kaliningrad desperately needs to solve its visa and transit problems and to simplify procedures of crossing borders, not just because it is separated from the mainland but also because it is highly depending on foreign trade and intensive human contacts with its neighbours (at present, the number of transborder private trips is up to 7 million a year). These sensitive issues were outlined in Russia's official documents long

ago and fairly well, they are more or less adequately understood in Europe, and occupy the central place in negotiations between Moscow and Brussels. Contrary to these issues, the prospect of rapidly growing backwardness of Kaliningrad is less evident, and neither Russia nor the EU seem to recognise it.

Meanwhile, the greatest trouble is that *the region is vulnerable in its economic fundamentals, and can easily become economic periphery in a double sense*, a marginal site of Russia, and an outside edge of Europe. The problem of this kind cannot be solved with the help of any simple international arrangements on technical or procedural issues.

4. The EU Enlargement: a Blessing or a Setback?

Establishment of new economic order in Europe brings liberalisation of trade and streamlining of trade relations between EU member-states, candidate countries, and third parties, including Russia.

As far as the EU representatives believe (for example, see *The EU Commission Communication "The EU and Kaliningrad"* of January 2001), this offers Kaliningrad, and also Russia in general, important trade benefits. It means that Kaliningrad will get a better access to European markets for exports (because Poland and Lithuania will introduce consolidated preferential tariff of the EU for third parties); regional goods will be granted duty free traffic through Lithuania and Latvia (because Russia has a status of most-favoured nation, according to the EU-Russian Partnership and Cooperation Agreement of 1997); and export-import cargo will move much faster across Lithuanian and Polish frontiers (as it has happened earlier at the Russian border with Finland).

However, given the present low competitive power of local products (in domestic market as well as in exports), there is no reason to believe that while getting immediately close to the borders of affluent

Europe with the EU enlargement, the region will automatically have a better chance to improve its economic situation. On the contrary, unless Kaliningrad reasonably prepares itself to new conditions, so as applicant countries are now doing, *it will automatically face an acute social and economic shock*, just shortly after Poland and Lithuania join the EU.

We suppose that with the EU extension, *the Kaliningrad informal sector*, which as mentioned, accounts for no less than 60% of the regional economy, will sharply decline. In particular, the volume of the so-called “shuttle trade” and other forms of shadow export-import operations will dwindle as soon as applicant countries tighten passport control at their borders and adopt tough customs procedures in accordance with the EU requirements, and as soon as the EU puts financial transactions of Poland and Lithuania under strict control (especially in the part of their dealings with Russia). In turn, real personal incomes will plunge, and open unemployment will grow at least tenfold (from the present 1.0-1.5% up to 15-20%). Upon a short time lag, this situation will pass on the officially registered sector of local economy. It will have a negative impact on consumer demand, retail trade, and especially on small businesses, most of which are heavily relying on informal activities. Finally, these developments will *curb tax revenue of the regional budget and bring a decline in gross regional product*.

Simultaneously, implementation of the EU plans for lowering of tariff barriers in trade with Russia, will not just fail to improve the local trade balance, which is deeply in the red, but even make the situation much worse. We should take into account that the present structure of local foreign trade is backward (the region is exporting mostly primary products and importing mostly food and finished goods), and that the neighbour countries, particularly Poland, have adopted a policy of promoting exports of their finished goods to Russia, while Russia has no opportunity yet to respond adequately. An inflow of competing imports

from Poland and Lithuania will put *another pressure on agriculture and industry of Kaliningrad*.

Moreover, we should not neglect the fact that harmonisation of trade within the EU is a powerful non-tariff barrier to imports from outsiders, especially to imports from those countries which have technologically backward economies and heavily rely on traditional sectors (agriculture, food etc.), thus constituting a threat to many interest groups within the EU. With most stringent regulations being imposed on imports from such countries, *the new barriers will be erected on the way of exports to Europe from Kaliningrad, and from Russia in general*. The EU may strictly require that local and Russian exports should meet high consumer, technological, and ecological standards, may toughen the standards for cargo carriers, and so on.

In this situation, Kaliningrad’s real balance of gains and losses will be far from the positive picture as it is drawn in official EU documents and declarations. On the one hand, the EU expansion may give the region a reasonable chance to turn to a new and challenging trajectory of social and economic development. On the other hand, it is clear that this chance is beyond whatever market forces can regularly do, and calls for deliberate government policies.

In the next 5-10 years, *the EU expansion and forthcoming liberalization will put more strain on social and economic conditions in the region, unless a far-reaching policy to revitalise Kaliningrad economy is adopted*, unless the region receive an appropriate support for its adaptation to European standards and new competition.

5. The Case of Kaliningrad – a Common Challenge to Russia and Europe

The prospect that Kaliningrad region will keep lagging more and more behind its advancing neighbours is a smouldering explosive and a potential blast on European continent. Even if the region’s trade and

communications avoid being cut off from the EU, Kaliningrad can become a distressed area, breaking the united European space down solely through its economic malaise. In such a case, damage to Russia's ties with Europe will be the best outcome, while a provocation for political hostilities and a danger that another Berlin wall can be put up, is the worst. This means that *economic vulnerability of Kaliningrad in the enlarging EU is growing into a serious challenge of our time*. To ignore this event will have great destructive consequences both for Russian and European security.

The Kaliningrad challenge is addressed equally to Russia and Europe. Considering the unique position of the region as the Russian enclave inside the unified European space, it constitutes a complex and unprecedented international problem. Actually, it is a new type of challenges in the 21st century. This type has probably no positive answers if a single country tries to find any, but requires that joint international initiatives should be taken for identifying common concerns, revealing mutual interests and encouraging close cooperation within a whole group of countries.

