

**ECONOMIC DEVELOPMENTS AND
REFORMS IN COOPERATION PARTNER
COUNTRIES: THE LINK BETWEEN
ECONOMICS, SECURITY AND STABILITY**

**L'ÉVOLUTION ET LES REFORMES
ÉCONOMIQUES DANS LES PAYS
PARTENAIRES DE LA COOPERATION:
LE LIEN ENTRE L'ÉCONOMIE,
LA SÉCURITÉ ET LA STABILITÉ**

Reiner Weichhardt
Editor
Deputy Director
Economics Directorate, NATO



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Colloquium
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PREFACE

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The 1999 NATO Economics Colloquium - one of the main events under the Action Plan 1998-2000 of the Euro-Atlantic Partnership Council - dealt with the link between economic developments, security and stability in Cooperation Partner countries. This thematic approach - demonstrating NATO's awareness of economic factors in its endeavour of projecting security and stability to Central and Eastern Europe - raised great interest among some 150 experts from academia, business, government and international organisations. A particularly strong contribution was made by members of the Economic Committee of the NATO Parliamentary Assembly.

The conference, chaired by Mr. Daniel George, NATO's Director of Economic Affairs, was opened by Deputy Secretary General, Ambassador Sergio Balanzino. The Keynote Speech was delivered by First Deputy Foreign Minister of Ukraine, Dr. Evhen Bersheda.

In an introductory session special tribute was paid to NATO's 50th anniversary in 1999, commemorating the development and the rôle of the Economics Colloquium over many years.

The conference subject was broken down into a series of concrete case studies highlighting the link between economy and security. Particular attention was paid to developments in South-Eastern Europe, Russia, Ukraine, Belarus and the Southern Caucasus. These are regions where economic development on the one hand and political and social stability on the other hand are particularly intimately linked. Various pertinent issues were discussed such as economic performance and reforms in a broader political and social context, crucial sectoral developments, economic risk factors, regional cooperation and short- and medium-term economic outlook on the eve of the 21st century. In a concluding Panel, an overall assessment on the economic dimension of a comprehensive security concept was made.

A concise overview of the presentations and discussions can be found in the Chairman's Summary. Moreover, an Annex includes a bibliography covering the historical series of 29 Colloquium books.

The book contains all the papers submitted at the Colloquium. In a number of cases papers have been up-dated by authors. I would like to thank Peter Sutcliffe of the Economics Directorate who invested considerable work in preparing this book's publication. I also want to thank Ms Kristina Thony

from Germany for her valuable paper on the Colloquium discussions, which helped us to produce a balanced summary report.

Brussels, March 2000

OPENING REMARKS

Ambassador Sergio Balanzino

Deputy Secretary General, NATO

Minister Bersheda,
Excellencies,
Ladies and Gentlemen,

It gives me great pleasure to welcome you to the 1999 NATO Economics Colloquium. For almost 30 years this Colloquium has provided us with first-rate information and analysis of pressing economic issues. And just as NATO has changed in order to remain in step with a changing world, so this Colloquium has evolved to adapt to the new demands of a new international environment.

Security and economics are linked. One cannot flourish without the other. Today, such statements seem self-evident, almost like platitudes. In my brief remarks this afternoon, however, I would like to make the point that the linkage between security and economics is not so new at all, and that NATO has acted in accordance with this logic from its very beginning half a century ago.

I would argue that from the very beginning in the late 1940s, the project of building Europe was a **twin project**: on the one hand, there was political and economic integration; on the other, there was security. This logic was embraced by European leaders, like de Gasperi, Adenauer and Monnet; and by American leaders like Truman, Acheson and Marshall. Hence, as President Truman put it, the Marshall Plan and the Washington Treaty were “two halves of the same walnut”.

This strategy has brought spectacular dividends. The fact that NATO’s 50th anniversary this year coincided with the launching of a European common currency testifies to the power of this twin project. Today, not only has Europe evolved towards ever-closer union, but America and Europe have become a tightly knit community, with a degree of co-operation and interdependence that exists nowhere else on this globe. The United States and the European Union enjoy the strongest economic relationship in the world.

The need for European integration and for linking security and economics still applies today. After all, for 40 years, the twin project of security and economic integration could only unfold in Europe’s western half. Today, the nations in Europe’s east are back on the political map, and they, too, want to become a full part of this unique project.

Nowhere is this more visible than in the complementary efforts by NATO and EU to project stability eastwards by offering membership to some, while

associating others. Again, we are talking about a twin project. The EU, through its association agreements, is giving many countries in Central and Eastern Europe new perspectives of economic growth and of political integration. NATO, through its enlargement process and through co-operative mechanisms such as the Partnership for Peace is establishing common approaches to security across the continent.

Both institutions have also developed special relations with those nations that cannot be integrated in the same way as others. For example, NATO and EU both have developed specific programmes to deal with Russia, as both act on the conviction that Russia, being a part of Europe, must be “in”, not “out”. And both institutions have developed links with their southern Mediterranean neighbours, to make sure that the Mediterranean plays its traditional role as a bridge, and does not become a new divide.

In short, both institutions are shaping the strategic environment in a similar way: by establishing co-operation as the key principle for the conduct of effective foreign, security and economic policies. Both institutions have opted for a strategy of engagement, against indifference and against re-nationalisation. They remain a twin project. Security and economics remain “two halves of the same walnut”.

This logic must now be extended even further: to Europe’s South-Eastern region. The tragedies happening in and around the former Yugoslavia remind us that there are parts of this continent that have not yet made the transition towards democracy and ethnic pluralism. The history of the collapse of the old Yugoslavia also shows the other side of the linkage between security and economic stability: not only does economic progress require a secure environment, a dwindling economy can also lead to political instability - and this political instability can even erupt into military conflict.

South-Eastern Europe thus requires **all** parts of the package: security, political stability, and sound economic perspectives. In Bosnia, we can already see that this combined approach works. NATO and its Partner countries provide the military stability that forms the indispensable basis for the political and economic reconstruction of this war-torn region. The OSCE has organised free elections. And the EU acts as a major donor and creates the economic incentives that will ultimately turn Bosnia-Herzegovina into a viable state.

In Kosovo, too, we can see a pattern emerge: security provided by NATO and Partner countries, and broad international engagement in order to create the political and economic conditions for reconstruction.

The European Union’s Stability Pact focuses on three areas: democratisation and human rights; economic reconstruction, development and co-operation; and security issues. These are the areas in which nations and relevant organisations should concentrate and co-ordinate to achieve long-term stability and security in the region.

Through its South-Eastern Europe Initiative, NATO will play an important role in support of the Stability Pact, most actively in the security field. For example, we will work closely with our Partners in the Euro-Atlantic Partnership Council to develop additional practical ideas for regional co-operation in South-East Europe. We will use the Alliance's new Membership Action Plan to help aspirant countries from South-Eastern Europe to prepare their candidacies for NATO membership. And we will maintain the long-term goal of membership in EAPC and Partnership for Peace for Bosnia-Herzegovina, Croatia and, ultimately, for a democratic Yugoslavia.

Clearly, the interconnection of security and economics should not lead one to assume that we could devise one wholesale approach for the entire Euro-Atlantic area. Each region - indeed each nation - is unique, and thus requires a tailored approach. The focus of this year's Colloquium on developments in South-Eastern Europe, Russia, Ukraine, and in the southern Caucasus acknowledges this diversity. But, maybe, by acknowledging the differences we may also find the similarities.

Economics and security remain linked: let me stress once again this concept. During the years of the Cold War, the twin project of European integration and transatlantic security co-operation was a unique feature of the West. Since the end of the Cold War, this project is being extended to engage all nations throughout the Euro-Atlantic area.

Nowhere is the linkage between security and economics expressed more visibly than in the NATO Economics Colloquium. For almost three decades now, this forum provides the linchpin where security and economic considerations meet - and merged into providing us with new insights and new perspectives. Given this unique portfolio, it is only natural that the Colloquium has become a flagship of NATO's outreach and partnership activities. The high quality of analysis generated by these meetings has always been of great interest to Allies and Partners alike. Today's meeting will be no exception to this rule. It will help us in sharpening our focus on the crucial linkage between security and economics. In short, it will help us chart the way ahead into the 21st century.

I wish you a successful and stimulating conference.