Thus, in the early 21st century, Kaliningrad region is no longer a mere Russian exclave in the Baltic area of Europe, but rather a place of crucial importance for the whole European community. It is sending out waves of disturbance that may be positive or negative, but either may have far-going implications of strategic sort, much greater than the relative significance of the region in terms of its size or economic power. For this reason, the very response to the Kaliningrad challenge will actually show *how Russia and the EU see their future relations, and generally speaking, what will be the future of Europe in this century*.

Obviously, Russia and the EU have no other way out but to maintain a close contact and an intensive dialogue on the future of Kaliningrad. Both parties have to recognise, first of all, the common nature of the challenge (both wish not a decay but prosperity in the

region); secondly, its meaning (to push the local economy up to sufficient European standards); and thirdly, the necessity to share responsibilities for meeting it. We believe that the issue requires not only a positive action but also a common policy stance and a joint comprehensive programme. Here are some arguments in favour of this sort of approach:

1) Social and economic systems in Russia and in the EU countries are basically incompatible. There are fundamental differences between

Russia, including Kaliningrad, in terms of structure of production costs, technological and ecological standards. So, adaptation of Kaliningrad to European environment and to a new market situation will require some special know-how, similar to the know-how that applicant countries are using. In 2000-2006, the EU support of applicants includes massive financial aid (about 22 billion euro is allocated by country, according to its territory, population, and per capita GDP), a comprehensive set of innovations (institutional, legal and administrative), and a training programme on standards of economic behaviour and business practices in the united Europe.

2) Russia lacks the needed volume of resources to provide large-scale modernisation of Kaliningrad economy. To achieve a reasonably high level of well being, at a par with neighbouring European countries, Kaliningrad needs massive capital investment, which is hardly within Russia's powers. For example, according to independent expert estimations, in order to become at least comparable with the neighbours by scale of investment in economic infrastructure, Kaliningrad will need in the next six years about 650 million euro, or 40 billion a year as grants (against the scheduled by the EU 8 billion euro for Poland and 1 billion for Lithuania). This need is absolutely incomparable with the present 3 - 3.5 million euro a year that Kaliningrad is granted under the TACIS programme.

3) *Europe has no proper means to deal with peculiar Russian rules and economic practices.* The basic doctrine of the EU enlargement implies that the typical European set of institutions (political, economic, ecological, and legal) will be mechanically extended to the territories of new potential member-states in a “do-it-as-we-do” manner, regardless of social customs and traditions of the latter. Considering that in Russia, as well as in Kaliningrad, many rules and practices are irregular, that the boundary between official and shadow economies is totally blurred, and that the majority of market institutions have the so called pseudomorphosed nature (that is they are adequate in appearance and faulty in real meaning), this European manner of extension will inevitably impede integration of Kaliningrad into Europe. Meanwhile, it is joint efforts that can prevent or remove this barrier.

6. Recognition of Kaliningrad as a Challenge: How Adequate are Moscow and Brussels?

Position of the Federal Government

Official documents of Russian leadership and interviews with high Russian officials contain a lot of frank declarations that the Kaliningrad problem is highly important and that the Federal Government is ready to seek its positive solution. However, in actual practice, not a single agency in the federal administration, which is more or less accountable for this problem, has a clear vision of the real potential of Kaliningrad challenge and its macroeconomic background.

The Russian Ministry of Foreign Affairs, which is responsible of preparing most important documents for regular official exchanges between Moscow and Brussels on the expansion of the EU, concentrates its attention mostly on trans-border issues, while the problem of macroeconomic vulnerability of Kaliningrad is neither formulated in the documents, nor referred to in the talks. This problem is avoided in the same manner in the recent decisions of the Federal Government last

March, based on documents prepared in the Ministry of Economic Development and Trade (*Special Government Resolution of March 22, 2001*). The documents officially declare a liberal turn in policy on the Kaliningrad issue, but in fact, keep the long run objectives as vague as ever, with giving also no clear notion which scenario of the region’s development is preferable in the short run.

Federal documents related to Kaliningrad, which are now in force (*Federal Law “On Special Economic Zone in Kaliningrad region” of 1996, Federal Special Programme of 1997 for development of the Kaliningrad SEZ for 1998-2005, Agreement on Delimitation of Jurisdiction between the region and the federal Centre of 1997*), were once designed to compensate the costs of its exclave position. Today, they need a considerable correction because the region has performed poorly, and because the new European reality is assuming greater importance in the region. However, as far as we can judge from decisions of the Federal Cabinet meeting on March 22 this year and from the draft *Conception of Federal Economic Policy in Kaliningrad region*, which has been considered at the meeting, the approach to this task is fairly shallow if not counter-productive.

The Federal Government policies for lowering the level of bureaucratic discretion in Kaliningrad, such as simpler screening of investment projects, easier registration procedure for enterprises, simple monitoring, are quite in line with liberal course of the official Strategy for Russia’s Development till 2010. However, these policies seem to be rather superficial and unimportant, if compared with the level of structural changes that Kaliningrad has to go through in order to become truly competitive.

And what is more, these policies actually conserve the present, quite unhealthy dependence of Kaliningrad on exclusive federal favours. In particular, the key idea of the draft federal Conception on Kaliningrad, as the regional authorities have offered it, is that duty-free

trade should be supplemented with profit tax allowances, and the scope of federal favours should be expanded to service sector (communications, recreation, etc.), and stability of these enlarged privileges of Special economic zone should be warranted for years under international law (through a Special EU-Russian Arrangement On Cooperation).

In their approach to vitally important issues in the region (power supply, ecological safety, access to trans-European transport corridors) both the Conception and protocols of the Federal Cabinet meeting still continue to rely on costly methods, which lay a heavy burden on the federal budget. Unfortunately, no efforts to choose optimal investment schemes are made, and neither the concrete Brussels proposals on Kaliningrad, nor the results of relevant studies under the TACIS programme are taken into account. For example, the problem of energy supply in the region is planned to be solved exclusively by means of constructing a new large thermal power station (TPS-2), while there is still much doubt about economic efficiency and ecological safety of this project.

There is still more evidence that the present Moscow treatment of the Kaliningrad problems is far from whatever the region actually needs to develop successfully under the EU enlargement. Rather it is a demonstration of the federal Centre surrender to traditional pressure from local interest groups that call for “both freedom and money” from the Federal Government.

Position of the European Union

In theory, the EU had three possible approaches to the Kaliningrad issue considering the enlargement of Europe. The first is *a policy of economic isolation* (prospects for deterioration in Kaliningrad in the new surrounding may be recognised, but the problem claims to be a domestic Russian matter); the second is *indifference* (the problem of Kaliningrad

may be recognised, but with no relevant adjustments of the TACIS Programme for Russia); the third is *a policy of integration of Kaliningrad into Europe* (the region may get the full measure of support, as if it were one of the applicants for joining the EU). In this context, the Brussels initiatives, as formulated in *the EU Commission’s Communication “The EU and Kaliningrad”* of January 2001, may be identified as something like *half-indifference* towards the region, because Russia is made fully responsible for its future, and the EU seems ready to do what it can.

On the one hand, the EU Communication is a step towards Russia and a strict response to the last year *Russia’s Letter of Concern* about the trans-border consequences of the EU enlargement. Brussels is expressing its readiness to take a range of practical measures to develop infrastructure at border crossings points and simplify borders crossing procedures, to help solving problems of energy supply and construction of transport facilities in Kaliningrad. Moreover, the EU is going to test its “basic rule” of free movement and transit in borderline parts of the region, close to the external border of the EU (with possible application of special arrangements, similar to those that are already worked out with candidate countries). This is probably the maximum agenda, which Brussels could offer Moscow, the latter having no clear scenario for the region.

On the other hand, the Brussels approach to the Kaliningrad issue focuses mainly on applied matters at the expense of fundamental ones, thus ignoring its importance as an original international case. Kaliningrad will come within the general principles of the EU relationship with Russia as an outsider to the unified European space, and within the common rules of the EU-Russian collaboration, as they are established in *the EU Collective Strategy on Russia of 1999*, in *the EU-Russian Partnership and Cooperation Agreement (PCA) of 1997*, and in *the TACIS Programme of Technical Assistance for Russia*. And

though Brussels is planning to pay some additional attention to the region, it is not ready to go beyond the established institutional framework. However, these principles and rules have no sufficient regional dimension and are not shaped for the unique position of Kaliningrad *inside* the European space.

The January EU initiatives call for starting a multilateral dialogue on Kaliningrad (within the EU leadership, between the EU and Russia, between the EU and applicant countries) to seek for a genius solution that could let the region take as much benefits from the EU enlargement as possible. However, these initiatives do not touch upon the main issue, how to carry out a structural reform and technological modernisation of Kaliningrad economy in order to make it adaptable to external competition, to develop its export potential and to reduce its gap with Europe.

Instead of a comprehensive approach to the fundamental problem of providing incentives for higher economic growth and competitiveness of the region, along with granting to it the needed organisational and financial support, the Commission's Communication entails a piecemeal and inadequate handling of the issue. This is a plan to discuss separate aspects of the Kaliningrad economic development one by one at the level of PCA branch sub-committees and at workgroups by situation, with the following looking for funding the requirements that come into light. Such an approach does have its reasons, but it obviously *lacks a system-formatted answer to the Kaliningrad challenge*.

Brussels is reluctant to treat Kaliningrad as an individual case of the EU enlargement subject because it does not adequately assess the extent and implications of the region's macroeconomic vulnerability in the expanding Europe. In particular, there is no comprehension that even if the Kaliningrad setting immediately close to the EU borders can produce positive effect on its development, this influence will not necessarily be automatic, and on the contrary, every automatic effect will

not necessarily be positive. For eight years, informal business networks connecting Kaliningrad economy with its European neighbours have worked as built-in stabilisers. As soon as these networks are sharply destroyed along with streamlining of controls over movement of people and goods, the region will fall into a severe crisis.

Moreover, at present, the format of the EU-Russian dialogue on the Kaliningrad prospects largely depends on the extent to which the EU is actually ready to support the region's development. This readiness is limited by the EU's comprehension of menace, which is constituted by Kaliningrad. Today, as far as we can observe, the EU maintains the following range of priorities in assessment of this menace: (1) nuclear waste, utilisation of submarines; (2) ecological environment, AIDS, tuberculosis; (3) criminal activities, particularly drug traffic; (4) economic development. This ranking means that Europe is recognising the so-called "soft risks" as matters of main concern, while issues of economic growth and welfare in Kaliningrad are treated as matters of lowest importance.