PRESENTATION THE CONTRIBUTION OF THE ECONOMICS COLLOQUIUM TO NATO'S ECONOMIC AGENDA: AN EVOLUTION OVER 30 YEARS

Philip Joseph, OBE

Secretary General, Chairman, Distinguished Visitors, Ladies and Gentlemen,
The NATO Economics Colloquium, started in 1971 is, I believe, the longest running series of economics conferences in the world devoted solely to the Soviet Union, the CIS (Commonwealth of Independent States) and Central and Eastern Europe. I have been privileged to set up eight such colloquia and to participate altogether in 24 out of the 27 which have taken place before today's, in NATO's 50th anniversary year. In those 27 events, 360 authors presented 548 papers which are reproduced in the 27 volumes of proceedings. This says nothing of you, the participants, who have taken part in the discussions, made your views known and influenced the outcome.

You will understand therefore, why, when I was first invited to say something about the evolution of the NATO Colloquium, I accepted the honour with some trepidation. My fears were justified when I started to review the 27 volumes of proceedings and tried to describe this evolution. The result of that review is a paper which I thought might be of value to future students of the area and it has therefore been distributed to you. It contains, in three appendices, a list of the papers arranged in chronological order, one in alphabetical order of authors (which is a list of experts without compare) and another in alphabetical order of subjects.

Aims

I am frequently asked why NATO, fundamentally a defence organisation, is concerned with economics at all. Most of you know the answer but it is not a silly question: we should pose it from time to time to verify whether the work continues to be justified. According to its Fiftieth Anniversary Handbook, NATO is "an association of free states united in their determination to *preserve their security* through mutual guarantees and stable relations with other countries". The organisation "provides the structures needed to facilitate *consultation and co-operation between them*, in political, military, and *economic* as well as scientific and other non-military fields".

The preservation of security requires continuous assessment of the intentions and capabilities, of the strengths and weaknesses of friends and potential foes alike. Their economies are a vital element of such assessment. Thus the aim of the Colloquium has always been to provide the nations of the Alliance with the best information possible on the economic factors affecting their security and stability. [Moreover, Article 2 of The Treaty calls for the '*elimination of economic conflict and the encouragement of economic collaboration*' hence the need here also for economic assessments]. How better to gather the information, the interpretations and analyses necessary for such assessments, than to bring together the most expert brains in the world in such studies? As the Secretary General, the late Manfred Wörner, said at the opening of the 1992 Colloquium "...the results ... will help us to decide on how we proceed in those questions which really affect both economic realities and security."

Studying the economic development of one's friends and potential foes is not new. Let me quote from the record of a meeting between two heads of state: "The report I heard in my country was true but I did not believe it until I came to see for myself. Yet only half had been reported, your prosperity, your economic strength, is far greater than anything I have ever heard of". This was the Queen of Sheba talking to King Solomon during a visit to Jerusalem some three thousand years ago! One might be tempted to ask whether it was only economics that was of interest about this man who had 500 wives and even more concubines. However, there was an exchange of gold and other precious goods brought by the Queen, possibly for arms and equipment, and a son was born to the Queen. Ethiopian tradition has it that he became Menelik I, who founded the royal dynasty of Ethiopia.

Evolution Over the Years

A year by year comment on the development of the Colloquium is given in my paper but I would like to recall here the main lines. During the 30 years since the Colloquium was first conceived, the Soviet Union, and later Russia, has been led by five men: Brezhnev, Andropov, Chernenko, Gorbachev and Yelstin. All have introduced political and economic reforms made possible by, and deeper than, their predecessors' until, with Boris Yeltsin, the Soviet Union disappeared and the Commonwealth of Independent States was created.

During its first 10 to 15 years the Colloquium was geared mainly to the Five-Year Plans and concerned itself largely with their fulfilment. Towards the end of that decade (1980) conditions in the USSR were changing decisively: the dramatic movement in population distribution from 33 urban/67 rural in 1940 to 62 urban/38 rural in 1977 was of serious concern to the authorities. There was demand for greater regional autonomy. East-West trade, already affected by adverse Western conditions, was suffering from sanctions imposed

by the West in protest against the Soviet invasion of Afghanistan in December 1979.

The early 1980s, according to our colloquia, saw the faster development of the black economy in the USSR and Eastern Europe as a result partly of a disastrous Soviet harvest in 1981 which increased the need to import huge quantities of Western, mainly North American, grain and partly of continued Western sanctions. The small progressive reforms introduced during the preceding years had done little to avert this development.

Leonid Brezhnev died in November 1982. His successor, Yuri Andropov, introduced some wide ranging reforms designed to improve the lot of the consumer and revitalise the economy but he died after 14 months. His successor, Chernenko, in power only a year, did not have time to achieve anything of note.

Mikhail Gorbachev came to power in March 1985 and the second half of the 1980s was marked by accelerated political and economic changes. At last the nations of Eastern Europe were free to introduce their own systems of government, and Hungary, Poland and Czechoslovakia were the first to take advantage of this situation. In 1986, accordingly, we took an overall and penetrating look at the economies of Eastern Europe and their foreign economic relations. Before the end of the 1980s the Berlin Wall had fallen, the economies of Eastern Europe were unrecognisable, Germany was well into the process of unification and the withdrawal from Afghanistan was completed.

It seems to be in the nature of reforms that each set is made possible through earlier ones and, in turn, each set gives rise eventually to further reforms. Thus the Nineties have seen even greater changes under Boris Yeltsin; they are reflected in the colloquia starting in 1991 when **one Czech and three Soviet** speakers shared this platform and established the precedent honoured ever since of EE and Russian participation. The Colloquium has been a regular feature of the NACC Work Plan since its beginning. The disappearance of the Soviet Union brought revolutionary changes in the economies of Russia and its CIS companions. The colloquia did much to bring understanding of the new atmosphere, of the depth of shock and pain of transition from command economies to the market, of the difficulties of conversion of the defence industries and of the problems of transformation to private ownership in the countries which were to become "Cooperation Partners". By 1997 **12 of the 23** speakers were from Central and Eastern Europe including the Former Soviet Union thus giving substance at the colloquia to the links between us enshrined in the "Founding Act" which had created the basis for a "Joint Permanent NATO-Russia Council".

Last year, 1998, saw another first when Marjan Senjur, Minister of the Republic of Slovenia for Economic Relations and Development, invited the Colloquium to take place in Ljubljana and to discuss "The Role of the State with Particular Focus on Security and Defence Issues".

Overview

The changes in format, in participating nationalities, in subjects examined at the colloquia and in the priorities accorded to them, all reflect the reforms, the changes in policies and the economic developments in CEE, in the USSR and in the FSU, and in the new relations between East and West. Thus our evolution followed the succession in Soviet and FSU leadership and in parallel developments in CEE.

I have been asked if the Colloquium predicted the changes we have seen. It has always been my view that it is not the function of this meeting to predict: prediction needs also military, political, social, ethnic, and other inputs. Our job here is to research, to analyse and to interpret the facts and the statistics which present themselves, and the plans which are exposed by the leaders of the countries we study. These functions have been carried out thoroughly and the meetings of the late 1980s and early 1990s were particularly penetrating in their analyses. Prediction would jeopardise objectivity and would render much of the work of doubtful value. Over the years we certainly studied and drew attention to the steady deterioration in the Soviet and East European economies which occurred in spite of reforms, and we emphasised how dependent political and social stability were on economic success.

Nevertheless most of the reforms have drawn the nations involved into closer links with the West and into closer integration in the global economy.

Unfortunately, the impatience too often shown in CEE countries and in the West tends to mask the strides made since Brezhnev died. There was talk of solutions which would be found in days - **500 days** was one programme - but few people seemed to remember how long it took the Western nations to re-establish themselves after 1945. As an example, it took us in the UK something like **500 weeks** to transform our economy from the command structure it had during the war to the mixed economy which it became ten years later when rationing disappeared. This was when we had the advantage that practically all our pre-war contacts abroad had remained intact, and when there was an almost unlimited market for capital equipment as well as consumer goods.

I submit that the CEE nations, and perhaps even more we, in the prosperous West should therefore appreciate the great efforts we have witnessed and the successes so far achieved. But we should never forget the close link that has always existed between economics and international as well as national stability.