So, *neither Moscow nor Brussels do not yet recognise the problem of growing development lag of Kaliningrad behind its European surroundings as a real threat to European security*. For this very reason, both Moscow and Brussels give their prime consideration to the transborder consequences of the EU extension. And for this very reason, the problem of incentives for economic rehabilitation of Kaliningrad region is mistreated as a matter of primarily Russia's domestic concern.

7. A Joint Response to the Challenge: the Idea of Turning Kaliningrad into a Pilot Region

The Starting Point of the Idea

There is a couple of well-known ideas dealing with possible ways to fit Kaliningrad into integrated Europe with no damage to its belonging to sovereign Russia. One of them is the concept of "*Europe of Regions*"

which focuses on progress of trans-local cooperation of municipalities, social organisations, and business entities, and is popular among the participants of Northern Dimension Initiative. Another one, known as the concept of “*Triangles of Growth*”, was offered by a Finnish Professor Urpo Kivikari and is focused on economic cooperation of three and more regions in different neighbouring countries.

However, the common nature of the Kaliningrad challenge, as discussed above, suggests that the most promising scenario for the region is a joint EU-Russian response to the challenge.

Such sort of idea was designated in 1999 in Russia’s Strategy for Developing Relations with the EU till 2010 (the so called *Medium-term Strategy for the EU*). Particularly, its 48th article admits a possibility “*to transform Kaliningrad into a pilot Russian region within the framework of cooperation between Russia and the EU in the 21st century*”. And this vision of the region’s future could be fairly found as the Russia’s reciprocal break-through initiative for Kaliningrad against the present EU position, as expressed in the Commission’s Communication.

The Medium-term Strategy was handed over by the Russian President V. Putin (then the Russian Prime Minister) to the EU leadership at their meeting in Helsinki on Northern Dimension in October 1999. This moment can be regarded as the formal starting point of the pilot region concept. In Summer 2000, Kaliningrad’s researchers in a way promoted this idea by calling Moscow and Brussels for signing an international agreement on turning Kaliningrad into a “region of cooperation”.

Still, it was not until November 2000 when the pilot region concept made its first actual move at an international conference on trans-border cooperation held by the East-West Institute. Three months later, in February 2001, the concept was submitted to special hearings at Kaliningrad Regional Duma, with following detailed recommendations to the Federal Government. And in April 2001, at the second forum of

Northern Dimension in Luxembourg, Russian Vice Prime Minister V. Khristenko has said that the future of Kaliningrad is with “the pilot project of Northern Dimension, and Russia is looking forward to its positive outcome”. Head of the Kaliningrad regional administration V. Yegorov has shared this view.

The “Pilot” Principle and Areas of its Application

The notion of a “pilot region” means that a territory is a field for testing new mechanisms, technologies and rules, which are adequate to positive tendencies and may be later reproduced en masse in other territories. Transforming Kaliningrad into such a territory does not suggest that its administrative and political status should be necessary changed, but rather implies testing the innovations which are relevant exclusively to the task of the region’s economic growth. In this connection, all points of the Kaliningrad thesis in the Medium-Term Strategy should be accentuated: *first*, the region can become pilot; *secondly*, it will in any case remain a Russian region (under Russia’s sovereignty); *thirdly*, this transformation is feasible in the framework of cooperation of Russia with the EU.

Here follows *the two-sided scheme for application of the pilot principle*: it can be attached both to the pattern of the Kaliningrad region development, and to the pattern of partnership between Russia and the EU on this subject.

The first case implies testing in Kaliningrad the standards of economic activities, which are new to Russia but routine in Europe. Among them, there are new rules of business behaviour that are able to rehabilitate business environment, cut transaction costs down, and drastically reduce entrepreneurial risks in the territory.

The second case is a matter of new quality of relationship between Russia and the EU as strategic partners. Presumably, this relationship will be more trustworthy, reciprocated and open; in other words, it will

stand on a better base than the principle of bargain, which has been prevailing in the dialogue between the two parties up to the present.

Generally speaking, the pilot region idea should allow to see Kaliningrad as *a proving ground for testing development strategies*, which concern the region itself, the new stage of relations between Russia and the EU, and also prospects for the Russian North-West in the context of Northern Dimension Initiative.

As mentioned, turning Kaliningrad into a pilot region will keep Russian sovereignty over this territory intact. At the same time, this project does not leave Russia face to face with the problem of economic vulnerability of the region, but raises the question how to combine Russian and European efforts to cope with it.

The economic ground for joining efforts is objectively formed by a common interest in Russia and the EU to get social and economic situation in Kaliningrad in the expanding Europe fundamentally improved. And the legal basis for joint activities could be created through a *Special agreement* between Moscow and Brussels. The agreement should be concluded not merely to protect the region's interests as of a member-state of Federation (as offered by Russia in Middle-term Strategy), but basically to carry out the joint project of Russia and the EU for developing Kaliningrad as a pilot Russian region, or in short – the *Kaliningrad Pilot Region Project*.

There is also a less preferable way to legitimate this joint project with a Special Protocol of two parties to be signed by the Russian Federal Government and by the EU Commission. However, in any case in should contain a *Joint Action Plan for Kaliningrad till 2010*.

The Joint Action Plan would create a precedent of real strategic partnership between Moscow and Brussels in the regional field of cooperation. On the one hand, it will become a factor of discipline for Russia and Europe to meet concrete obligations to Kaliningrad. Russia will have to accept a clear Federal Strategy for the Kaliningrad region

development, adjusted for the EU enlargement, while the EU will have to coordinate its Common Strategy on Russia of 1999 with its *Enlargement Strategy* (particularly, with the Commission's Enlargement Paper of November 2000), allowing corrections of the latter for administrative units of the European Commission. On the other hand, implementation of the Plan would mean that many painful developments, which may occur in Kaliningrad under reinforcement of internal order and frontier regime in the EU, are to be put from the outset under bilateral control.