André de Staercke who spent many of the wartime years in the UK with Paul-Henri Spaak said that "NATO was born out of fear and hope". Is it fear or hope that have led the nations of the Alliance, during its 50th Anniversary year, to unite in an attempt to establish humanity and stability in a region of Europe where stability has been but a fleeting and unreliable visitor in the past?

The maps of Western Europe are spattered with battlefield sites of historic origins. I believe that the signatories of the Washington Treaty would regard

it as a success that the gazetteer of such sites has not been expanded in 50 years since NATO was formed. This Colloquium, and especially your analyses, interpretations and contributions to our understanding of the economic changes and realities have played a part in this success.

Ladies and Gentlemen,

Thank you for your patience, thank you for your attention.

KEYNOTE SPEECH
LE DEVELOPPEMENT ET LES REFORMES
ECONOMIQUES A TRAVERS LA
COOPERATION AVEC LES PAYS PARTENAIRES:
LIEN ENTRE L'ECONOMIE,
LA SECURITE ET LA STABILITE

Evhen Bercheda

Premier vice-ministre des Affaires étrangères de l'Ukraine

Monsieur le Président,
Mesdames et Messieurs,

Je salue les participants au colloque.

Je voudrais commencer par faire remarquer que, si l'Alliance de l'Atlantique Nord prête attention aux problèmes de développement économique, ce n'est pas seulement parce que l'économie est importante pour assurer la stabilité du monde contemporain. Cela prouve aussi que **l'élargissement de l'Alliance s'inscrit dans l'actualité, il ne se borne pas au domaine géographique, mais se poursuit dans deux sens: à la fois territorial et fonctionnel.**

En effet, la sécurité et la stabilité en Europe et dans l'ensemble de l'espace euro-atlantique sont confrontées non seulement aux risques militaires et politiques, mais aussi à ceux économiques et sociaux.

Exercer des influences, voire même des pressions économiques, devient de plus en plus courant dans les pratiques internationales.

Dans ces conditions **la tâche d'assurer un développement économique stable à chaque pays, ainsi qu'à la communauté internationale, devient de plus en plus importante pour la sécurité et la stabilité.**

Et maintenant permettez-moi d'exposer quelques réflexions générales concernant les priorités de la politique économique de l'Ukraine.

En premier lieu, il faut partir de l'idée que **dans le monde nucléaire, la sécurité économique est devenue le fondement de la sécurité nationale et internationale; elle est également devenue une priorité de la politique économique.** Nous ne devons pas permettre qu'avec la globalisation de l'économie, les guerres chaudes et froides soient remplacées par des conflits douaniers et commerciaux.

Dans plusieurs pays partenaires de l'OTAN, y compris l'Ukraine, la formation du système national de sécurité économique a coïncidé avec la transition de

l'économie administrative et dirigiste vers celle de marché, mais aussi avec l'intégration de ces pays dans le système économique mondial.

De ce point de vue l'Ukraine se distingue par plusieurs traits spécifiques. Ce qui est perçu à première vue comme résultats négatifs des réformes économiques n'est en réalité qu'une conséquence des défauts de leur mise en oeuvre. La profondeur et l'envergure de ces derniers sont dans une large mesure causées par l'absence en Ukraine d'une base socio-politique, voire même culturelle et religieuse, pour les réformes économiques, laquelle avait existé dans la plupart des pays de l'Europe centrale et orientale au moment du déclenchement des réformes. Cette base comprendrait, par exemple, une longue expérience historique de souveraineté nationale ou bien une religion unique.

En même temps, nous avons conscience du fait que **les réformes économiques libérales, mis à part leurs avantages, comportent aussi de sérieux risques qui doivent être constamment repérés et neutralisés en temps utile grâce à une politique sociale active.** Je tiens à souligner que si les mesures adéquates ne sont pas prises, ces risques seront en fin de compte susceptibles de constituer une menace pour la liberté et la démocratie, voire même pour la souveraineté de l'Etat.

En second lieu, il faut se rendre compte que pour l'Ukraine, ainsi que pour d'autres pays en transition, le danger principal ne provient pas des réformes en tant que telles. Plusieurs raisons d'ordre économique, politique, historique et autres ont fait que **la transition vers le marché n'a pas toujours été accompagnée d'une stratégie sociale adéquate et a trop traîné en longueur.**

L'exemple de la Pologne, de la Hongrie, des pays Baltes, nous démontre l'avantage de réformes rapidement réalisées et bien coordonnées.

Le manque de dynamisme dans la politique sociale, les mesures tardives du gouvernement dans le cadre de la protection sociale, le fait d'être dépassé par les événements, peuvent provoquer le mécontentement des gens à l'égard des réformes, leur déception vis-à-vis des valeurs démocratiques et leur méfiance envers les institutions de l'Etat.

La paix civile dans les nouveaux Etats indépendants est menacée par les phénomènes tels que le manque provisoire de contrôle de la distribution et de l'utilisation des biens de l'Etat, la trop grande disparité dans le niveau de vie des citoyens (pas toujours justifiée par leur contribution économique réelle), les retards de paiement des salaires et des pensions, le chômage manifeste et latent, l'élimination des producteurs locaux du marché national, la criminalité, la commercialisation excessive des mass-média, etc.

Les politiciens démagogues de tendance extrémiste essaient d'exploiter à leurs fins le mécontentement naturel des gens causé par l'état actuel des choses. Cela a pour résultat l'apparition d'une menace pour les transformations démocratiques et pour la coopération des nouveaux Etats indépendants avec les structures européennes et euro-atlantiques.

Ainsi, **la sécurité sociale des réformes économiques, ainsi que la protection des droits sociaux et économiques des citoyens, deviennent aujourd'hui une priorité extrêmement importante pour le gouvernement de l'Ukraine.**

Nous sommes d'avis que les réformes de l'économie ukrainienne doivent être réalisées en tenant compte des intérêts de la sécurité économique et sociale, de la protection des intérêts économiques de chaque citoyen, des groupes sociaux, des principaux acteurs économiques, des régions de l'Ukraine, ainsi que de la société et de l'Etat, contre les risques internes et externes.

L'exécution de trois tâches corrélées dans le domaine de la sécurité économique devient de plus en plus l'objet de l'attention du gouvernement ukrainien. Il s'agit particulièrement de:

1. La définition, la surveillance et le pronostic des facteurs qui minent la stabilité du développement socio-économique du pays;
2. La réalisation d'une politique économique qui pourrait éliminer ou au moins atténuer l'influence négative des facteurs en question;
3. L'adoption de mesures afin d'éviter les risques pour la sécurité économique du pays.

L'Ukraine est en train d'achever l'élaboration de sa *Stratégie de la sécurité économique de l'Ukraine* qui devra être soumise à l'examen et à l'approbation du Cabinet des Ministres.

Ceci prouve que **le gouvernement de l'Ukraine** ne ménage pas ses efforts afin de maintenir et de développer la production nationale et de stopper la chute du niveau de vie de la population avant qu'elle n'atteigne la limite critique. **La sécurité économique des représentants de la propriété privée, publique et mixte** devient l'axe principal de ces efforts.

La finalisation de la réforme agraire, accompagnée de la commercialisation des terres cultivables, est d'une importance majeure pour l'Ukraine. Le blocage de la solution de ce problème stratégique s'explique, entre autres, par la ténacité des stéréotypes idéologiques de l'époque soviétique.

En troisième lieu, outre **les conséquences négatives** soi-disant "ressenties à l'intérieur du pays", **des changements trop lents dans les réformes de l'économie**, il y a **aussi** celles qui **se manifestent à l'échelle internationale**.

Les preuves en sont, en particulier, la perte de plusieurs marchés traditionnels en Orient et la progression très lente des produits ukrainiens en Occident.

Selon les critères de la sécurité nationale, dans les exportations d'un pays qui se veut attribuer le statut d'Etat économiquement indépendant, la part des produits des industries de transformation doit atteindre au moins 40 pour cent. De surcroît, au moins un dixième des livraisons vers l'étranger doit être constitué de produits de technologie scientifiquement avancée. En fait, la majorité des exportations ukrainiennes appartient actuellement aux marchandises de niveau de transformation primaire. Le groupe le plus important de biens exportés est constitué de produits sidérurgiques (plus de 20 pour cent des ventes).