Practical Goals and Targets of the Project

Development of Kaliningrad as a pilot region is an international project aimed first and foremost at economic growth and welfare of this territory under the present geo- economic changes in Europe. More simply, the crucial task is to ensure *an economic breakthrough of Kaliningrad and to achieve a success in its market adaptation to the European environment*. Hence follow **two practical tasks**: *in the short run*, to modernise the institutional and technological set-up of Kaliningrad economy, and *in the long run*, to push social and economic indicators of the region's performance up to satisfactory European levels. To this end it is of key importance to carry out the modernisation programme within the shortest possible time, as well as to make certain that the quality of economic growth, in other words, not just its rate but also its technological level will be high.

Along with this main goal, concerning Kaliningrad itself, the Pilot Region Project pursues some *structural effects that can accelerate Russia's movement to get closer to the EU*. Particularly, federal and regional authorities, working side by side with European experts, will have a chance to get a more realistic perception of economic prospects in Kaliningrad, and at the same time to learn from experience how economic cooperation in the uniting Europe works. In this sense, the

Project can become for Kaliningrad a sort of analogy with the EU programmes of support to applicant countries, while Kaliningrad can become for Russia a sort of testing ground for upgrading methods of cooperation with the EU and for their further use in the Russian economy as a whole. Similarly, this experience of cooperation with Russia will be important to the EU as well.

To put it more generally, as a pilot region Kaliningrad would turn into a *place for accumulation of technological experience in the following areas*:

- adaptation of European standards (institutional, legal, technological, ecological, etc.) to Russian conditions and their introduction in Russia;
- developing a new form of economic cooperation between Russia and the EU, based on initiating joint regional projects and on implementing joint action plans to ensure economic upswing in a separate territory;
- working out new principles of economic partnership between Russia and the EU, that help to achieve concrete results of joint activities either in the shortest possible time or with the lowest possible costs.

Besides, the Pilot Region Project can produce some important *demonstration effects*, which would raise the grade of social trust in Kaliningrad, and increase confidence both in Russia's policy in the Baltic area and in the EU extension strategy in Eastern Europe. The EU will get a fair chance to demonstrate Russia positive effects of its enlargement. Russia, in turn, will get a chance to show the EU a definite policy to promote reforms and to become closer to Europe.

Moreover, if the Kaliningrad experiment is a success, it will show the rest of Russian regions that the real way to improve investment climate is not to get benefits, but to introduce institutional and

organisational innovations that can help to curb entrepreneurial risks and to cut production costs down.

8. Kaliningrad as a Pilot Russian Region: Choosing a Pattern of Development

Transparency is the Key Principle

Turning Kaliningrad into a pilot region should make its economy not only more liberalised, but also more manageable. In this case, by further liberalization we mean not merely offering to Kaliningrad extra federal favours but making its economy free of exorbitant transaction costs that have grown in the previous years under bureaucratic discretion, corruption, expansion of shadow activities, and monopolistic behaviour of oligarchic business groups. In turn, a better manageability can be achieved not through extension of administrative controls, and by no means through setting up a special commission for elimination of bureaucratic discretion (as recently offered in one of the official federal documents), but through enlarging the scope and elevating the grade of economic transparency in the region.

Introduction of transparency standards, both fiscal and ecological, will be a formidable challenge to Kaliningrad where more than a half of economic activities is informal. However, if this problem is not approached in earnest, the region will suffer contraction of the informal sector and lose its additional shadow rents in the expanding Europe in any case, but the cost of this "spontaneous" loss under the EU enlargement will be unpredictable both for Kaliningrad and for the Federal Government, as well as for Russia's ties with the EU.

Moreover, it is the principle of transparency, accompanied by a proper standard of business behaviour, that would give the Special Economic Zone a good chance to perform effectively, for it lets to reasonably adjust the scale and scope of federal favours along with keeping the region's financial flows under a close observation.

Adjustment to European Standards

As a pilot region, Kaliningrad basically calls for just the same structural and institutional changes as Russia does, but here they must be carried out earlier (a reform of public finance, development of land legislation, introduction of a code of good corporate governance, application of bankruptcy laws, etc). Simultaneously, Kaliningrad is in urgent need of joint projects aimed at a better conjunction of its economy with that of the unified Europe (such as a project of harmonisation of standards and procedures for specification of quality of goods and services), with the start up of such projects developing a pilot field of collaboration between Russia and the EU. In the aggregate, structural reforms and adjustment to European standards in Kaliningrad have to ensure its *transition from the present rent-oriented model of development to a regime of self-sustained growth*.

Development Vector and Industrial Specialization

At present, the majority of experts on Kaliningrad are sharing the opinion that out of three possible ways to modernise local economy – *a policy of isolation* (to keep it exclusively or mostly self-reliant), *a policy of introversion* (to restore and revitalise traditional economic relations that had been broken after the collapse of the USSR), and *a policy of integration into the EU*, the third way, together with some elements of the first and second ways will be the most effective one.

It would be definitely wrong to treat the integration scenario as an attempt to cut off Kaliningrad forcibly from the economy of mainland Russia. A more appropriate approach is to consider the case of optimal industrial specialisation of the region, keeping in mind the following factors.

First, the region is too small in terms of its basic economic parameters (population, domestic demand, investment potentials) to maintain a self-reliant and competitive economic system. *Secondly*,

being too remote from the Russian hinterland the region is unable to be a valuable supply and sales market for the mainland. *Thirdly*, for the same reason, the region is hardly in a comfortable position to become a base for inflow of foreign capital into Russian economy. *Finally*, the present Kaliningrad's specialisation as a mass custom clearance service point for Russian export-import traders can't be seriously considered as a civilised industrial profile.

All in all, we can't avoid the conclusion that Kaliningrad has no other economic choice than *to orient itself mostly at Europe*. And the alternative orientation mostly at Russia is beyond economic rationality, requiring enormous resources that Russia does not have.

In this case, it should be taken into account that even if basic industries of the region (such as fishery and fish processing) receive proper modernisation, Kaliningrad will never get a competitive edge as an exporter over its neighbour countries, which are entering the EU. Consequently, in the near future Kaliningrad would rather obtain the so called *exports-for-covering-deficits specialization*, namely, to cover the EU trade deficits with third countries as a marginal exporter (while Poland, Hungary and the Czech Republic will most likely become main exporters). Simultaneously, in the face of Kaliningrad Russia could get a good channel to enter the world export markets for finished goods.

In a more distant future, Kaliningrad could be *specialized in innovations*. Taking into account that the region has no distinct competitive edge but skilled labour, and that as a pilot region it has an evolution programme in its background (the Joint Action Plan), its forward-looking profile can be developed from scratch. Particularly, Kaliningrad can be focused on nurturing industries related to the worldwide information-technology revolution, which are still embryonic in Russia. Development and sales of local IT products, and above all, export and import trading, international fairs and commercial intermediation in this commodity market will help to eliminate the

present factor of distance between Kaliningrad and mainland Russia, minimise the costs of its enclave/exclave position, and let Russia do away with a traditional concern that “getting Kaliningrad closer to Brussels inevitably means getting it farther from Moscow”.

9. Kaliningrad as an EU-Russian Pilot Project: Choosing A Pattern of Cooperation

Additional Arguments for a Joint Project

The existing EU institutions and the EU agreements with Russia do not provide for appropriate framework to response to the Kaliningrad challenge.

First, the EU Common Strategy on Russia do not recognise regional international cooperation as a separate course, and for this reason, responsibility for Kaliningrad’s development is diluted between 9 executive subcommittees of the PCA.

Secondly, its major documents regard Russia as a homogeneous space outside the EU, neglecting the position of Kaliningrad as an enclave in the unified Europe (for example, in calculation of technical aid to Russia, the same standard criteria are applied to Kaliningrad as to the other 88 member-states of Federation).

Thirdly, dividing Europe into member-states and outsiders of the EU, Brussels gives a priority to internal issues of the Union and to international relations between the member-states. Meanwhile, no proper attention is given to relations of the EU with its exterior and to development of trans-local cooperation at its external borderlines (such as communication of Kaliningrad with Poland and Lithuania).

Finally, the EU idea that expansion of Europe will automatically benefit Kaliningrad from the outset is an argument against regarding this region as a unique case and for refraining from any relevant special steps which would be useful for the region but could run counter the EU “basic rules”.

In this situation, a joint EU- Russian pilot project would give the Kaliningrad problem a proper dimension for finding its solution definitely, comprehensively and promptly.

Code of Strategic Partnership

In their dealing with Kaliningrad, Russia and the EU should build up their relationship on definite and predetermined principles that can help to resolve concrete economic problems in the region in the most efficient way and in the shortest possible time.

Among other things, it is important that Moscow and Brussels should officially recognise that development of Kaliningrad as a pilot region pursues predominantly economic goals. To reach a success, they must forget about political bargaining and political speculations, minimise bureaucratic coordination, cultivate the atmosphere of mutual confidence and resist the activities of pressure groups, which can destroy this atmosphere.

The set of shared principles could be summarised in a *Code of Strategic Partnership* that would become a guideline for the parties over the entire term of the project. Eventually, it is necessary for Russia and the EU to *reduce to a minimum transaction costs of the project’s implementation*, in order to achieve its major goal, namely, an economic breakthrough of Kaliningrad, in the shortest possible time.

A Principle of Equal Rights

The joint pilot project for Kaliningrad allows Russia to view itself not as a victim of the EU expansion but as a full-fledged beneficiary. Therefore, in cooperation with the EU over Kaliningrad, Russia can and must claim to equal partnership rather than to compensation of some damage. This *principle of equal partnership* will make Russia’s relationship with Europe steadier, increase mutual confidence and give the Kaliningrad regional administration a sound framework for its actions.

Enforcement of the principle of equal rights supposes that the traditional pattern of financial aid, which usually creates a kind of dependency on the part of recipients, will be minimised. Such issues as improvement of ecological situation or waste disposal should be solved in Kaliningrad not with the help of European grants but rather through joint elaboration of more effective financial schemes (in roundtable discussions or with investment bids).

On the European side, it should be reasonable to convert *the TACIS programme* for Russia from a programme of purely technical aid into a programme of technical assistance, letting Russian and European experts engage in a team-work from the start. On the Russian side, it should be no less important to elevate the status and correct the goals of *the Federal Special Programme for the Kaliningrad SEZ development*: to transform it from a purely domestic programme, aimed at compensating disadvantages of Kaliningrad position as a Russian exclave, into a programme of Russia's sharing the joint pilot project for Kaliningrad.

Will the Joint Project Cost Very High?