La structure défavorable des exportations s'accompagne d'une fuite des capitaux, d'une croissance de la dette extérieure et d'une expansion commerciale étrangère sur le marché national.

En partant des intérêts de la sécurité économique, **l'Ukraine tend à assurer, un accès égal mutuellement libre aux marchés mondiaux, ainsi qu'à éliminer les barrières dans le commerce.**

Au cours de la réalisation de la politique de réformes économiques, trois démarches liées entre elles d'une importance particulière pour le renforcement de la sécurité économique nationale et internationale ont été faites récemment: il s'agit de la libéralisation des prix, de l'unification des taux de change et de la libéralisation des exportations.

Grâce au blocage de l'inflation **en Ukraine, les conditions préalables ont été créées pour la réalisation d'une politique socio-économique** efficace. La pénurie des marchandises est éliminée, les engagements extérieurs sont remplis, la formation du budget de l'Etat, les paiements des livraisons énergétiques, ainsi que d'autres produits sont en train de se normaliser.

L'option vers la dynamisation sociale de la société ukrainienne se réalise peu à peu par une motivation élevée du travail suscitée sur base de la propriété privée, des crédits pour la construction des logements et pour l'agriculture et de la compétitivité des contrats de travail.

Cette dynamisation importante a lieu dans le cadre du travail de mise en place d'un pouvoir public démocratique capable de devenir un outil efficace non seulement pour les réformes économiques libérales, mais aussi dans l'optique de la prévention des menaces sur le marché. L'élaboration et l'adoption de la constitution de l'Ukraine ont joué un rôle décisif pour l'intégration ultérieure du pays dans le système européen et global de la sécurité internationale.

Dans ce cadre, **la poursuite de la coopération active et du dialogue de l'Ukraine avec l'OTAN** est un élément important pour l'Ukraine, ainsi que pour toute l'Europe. Ces deux dernières années les accents d'une telle coopération ont été déplacés vers les domaines spécialisés.

L'année passée **le Président de l'Ukraine a approuvé le Programme d'Etat sur la coopération avec l'OTAN pour la période jusqu'à 2001**, dans lequel il y a un chapitre à part consacré au domaine économique et aux problèmes de la sécurité économique.

Il convient de mentionner les consultations et les actions menées en commun avec l'Alliance par le Ministère des Situations Extraordinaires, le Ministère de l'Economie et d'autres Ministères et Départements. Grâce au rôle actif du Comité Economique de l'OTAN, ces dernières années, une série de manifestations dans le cadre Ukraine-OTAN ont été réalisées, à Bruxelles et à Kyiv.

Dans ce contexte, je voudrais souligner la réunion du groupe de travail Ukraine-OTAN sur la sécurité économique qui a pour titre "Approches adoptées

par la Pologne et par d'autres pays de l'OTAN pour assurer la sécurité économique", qui se tiendra à Kyiv les 22 et 23 novembre prochains.

La mise en œuvre en Ukraine de l'expérience accumulée par les pays démocratiques à économie de marché en ce qui concerne les dépenses militaires est aussi un domaine important de coopération avec l'OTAN. Il s'agit des "techniques" de la détermination, de l'audit, ainsi que du contrôle civil de ces dépenses.

La coopération dans le domaine de la reconversion des militaires délogés des cadres a, elle aussi, de bonnes perspectives, en particulier dans l'enseignement de l'anglais, du français ou de l'allemand.

La Déclaration des chefs d'Etat et de gouvernement qui ont participé aux travaux de la Commission Ukraine-OTAN au niveau supérieur, adoptée dans le cadre du sommet de l'OTAN à Washington en avril 1999, est devenue un des acquis importants obtenus par ladite Commission. Nous notons avec satisfaction que la Déclaration a mis l'accent sur l'importance d'augmenter la contribution de l'Ukraine au renforcement de la sécurité en Europe centrale et orientale, aussi bien que sur le continent européen en général. **Le Concept stratégique de l'OTAN** accorde à l'Ukraine une place particulière au sein du système euro-atlantique de la sécurité; elle traduit le soutien par l'Alliance non seulement de la souveraineté et de l'indépendance de l'Ukraine, de son intégrité territoriale, de son développement démocratique, mais aussi de sa prospérité économique.

Il y a donc des raisons d'espérer que la coopération de l'Ukraine avec l'OTAN contribuera, entre autres, à la protection des intérêts de sécurité économique de notre pays.

Les relations Ukraine-OTAN ont déjà connu les développements politique et juridique requis, ce qui crée des conditions favorables au maintien du cap vers l'intégration graduelle de l'Ukraine au sein des structures euro-atlantiques de sécurité.

Mesdames et Messieurs,

Parmi ces structures euro-atlantiques de la sécurité, une place particulière appartient à l'Union Européenne, dont la compétence jusqu'à une époque récente ne touchait que la sécurité surtout économique.

Par ailleurs, nous sommes témoins des changements historiques dans le domaine de la sécurité européenne. Ce n'est pas par hasard que l'ancien Secrétaire Général de l'OTAN, M. Javier Solana, est devenu *le Haut Représentant de l'UE pour la politique étrangère et la sécurité commune*. Conformément aux exigences du moment, **l'UE passe de l'élaboration de la position commune des pays membres concernant les problèmes des relations internationales vers la réalisation de la politique commune en question**. Le Pacte de stabilité pour l'Europe du Sud-Est peut être considéré comme le résultat concret de cette transformation. Ainsi, l'Ukraine tend à y participer, tout en estimant que ce Pacte représente une sorte de programme ayant pour but le renforcement de la sécurité économique dans cette région importante de l'Europe.

L'économie de l'Ukraine continue de subir des dommages causés par la crise yougoslave. Notre commerce avec les pays de l'ex-Yougoslavie a considérablement baissé, tandis que la reprise de la navigation sur le Danube est devenue une des tâches primordiales pour l'Ukraine, ainsi que pour les autres pays danubiens, membres et partenaires de l'Alliance. Les dommages pour les compagnies ukrainiennes causés par l'arrêt de la navigation se calculent par dizaines de millions de dollars par mois. De plus, il y a le danger des grandes crues d'hiver et de printemps du fleuve, bloqué par les débris des ponts détruits.

La participation des entreprises ukrainiennes à la réalisation des programmes de reconstruction des Balkans pourrait devenir une des formes du soutien économique accordé à l'Ukraine.

Sur le continent européen, l'on ressent particulièrement vivement que les risques traditionnels pour la stabilité et la sécurité sont actuellement complétés par les risques liés à l'hostilité ethnique et religieuse, au terrorisme, au trafic illégal des stupéfiants et des armes, aux migrations clandestines, etc.

Il est plutôt inutile d'exposer ici les faits prouvant que **la solution des problèmes de la sécurité non militaire ("soft security")** se trouve directement liée à un développement économique viable et assuré non seulement pour les pays membres de l'Alliance, mais aussi pour leurs partenaires et leurs voisins. **En revanche, les crises économiques engendrent ou bien des risques pour la stabilité, ou bien en favorisent la propagation.**

L'Ukraine, située dans la partie sud-est de l'Europe et soucieuse de sa propre sécurité, joue le rôle d'un "cordon sanitaire" pour ses voisins occidentaux. Et cela sans aucun résultat positif pour elle-même, car les transgresseurs des frontières restent en Ukraine du fait que jusqu'à présent nous n'avons pas réussi à conclure d'accord de réadmission avec la Fédération Russe.

Mesdames et Messieurs,

J'aurais voulu encore une fois souligner que le potentiel de l'Ukraine en ce qui concerne le maintien de la stabilité et de la sécurité internationale ne peut être assuré qu'**avec le soutien des deux structures les plus respectées dans ce domaine: l'Alliance de l'Atlantique Nord et l'Union Européenne.**

Dans ce contexte, ce n'est pas la simple reconnaissance des relations bilatérales entre l'Ukraine et l'Union Européenne en tant que "partenariat unique et stratégique" qui devient le point décisif. L'élaboration d'un programme détaillé de coopération entre l'Ukraine et l'Union Européenne pourrait constituer une étape suivante de la cooptation de l'Ukraine aux activités visant à assurer la stabilité du continent et à trouver les solutions des problèmes de la sécurité non militaire ("soft security"), en définissant en particulier les mécanismes de la coopération dans ce domaine. D'ailleurs ceci est prévu par l'Accord sur le Partenariat et la Coopération entre l'Ukraine et l'UE.