Modernisation of Kaliningrad economy will involve great efforts and massive investment, which can make the project of pilot region look too costly, especially for Europe. However, the problem of project costs should not be considered in such a narrow sense.

In the first place, a rapid economic breakthrough in the region will bring great benefits: both Europe and Russia will make priceless strategic gains in terms of their security. Moreover, Russia will be able to cut its present financial support of Kaliningrad substantially down, and the EU, including the close neighbours of the region will receive a valuable new place for location of businesses, which is fairly well adapted to European institutional standards.

In the second place, the Joint Action Plan for Kaliningrad will be a guarantee against a military scenario for its development. Besides, the

Plan can eliminate political bargaining around the region's vulnerability and lower the level of political risk in this area. For this reason, on the side of Europe, economic rehabilitation of the region will be obviously much more cost-effective than any outlays for an alternative system of early conflict prevention in this area, to say nothing of expenses on clearing out the outcome of possible political conflicts resulting from the Kaliningrad problem.

In the third place, the pilot framework of the Kaliningrad project allows to use innovative mechanisms of collaboration, to find the best ways of financing the regional development relying mostly on private initiative and reducing dependence on the money of Russian and European taxpayers to a minimum.

10. Implications of the Pilot Region Project *(a concluding remark)*

In all respects, the idea to create a pilot region seems to be the most adequate response to the Kaliningrad challenge and the most reasonable alternative to the prospect of transforming the entire region into a closed military base. Basically it calls upon Russia and Europe to engage in the process of economic rehabilitation of a relatively small but highly vulnerable part of Russia, to join efforts for generating schemes that could ensure a proper quality of economic growth at least in one of the Russian provinces, which is situated in the extreme West of the country.

Designed for creating a pilot region, the EU-Russian project should be of a pilot type itself, that is to serve as a navigator both in Kaliningrad (introduction of new standards and instruments of business activity) and in collaboration of Russia with Europe for this end (testing new forms and principles of economic partnership). Implementation of the project must supply Kaliningrad with the necessary setting for modernisation of its economy, for bringing it to a regime of self-

sustained growth, for making it a stable and affluent region with a full set of economic ties with its European environment.

As any breakthrough, the pilot region concept will be a hard trial for the local society, able to break down the established patterns of behaviour and networks of group relationships. However, it fully conforms to strategic interests of Russia and Kaliningrad, because it can bring them stable benefits from their closer ties with the united Europe and what is more, to absorb the shocks resulting from the EU Eastern extension. With this project, Russia will be able to make its best from the EU enlargement and to gain the experience of new partnership with Europe. The EU will have no smaller strategic gains from accelerated Europeanizing of Russia in case it accepts the plan of a more close and active cooperation in Kaliningrad.

The common nature of the Kaliningrad challenge is creating a unique chance to bring economic relationship between Russia and the EU to a different, principally higher level. However, to decide on a daring joint initiative in this exclave/enclave region, both parties will need a strong political will and a new type of security thinking (to be called geo-economic thinking against geopolitical one).

Moscow and Brussels have to recognise that while common activities in Kaliningrad are based on their general Partnership and Cooperation Agreement of 1997, at the same time they constitute *a separate line of their collaboration in the 21st century*. For this reason, both parties have to move further and *to agree officially on transforming Kaliningrad into a pilot Russian region*, that is on implementing the Russia's initiative for Kaliningrad as expressed in article 48 of the Middle-term Strategy for the EU.

At the same time, it is reasonable to create *a joint group of experts* with the following tasks:

- to make an impartial analysis of possible outcomes of the EU enlargement for Kaliningrad;

- to compare the EU and Russian approaches to prospects for the region;
- to identify concrete economic problems of the region that require common concern and a team-work of Russia and the EU;
- to prepare a draft of the Joint EU-Russian Action Plan on turning Kaliningrad into a pilot region, to be submitted for further official consideration.

The aforesaid group can be formed either within the PCA (as a specialized expert body for Kaliningrad), or as an international group of independent experts (from Russia, Europe and perhaps from the North America countries, paying noticeable attention to the Kaliningrad case and to the Northern Dimension initiative.

It is worth noting, that *geo-economic implications of the pilot region project are difficult to overestimate*.

Unification of Europe is progressing at such a pace that Russia has no spare time to cultivate an image of a bona fide strategic partner in the eyes of the EU and to win the benevolence of the world investors' community. Similarly, Europe has no spare time to effectively link Russia's economic potential to the common economic space. In this situation, a rather small-scale joint project in Kaliningrad can serve as a powerful accelerator to Russian-European integration, and consequently, as an effective means of strengthening European security and enhancing Euro-Asian cooperation.

Thus, Kaliningrad is not just a potential place of break in the unified European space but also a promising chance to transform border barriers into interfaces and make the development of Europe in the 21st century more safe and confident. How will this "window of opportunity" be used, if ever, depends on concrete efforts of Russia and the EU, the efforts by no means being limited to top official level.

And the final remark on the Kaliningrad issue.

According to George Soros, the West has already lost the new Russia one day. Those not a few people in the West who envisage the global future without the new Russia on the stage, will most likely never identify the present Kaliningrad challenge. After all, what is outstanding about the Russian enclave in Europe (and about Russia's hardships on the whole) against a background of serious problems and challenges that democratic world is permanently facing at home !

Still, whatever miserable the Kaliningrad case may look in a global dimension, it strongly underpins two important principles. First, one should never forget for whom the bell tolls. Second, one should not let the problems of today obscure the opportunities of tomorrow.