J'aurais voulu souligner que **l'Ukraine a un scénario précis de réformes économiques, qui coïncide pratiquement avec celui du rapprochement du**

pays vers l'adhésion à l'Union Européenne. La gestion de l'économie devient de plus en plus pragmatique.

Depuis le mois de mai 1999 on a constaté une croissance de la production industrielle. Ainsi en septembre dernier par rapport au mois de septembre 1998, celle-ci a atteint plus de 18 pour cent. Pour la première fois depuis la crise financière de l'année passée, le produit national brut a connu une croissance.

Les dettes extérieures sont remboursées selon l'échéancier prévu.

Il y a eu le lancement réussi de la fusée-porteuse ukrainienne "Zénith" à partir d'une plate-forme flottante dans le cadre du programme international "Sea launch". Les essais de l'avion de transport militaire Antonov-70 se poursuivent.

Quelques succès ont été enregistrés en ce qui concerne le développement de contacts directs entre certaines régions de l'Ukraine et les Etats membres ou candidats à l'adhésion à l'OTAN ou bien à l'UE, dans le cadre de la coopération économique, militaro-technique, etc., ainsi que de la promotion des investissements et de la coopération transfrontalière.

La reprise graduelle de la croissance économique est réalisée avec l'aide financière de l'Union Européenne, des Etats-Unis et des institutions financières internationales. La réforme structurelle des services publics est en cours, la privatisation s'achève, les petites et moyennes entreprises se développent, tandis que les systèmes de sécurité sociale et de protection de l'environnement s'améliorent.

Le soutien politique des efforts de l'Ukraine que nous attendons de la part de l'Union Européenne est d'une importance particulière pour les réformes de l'économie du pays. Il s'agit seulement de la reconnaissance de la souveraineté et de l'indépendance de l'Ukraine, de son intégrité territoriale, de son développement démocratique, mais aussi de sa prospérité économique. Une telle reconnaissance pourra exercer une influence positive sur la société ukrainienne et **fortement encourager la coopération de l'Ukraine non seulement avec l'Union Européenne, mais aussi avec l'OTAN.**

La dynamique positive du développement de la situation économique de l'Ukraine, avec ses 50 millions d'habitants, contribuera beaucoup à l'augmentation du niveau de la sécurité européenne grâce à la diminution des risques et au renforcement de la stabilité dans les domaines économique, écologique, énergétique et autres. L'Ukraine aura des raisons politiques supplémentaires pour participer d'une manière plus active à la politique menée par l'UE dans les Balkans.

Le fait que la situation géographique de l'Ukraine se trouve dans l'espace qui relie le Nord et le Sud, l'Ouest et l'Est de l'Europe, conjuguée au développement des processus d'intégration dans le cadre de l'UE (j'entends par-là l'adhésion des voisins occidentaux de l'Ukraine à l'Union Européenne) ne doit pas **aboutir à l'apparition d'une nouvelle ligne de fracture en Europe tout au long de l'ancienne frontière soviétique** devenue la frontière ouest de l'Ukraine.

A travers le territoire de l'Ukraine le transit des ressources énergétiques se fait à une grande échelle entre l'Orient et les consommateurs européens. Avec la Pologne, est étudié le projet de construction du corridor multimodal

de transport “Odessa-Gdansk”, qui assurerait, entre autres, le transport vers l’Europe des ressources énergétiques de la Caspienne. La réalisation de ce projet, ainsi que de plusieurs autres ayant une portée stratégique, serait susceptible non seulement de favoriser le renforcement de la sécurité économique et énergétique des nouveaux membres de l’Alliance, mais aussi de contribuer à l’intégration ultérieure de l’Ukraine et de son économie aux structures européennes et euro-atlantiques.

La création d’une zone de libre-échange entre l’Ukraine et l’UE est un autre facteur important de réformes de l’économie ukrainienne.

Mesdames et Messieurs,

Pour terminer, je voudrais souligner que les transformations économiques et politiques en Ukraine se réalisent à la suite du travail systématique en commun qui se poursuit dans le cadre des relations Ukraine-OTAN et Ukraine-UE. Ce travail, dont le colloque d’aujourd’hui est un des éléments, rapproche tous les européens peu à peu sur le plan pratique vers un avenir sécurisé et stable.

CHAIRMAN'S SUMMARY

Daniel George

Director, Economics Directorate, NATO

Some 150 participants from academia, business, government, NGOs, the EU and the NATO Parliamentary Assembly representing 31 Allied and Partner countries attended this year's Colloquium, whose remit was to analyse the growing importance of non-military aspects of security and their importance in maintaining peace and stability in the 21st century. The focus was on transition in Cooperation Partner countries, exploring the linkages between economic reform, security and social stability. The Colloquium examined the role of economic progress (or lack of it) in building (or weakening) social, democratic and civic societies that form the guarantor of security in the modern world. The Colloquium was divided into five panels, four of a regional nature covering South-Eastern Europe, Russia, Ukraine and the South Caucasus, with the final session bringing together the various issues raised into a concluding assessment. Highlights, reflecting the views of Colloquium speakers but not necessarily those of NATO, were as follows:

Panel 1 - South-East Europe

“Balkanisation” is a word often used in a derogatory sense (the process of something tearing itself apart into smaller units) and as justification for ignoring the region's problems. But it is important to remember the reality of the starting-point that these countries faced at the onset of transition and the slight but real progress made. We were reminded how the economic crisis in Bulgaria in 1996/97 forced the government into remedial action which has led to a degree of macro-economic stability and, in the words of a Bulgarian expert, “a new life”.

One speaker described economic stability as “preventive medicine” to ward off unrest, instability and poverty, but warned that economic growth without a degree of income distribution would do nothing to enhance social stability. In other words, **“bad politics becomes the pro-genitor of bad economics”**. Another speaker added that **one “rogue” institution could contaminate others** leading to a whole culture of corruption throughout society. Regional cooperation will also be a useful tool with which to build stronger political ties between nation states.

The proposed Stability Pact for South-East Europe was compared with the Marshall Plan that helped to bring economic prosperity and hence economic

security (from want, hunger and disease) throughout post-war Western Europe. In this respect, the Stability Pact should be seen as an opportunity rather than as a cost, as indeed was the Marshall Plan before it. In this case, **altruism is self-interest**. It was also noted that perhaps the most valuable bit of altruism on the part of the West would be to open its markets, especially for farm products.

Panel 2 - Russia

No panellists saw any real hope for rapid improvement in the economy, which has now fallen faster and further than Western economies in the Great Depression of the 1930s. Massive investment in infrastructure renewal is required to kick-start growth but the internal resources from which the bulk of this investment must come are extremely limited. Much human and physical capital is absorbed by the military and nuclear sectors, which have limited if any growth potential. Future growth will thus be dependent upon the development of the internal market which needs a competitive exchange rate (as at present) to survive. As one participant said, “**poverty equals suppressed demand**”.

Nevertheless, this **decline has not yet led to social unrest because of the flexibility**, indeed informality, of the Russian labour market. The high rates of involuntary part-time work and wage arrears keeps unemployment low and mobility high, but at the cost of a slump in **productivity that is now much lower than in the Soviet era**.

Implied energy subsidies and barter allow value-subtracting firms to survive. There is no real pressure on these firms to reform, indeed, both social pressure and perverse economic incentives (subsidies, high tax on visible profits and the lack of competition) ensure that they keep going. A panellist claimed that **one-quarter of all employment is in single-industry towns** - often in remote locations - where no other employment opportunities exist. Thus the expressed fear that political stability might not survive the transition process.

The existing elite profits greatly from the current turmoil to the extent that real structural reform is unlikely to start soon. “Insiders” dominate the socio-economic environment and reinforce the status quo. Outside investment is actively discouraged. Prosperity cannot arrive until and probably sometime after these conditions eventually change. The danger with continuing economic stagnation is that so-called “reform” will take the blame, with some kind of authoritarian backlash (involving the relaxation of monetary controls to pay for a more proactive foreign policy) being the inevitable result. **Maybe we need to be more patient with Russian transition**, especially in view of the fact that the Russian economic crisis is - in the view of one panellist - of 90 years duration rather than just a decade.

It was further explained that Russia has a completely different understanding of security than the West because of its historic roots, its geographical size, its multi-cultural population and thinly populated regions. These factors make it especially difficult to realise a rapid and successful transition process. One of the main problems extant in Russia was the conflict between the **will to remain strong and secure** (a “power” to be reckoned with in world affairs) and the need for **modernisation** which, to be successful, requires an open, relaxed and international outlook on such matters as investment and trade. Russia appears to be closer to resolving this conflict today than it was a decade ago.

Panel 3 - Ukraine

Ukraine’s transition appears to be stuck between a command plan economy and the market, with the result that economic growth remains elusive and (most of) the population is getting steadily poorer. One speaker described the country as “being in Europe but culturally far away.” The now significant differences between Poland and Ukraine were graphically emphasised by one expert, who warned that EU enlargement could have a negative impact upon Ukrainian trade and prosperity.

Nevertheless, it was also suggested that the recent elections offer a unique opportunity for Ukraine to move forward. Ukraine has many advantages; good geography, a literate population, resources, no expensive military and/or diplomatic ambitions, is open to foreign investment, and has amicably settled long-running political differences (*inter alia*, over the Crimea and Black Sea Fleet) with Russia. These it must use and soon. Otherwise, **Ukraine’s dependence upon Russia would in future grow because of energy debts**. One panellist warned of the “culture of incompetence” that unless checked is passed on to the next generation.

Panel 4 - Caucasus

A highly turbulent and unstable region described by one participant as being “**full of independent states without any experience of independence**.” Another apt description was “the nexus region of the globe where security, resources, economy and diplomacy all come together.”

Rich energy resources were rightly identified as a potential source of wealth to further development and thus security, but it was also suggested that Norway - which has invested its oil revenues long-term - would be a better model to follow than Nigeria where a pampered elite has frittered away the wealth of the state. Thus energy will only equal security and stability if certain conditions are met - an evolution of democracy, the establishment of rule of law, equitable

management of resources and a fair distribution of wealth. There is a long way to go.

Outside influences in the region are strong, both from states and firms that have a strategic interest in securing long-term energy supplies and - more importantly - control over the routes by which oil and gas egresses this largely landlocked and relatively inaccessible region. Delegates generally agreed that such routes should be determined by commercial factors alone, but accepted that geo-politics would remain influential in determining what actually happens. **There was thus a danger of the whole region becoming marginalised** by such geo-political disputes, especially since reserves are generally much smaller than at first hoped and because the economies of the region, if not successfully integrated, will remain tiny and thus highly vulnerable to external factors such as financial crisis in Russia or another sharp fall in global energy prices.

Demography and water were also identified as potentially serious issues - too much of the former and too little of the latter - that could compromise stability in the future. Large numbers of young people will need productive and rewarding things to do. Otherwise, political or religious extremism could fill the void as has happened elsewhere. **The problem with oil and gas development is that they do not employ many people**, especially from the host country and especially once the infrastructure is built.

Regional cooperation - if geo-politics allows - can be the key to security in this region. Joint projects - such as the Baku-Supsa oil pipeline - involving FDI help to remove old animosities and suggest to states that flexibility and accommodation are the keys to future prosperity. Traditional national security concerns may need to be sacrificed if states wish to be included in what is going on.

Panel 5 - Concluding Assessment

The link between economics and security/stability is both obvious and complex. Historically, it was treated as a simple trade-off in that a state can choose whether to satisfy the requirements of private consumption or of state security, or, optimally, an efficient balance between the two. State security meant armed force or the threat of armed force, or, in an economic sense, the mercantilist use of that force to secure gold, treasure and spice. In the later mercantilist era, the governing elite became more interested in control over raw materials, trade routes and markets. The similarity being that only the few prospered at the expense of the many.

Today, this paradigm has changed in three important ways. Firstly, because of the homogenising effects of what is usually termed “**globalisation**”. Economic growth and prosperity (assuming states want these) means **opting-in** to the dominant or hegemonic market system and accepting the loss of raw sovereignty

involved. More specifically, it requires open borders whereas economic security - mercantilist definition - requires closed borders. In other words, many states think they are enhancing their economic security through protectionism when in reality they may be doing exactly the opposite.

Secondly, because of the growth of what could be termed “**unconventional**” threats, such as terrorism, proliferation of WMD, drug trafficking and international organised crime. **All these threats have a non-state or rather trans-national character that are and will continue to be impervious to traditional or mercantilist solutions.** Only international cooperation against such security threats will do any good.

Thirdly, because people and governments now understand (or are beginning to understand) **the dimension of human security** (basically from poverty) which is enhanced by and not inimical to private consumption. The worse-off a people are, the less they have to lose by challenging, perhaps violently, the legitimacy of their state or of other states. And vice-versa. But poverty need not be absolute to cause instability. People in Brezhnev’s Soviet Union did not become demonstratively worse-off, it was just that they were experiencing the stability of the graveyard and became aware of much better and constantly improving standards of living in the West. What one panellist described as “dynamic stability”. Another as “**consumption being the tool of stabilisation**”.

So the economy/security focus now has evolved from the **zero-sum game** of the mercantilist era in which any increase in “our” power, wealth and thus security was matched by an equal and opposite loss in “their” power, wealth and security (and vice-versa) into an altogether more complex paradigm. Today, **economy and security are indivisible and mutually reinforcing**, but beyond that obvious platitude, economics and security must also now be considered as part of a **highly complex global environment** encompassing concepts and issues such as hegemony, sovereignty, power, culture, history, democracy and the role of the state. These issues are explored in much greater detail in many of the papers submitted to the Colloquium and now published in this book.

THE LINK BETWEEN ECONOMICS, SECURITY AND STABILITY: THE CASE OF SOUTH-EASTERN EUROPE

Ambassador Lazar Comanescu

Head of the Mission of Romania to NATO

Introductory Remarks

In a book on security published in 1997, mention is made of the fact that “it has long been a staple in international relations that economics and security conflict with each other”¹. In other words, fully satisfying security necessarily means sacrificing at least some aspects of the economy or vice-versa. However, there are strong arguments to suggest that such an approach is no longer relevant. Indeed, during the last decades, the nature and content of political and economic relations among states and within each society have dramatically changed. Growing economic interdependencies and the globalization of the economy have produced significant transformations in the way countries view their national objectives and interests, and hence the ways and instruments to promote them. This applies for security and stability interests/objectives as well. Developments throughout the world demonstrate more and more that security and stability, political and social alike, are multi-dimensional concepts, and that economics is one of the most important dimensions.

In fact, a review, even a cursory one, of these developments clearly indicates a direct link between economy and security, which in most cases translates into the reality that where an economy is more developed, prospects for security and stability are much better. This does not mean at all a one-way approach, since it is equally clear that economic development depends on the policies promoted, be they at national or international level. Appropriate policies generate a greater feeling of security, which in its turn generates increased incentives for economic activities and, as a direct result, more prosperity. To try to put it in other words, security can thus be achieved more easily, provided of course that one paramount condition is fulfilled, namely that prosperity spreads to the greatest extent possible over all the members of the society. It is an objective that can only be properly obtained when economic development and prosperity are the result of democratically established policies. It suffices to look to the map of the world, especially Western Europe, North America and Japan, to see this assertion confirmed.

That being said, perhaps an even more convincing confirmation of the strong link between economics on the one hand and security and stability on the other is provided by the way countries in Central and Eastern Europe, South-Eastern included, evolved after the fall of the Berlin Wall. All these countries stated immediately after that turning point in European history that their top priority objective was reintegration into the community of democratic societies and market economies. The speed as well as the magnitude of the process has been different from country to country. The reality is, as indicated *inter alia* by the recently published annual report of the European Commission on candidates for EU membership, that as of now some of these candidates are more advanced, others like Romania are lagging behind.² It is, however, extremely important that in all cases the process has become irreversible.

Quite often, these differences are considered to be primarily if not exclusively the result of differences in the way the new policies were promoted. Those countries where from the beginning reform has been more radical are now either formally admitted into structures specific to democracies and market economies such as NATO and OECD, or are advanced compared to the laggards in their demarche towards integration into the European Union.