Table 1. **Kaliningrad Region as Compared to Russian, North-Western District: *Economic Growth Rates in 1991-2000***

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GRP/GDP, bill. roubles										
Kaliningrad Region	19,20	14,70	12,85	10,75	9,80	8,90	9,00	8,50	8,50	9,25
Russia	3065,0	2610,0	2370,0	2000,0	1885,0	1745,0	1760,0	1675,0	1725,0	1850,0
North-Western District	341,25	295,75	270,15	223,35	212,00	192,25	196,25	189,25	195,55	209,15
GRP/GDP, in % to the previous year										
Kaliningrad Region	94,35	76,56	87,41	83,66	91,16	90,82	101,12	94,44	100,00	108,82
Russia	95,33	85,15	90,80	84,39	94,25	92,57	100,86	95,17	102,99	107,25
North-Western District	94,41	86,67	91,34	82,68	94,92	90,68	102,08	96,43	103,33	106,95
GRP/GDP, index, % (1990 = 100%)										
Kaliningrad Region	94,35	72,24	63,14	52,83	48,16	43,73	44,23	41,77	41,77	45,45
Russia	95,33	81,18	73,72	62,21	58,63	54,28	54,74	52,10	53,65	57,54
North-Western District	94,41	81,82	74,74	61,79	58,65	53,19	54,30	52,36	54,10	57,86

Note: 1) Calculated at constant 1996 prices.
2) the 2000 data are 11-months estimates

Calculated from: Russian Statistical Yearbook, Goskomstat, 1999;
Economic and Social Conditions in Russia,
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Note: 1) Calculated at constant 1996 prices.
2) the 2000 data are 11-months estimates

Sources: Russian Statistical Yearbook, Goskomstat, 1999; Economic and Social Conditions in Russia, Goskomstat, # 11, 2000

Tables 2. **Kaliningrad Region as Compared to Russia and the RF North-Western District: per capita gross domestic/regional product in 1999-2000, \$1000**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Kaliningrad Region	10.20	9.65	7.40	6.45	5.10	4.70	4.25	4.25	4.05	4.05	4.40
Russian Federation	9.80	9.30	7.95	7.00	6.10	5.75	5.35	5.40	5.15	5.35	5.85
North-Western District	10.65	10.10	9.00	8.05	6.70	6.35	5.85	6.00	5.80	6.10	6.60
• Karelia	7.85	7.70	6.50	5.85	4.85	4.70	4.05	4.05	3.85	4.65	5.15
• Komi	12.80	11.60	10.10	9.10	7.20	7.15	6.90	6.85	6.50	6.90	7.40
• Archangel Region	9.70	8.75	7.70	7.05	6.00	5.40	5.05	5.05	5.05	5.65	6.40
• Vologda Region	10.50	9.95	9.80	7.95	6.60	6.70	6.30	6.25	6.05	6.70	7.45
• Leningrad Region	9.20	8.90	8.35	7.50	6.30	6.25	5.55	5.55	5.30	5.60	5.85
• Murmansk Region	10.50	9.40	8.15	6.85	6.50	6.15	5.50	6.20	5.90	6.00	6.90
• Novgorod Region	8.35	8.25	7.15	6.65	5.25	4.95	4.80	4.60	4.55	5.15	5.70
Pskov Region	7.65	7.30	5.80	5.55	4.25	3.80	3.70	3.55	3.30	3.55	4.20
St.Petersburg	12.35	12.00	10.45	9.90	8.25	7.85	7.00	7.50	7.30	7.30	7.70

Note: Calculated at 1996 prices and at purchasing power parity

Sources: Goskomstat RF. "Russian Statistical Annual, 1999"; "Social and Economic Situation in Russia" № 11, 2000; UN Economic Commission for Europe. Economic Survey of Europe, № 2-3, 2000.

Tables 3. **Kaliningrad Region as Compared to Neighbour Countries: per capita gross domestic/regional product in 1999-2000, \$1000**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Kaliningrad Region	10.20	9.65	7.40	6.45	5.10	4.70	4.25	4.25	4.05	4.05	4.40
Neighbour Countries:											
• Lithuania	10.45	9.85	7.75	6.49	5.85	6.10	6.38	6.85	7.19	6.98	7.23
• Latvia	10.75	9.65	6.38	5.53	5.65	5.70	5.93	6.50	6.80	6.85	7.20
• Estonia	11.28	10.15	8.85	8.25	8.18	8.65	9.05	10.10	10.63	10.70	11.35
• Poland	9.80	9.18	9.35	9.70	10.17	10.88	11.73	12.30	12.90	13.25	13.60
• Finland	19.15	18.23	17.45	17.40	17.76	18.35	19.10	20.18	21.05	21.82	22.78
• Germany	19.33	20.58	20.88	20.49	20.92	21.23	21.33	21.58	22.08	22.37	23.03
• Sweden	17.50	17.25	17.00	16.65	17.25	17.85	18.05	18.40	19.00	19.65	21.40
• Norway	19.85	20.50	21.20	21.80	23.00	23.90	25.05	26.25	26.75	27.00	27.50
• Denmark	19.75	20.00	20.25	20.55	21.65	22.25	22.75	23.50	24.10	24.50	25.00

Note: Calculated at 1996 prices. Converted into dollars at purchasing power parities of national currencies to the U. S. dollar based on international economic comparisons performed by Eurostat in 1996

Sources: Goskomstat RF. "Russian Statistical Annual, 1999"; "Social and Economic Situation in Russia" № 11, 2000; UN Economic Commission for Europe. Economic Survey of Europe, № 2-3, 2000.