Facts speak for themselves in the support of such a view. However, in order to have the best possible picture and explanation of such differences, other aspects have to be taken into account. Due consideration should, for example, be given to the significant differences as regards the starting points in the post 1989 process of transition. Since this is self-evident, there is no need to elaborate. Neither should one see any attempt from the laggards' side to find excuses for delay and slowness in adopting radical reform measures.

Nevertheless, analysis of the situation in Central and Eastern Europe, and even more so of that in South-Eastern Europe, confirms once more that while economic prosperity is strengthening security, the latter is in its turn a prerequisite for long term economic growth. Indeed, without confidence that resources invested today will still be owned and available tomorrow, investment will wither, growth will decline and, eventually, as assets depreciate, the economy will collapse. So security and wealth are necessary complements: one cannot exist without the other.³

In this respect, where do the countries from South-Eastern Europe or those directly neighbouring this region, like Romania, stand? In answering this question, one has to take into account the various ways in which South-Eastern Europe is viewed. Are we, for example, to tackle the issue from a geographical point of view? Should we on the contrary give priority to the economic dimension or to the political dimension which includes the status of relations of each country with the European and Euro-Atlantic structures? Another possibility would be to look to the region from the perspective of security challenges not only within the region but also to Europe as a whole. Probably this third approach fits best into the rationale of this Colloquium. However, it is clear

that the other aspects cannot be ignored. Therefore, a combination of all three possibilities could be more convenient.

No matter what dimension is considered, there are significant differences among the countries in the region under discussion: some are members of EU and/or NATO; some like Romania are hopefully about to enter EU membership negotiation and are candidates for NATO membership; whilst others have similar objectives but are in a more incipient stage. Last but not least, there are in the region countries which by their progress towards democracy and market economics, as well as by their active role at the regional and European level, are rightly perceived as factors of stability and security. However, unfortunately, there are others from which factors of instability or even threats to stability and hence security still originate. Note should be taken of the fact that those factors have to a significant extent an economic dimension/motivation. What has happened in ex-Yugoslavia, Kosovo included, can be considered as an example in this respect.

The Case of Romania

A Central-European country, directly neighbouring the Balkans, Romania, like other countries from the region, clearly stated very early in 1990 that its primary objective was the re-establishment of a democratic society and of a market economy. As a direct consequence of such an option, Romania's top foreign policy objective could not logically be other than integration into the European and Euro-Atlantic structures. How far has Romania gone from the economic point of view?

In general terms, since 1990 to date, Romania has made considerable progress towards the setting up of a market economy:

- the private sector constitutes roughly 60% of GDP;
- agricultural land is more than 75% privatised;
- two-thirds of exports and close to three-quarters of imports are carried out by private companies;
- price liberalisation has been practically achieved in full;
- approximately two-thirds of Romania's foreign trade is with the EU countries; if one adds trade with CEFTA countries - all of them future members of the EU - the percentage rises to about 75%;

That being said, one has to recognize that the economic situation is still fragile. Improvements are still needed to macroeconomic policies while in the restructuring of large state-owned enterprises there is still a lot to be done. It is encouraging, however, that in 1999 and in spite of difficulties, not least due to the international environment (particularly the Kosovo crisis), structural reforms have been stepped up. These developments facilitated the conclusion of new arrangements with the International Financial Institutions. Through the IMF stand-by arrangement, the World Bank loan for Private Sector Adjustment

(PSAL) as well as through the EU PHARE financed program of economic restructuring and privatisation, important additional support has been mobilized for the furthering of the restructuring process.

Full implementation of the targets set forth through all these arrangements and programs are the main objective of government policy for the next period. Particular attention is to be given, *inter alia*, to a further reduction in inflation; reduction of the current account deficit; further diminution of the budget deficit; stepping up privatisation so as to create conditions for reversing the decline in GDP, and relaunching economic growth in the year 2000. Indeed, estimations by the International Monetary Fund indicate 2% growth in year 2001.

On the other hand, further efforts have to be made to strengthen and stabilize the legal framework for economic activity, so as to encourage both domestic and foreign investment. Priority should also be given to strengthening financial discipline and to restructuring the large loss-generating state companies. Last but not least, a medium-term economic strategy needs to be urgently adopted and adequately pursued. Conditions will thus be created to develop an economic activity commensurate with the considerable potential that Romania has.⁴

All are measures and actions to be taken at the domestic level. However, their success will not depend exclusively on internal action. The external, specifically regional, environment can have an important influence, positive as well as negative.

The Situation in South-Eastern Europe

There are several aspects that need to be taken into account when looking at the situation from a regional perspective. First and as mentioned earlier, an analysis of the situation in each of the countries from the region under discussion indicates the existence of significant differences among them, including economic. Nevertheless, there seems to be a temptation to see the region as a whole, with specific consequences deriving therefrom. Take foreign investment. Of all the countries in Central and Eastern Europe that have an association agreement with the EU and seek EU membership, Romania and Bulgaria record the lowest level of foreign investment.

One reason for this, justified, is of course the delay in establishing a domestic legal environment conducive to investment, domestic and foreign alike. On the other hand, it is more than evident that the reluctance of investors also comes from the perception that countries like Romania are part of a region characterized by instability and a high crisis potential. Such a perception should at least be amended since throughout all this period of crisis and in spite of serious economic difficulties, Romania clearly proved to be not only internally stable but also a stabilizing factor in the region as a whole.

One question still unanswered is should one wait until everything is in place before investing in a particular venture/country, or should one look prospectively

and thus contribute to the acceleration of transformation. The latest developments appear to be encouraging. Reference should be made in this respect to the differentiated approach within the Stability Pact for South-Eastern Europe and especially to the recent recommendation of the European Commission that membership negotiations be started with all 10 Eastern European countries. It is almost sure that this will have a stimulating effect on the countries concerned. It will be all the more so once negotiations proper start. The experience with the association agreements is quite relevant from this point of view.

A second comment refers to the role of regional (economic) cooperation as an important factor in promoting economic development and, as a consequence, regional stability and security. Romania has been an active promoter of the development of regional cooperation in general and of economic regional cooperation in particular. Three main reasons are behind such a policy:

- regional cooperation is beneficial for each of the participants;
- regional cooperation contributes to strengthening confidence among the participants and, as a direct consequence, the security and stability of the whole area;
- regional (economic) cooperation is helpful in efforts to prepare for integration.

This is why Romania has been and will continue to be an active participant in schemes such as CEFTA, BSEC, etc. Similar reasons lay behind Romania's decision not only to welcome but also to actively participate from the outset in the Stability Pact for South-Eastern Europe. Romania considers that the implementation of the economic dimension of this pact will be crucial. Indeed, the success in promoting the other two dimensions - namely security/stability and human rights/democracy - will greatly depend upon how the economic component of the Pact evolves.

To reach concrete results in this respect means, *inter alia*:

- giving priority to reconstruction and economic development based upon well defined and realistic projects;
- substantial involvement of foreign investment, both public and private;
- giving countries in the region the key role of defining and implementing projects and proposals;
- giving particular attention to projects aimed at the development of (sub) regional cooperation.

A third and last remark bears upon the possible use and role of economic instruments in conflict prevention as well as during and after a crisis. Quite often, tensions and crises involving the abuse of human rights are at least to some extent associated with or are the result of economic discrepancies. Even the crisis in Kosovo confirms this in that one of the main grievances of the Kosovar Albanians was that the regime in Belgrade carried out an economic policy disfavoring both the province vis-à-vis the rest of Yugoslavia, and, inside Kosovo itself, the Albanian majority at the expense of the Serbian minority.

A remaining question is whether more intensive and determined use of economic instruments and/or incentives could have had a greater impact on the

efforts aimed at preventing the open conflict in Kosovo. Another question is whether and to what extent the recourse to economic sanctions produced the results expected or generated unforeseen or even undesired effects. A debate is now underway as to whether maintaining sanctions on the FRY is helping to strengthen and accelerate developments towards democracy in that country or is tightening the grip of the regime in Belgrade (the parallel here can be made with what happened in Iraq after the Gulf War).

A third and final question relates to situations of crisis and/or open conflict, specifically as to whether additional effort should be made to identify potential consequences of a particular course of action before such an approach is adopted. Past experience seems to suggest an acute need for such additional efforts particularly in order to identify all possible effects, not the least upon countries neighbouring the crisis area. Solutions to avoid or to alleviate such effects, including effects of the respective approach, should also be considered and identified in advance. The consequences of the air strikes on FRY on trade flows in Europe, particularly among both the countries within the region and between them and the countries riparian to the Danube, are a case in point. A similar point is that related to the cost of reconstruction.

The adoption of the Stability Pact for South-Eastern Europe and even more importantly its appropriate implementation becomes in such circumstances a *sine-qua-non* prerequisite for bringing lasting stability and security in the region. As mentioned before, the economic dimension is a key factor for the success of this endeavor. Regarding the development and implementation of projects within the economic dimension of the Pact, it is of paramount importance that projects are aimed towards both resuming and strengthening regional economic cooperation. Such projects should envisage first of all:

- development of infrastructure including the resumption of traffic on the Danube river (Romania has already put forward a concrete project proposal in this respect), the modernization of road and railway networks, and the setting-up a regional system for the interconnection of electric power grids;
- promotion of investment in the region, with the elaboration and adoption of well defined rules - perhaps under the format of an investment charter - being a valuable beginning;
- development of trade among the countries in the region as well as between each of them and the European Union;
- development of cross border cooperation schemes to ease border and customs controls, to fight against crime and corruption, and to protect the environment.

In developing projects along the ideas outlined above, one has to take into account the fact that some concrete proposals have already been elaborated and launched within various other initiatives and/or programmes related to South-Eastern Europe. Coordination and correlation of all these initiatives and programs constitute a matter of urgency. A first and indispensable step in this direction should be the elaboration of an inventory of the existing projects and programs.

Conditions would thus be created so as to avoid duplication and waste of effort.
Let efficiency prevail.

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RULE OF LAW AND ECONOMIC GROWTH - HOW STRONG IS THEIR INTERACTION?

Genc Ruli

Director of the Albanian Institute for Contemporary Studies, Tirana

Ten years of development in the post-communist countries of Europe have provided an unprecedented challenge for scholars in analyzing the linkage between the rule of law and economic growth. Critical issues that stimulated debate for decades could now be explored in almost experiment-like conditions. Post-communist societies faced the enormously complex task of the simultaneous transformation of political, economic and social structures. As it is rightly pointed out, the mutual interaction and conflicts involved in such a triple transformation created a new situation in which necessary economic reforms had a potential to undermine newly established democracy - and vice-versa.

It is quite true that almost all transition countries made remarkable achievements in undertaking market liberalisation reforms, in establishing democratic institutions and with the creation of the necessary legislation. **These results are evident, but to the same extent it is also evident that these achievements have still to be sufficient and sustainable.**

It can also be noticed that countries that underwent a quicker and sounder development of the democratic system have also had the most advanced and successful economic transformation. Meanwhile, the countries trailing behind with reforms and with poor economic performances also have fragile and less effective democracies and an oscillating political stability.

While all post-communist countries implemented a relatively rapid and easy **adoption** of Western models of democratic institutions, their effective **adaptation** has been quite difficult, especially as regards the second group of countries. The strategies and models were basically similar across the various countries; disparities have resulted mainly from differences of their starting conditions and the legacies of the past.

Economic liberalisation, as an indispensable reforming process for all post-communist societies, carries in itself the causes of several negative phenomena produced during transition. When these liberal reforms were not synchronized with a parallel establishment and development of basic institutions, the result was the transformation of economic liberty into anarchy, of the market economy

into a bazaar economy or crony capitalism, and additional costs of transformation such as artificial consumption and the waste of capital and energy occurred.

The establishment of the institutions of democracy and a market economy in many countries in transition was only partially and nominally implemented, and thus featured many distortions and large asymmetries. The Western model of institutions is a complex network of interlinked institutions that communicate with each other in the form of “capillary tubes”. The underdevelopment of some of them, or the distorted development of other institutions, spreads and compromises the whole set of institutions.

In many transition countries, one can clearly observe a sort of “de-modernisation” or a step back to rather primitive forms of social and economic organization. This concept materializes in several ways:

- The prevalence of informal institutions (behavior, conventions, habits) against the newly created formal ones.
- Poor quality of informal institutions that slow the development of formal institutions.
- The spontaneous establishment of individual instruments against a poor and slow development of social instruments. For instance, the lack of institutional protection induces individuals to develop instruments and behaviors of self-protection or self-security.

The history of transition in **Albania** provides a somewhat specific but also typical example of the strong dependency between the level of democratic development and rule of law on one side, and the achieved level of market reforms and economic growth on the other.

In the first phase of transition in 1991-1994, enormous transformations took place: several pluralist elections were held; democratic institutions were established and started functioning; the civil administration was restructured; and a series of laws to support liberalisation reforms were produced. The economy was liberalised rapidly and market institutions were inaugurated. Market and price liberalisation, as well as privatisation of small enterprises in agriculture, were satisfactorily completed in the first three years. Albania witnessed a surprising economic growth (almost 9% annually), a significant reduction of the inflation rate (from 200% in 1992 to 10% in 1995) and the local currency was stable over these years. Huge foreign aid was flowing in and foreign and domestic investments started to thrive. The government’s role in implementing these reforms found from the beginning a wide consensus amongst the population.

However, the big political and social crisis of 1997 took even the most skeptical analysts of transition by surprise. The results achieved through hardship and at high cost evaporated almost instantly. But the complete and immediate paralysis of state institutions, the loss of public order, social anarchy and several acts of violence and destruction that seized Albania **were not an accidental product of circumstantial factors**. The causes of this crisis lay within the wide historical context of Albanian societal development where, of course, the

events that occurred during the transition period itself have had an impact of their own.

The weakness and fragility of state institutions and public distrust in political institutions were the most obvious indicators of the crisis, while the fall of pyramid schemes - into which over 50% of Albanians had placed their savings - was perceived as the direct cause. As a matter of fact, this crisis was not produced by economic factors alone. Neither the significant economic and social difficulties naturally generated by transition, nor the big loss of savings in pyramid schemes were in themselves sufficient cause to provoke the tragic social turmoil that occurred.

The 1997 crisis was mainly political and institutional, and was only the final act of reaction to negative political phenomena that built up gradually during the initial phase of transition. These phenomena that were either not understood or were ignored during their evolution had in fact undermined the *raison d'être* of the embryonic democratic institutions and the existence of the rule of law. These negative political phenomena were:

- Reformist demagoguery and populism, inspired by an unprincipled political opportunism, gradually replaced the ambitious reforming policies. Strategies of reforms were transformed into electoral propaganda rather than being a consistent program of policy actions.
- The freshly created Civil Administration was usurped by the governing party and became very much politicized. This significantly reduced its motivation, professionalism and efficiency. Drafting and implementation of reforms was not any more the domain of professionals and their pace was synchronized completely with the oscillations of the government party will.
- The new democratic institutions did not consolidate their regulatory role in social life. Political intervention of a dilettantist and pragmatic nature seriously harmed their identity and public mission. On the eve of the crisis, government institutions were just formal structures and the arbitrary authority of powerful individuals replaced their legal authority.
- Democratic norms that regulate political activity itself were systematically violated. Political life was characterised by conflict and aggression. This situation, combined with the immaturity of the political class, reflected to some extent the poor political culture of society itself, but it is hard to believe that it also represented the real interests of society. The Cold War that had ended in the international arena was alive and kicking within Albanian domestic politics.
- Respect for the basic constitutional principles of a liberal democracy was becoming more and more a mere formality. The declared separation of powers and the independence of the judiciary were either never fully accomplished or became seriously jeopardized. An authoritarian leadership born from anti-communist forces of the 1990s was turning into an anti-democratic factor. Political pluralism and the right to vote do not constitute a sufficient guarantee

when adopted by such hybrid, quasi-democratic regimes. On the contrary, they can serve as instruments of political manipulation at home and as a deceiving **facade** for international observers abroad.

The unfortunate rise of these phenomena in the period 1991-1996 clearly reveals the lack of credible political commitment to the rule of law. **When the rule of law is undermined, both the economy and the whole system grows sick.**

The worst deviations or distortions in the process of economic transformation that occurred during this period were:

- The high economic growth recorded during these years came mostly as a result of the immediate release of pent-up energy due to the introduction of free initiative and the rapid privatisation of small businesses. But this was not sustainable since market mechanisms remained embryonic, inadequate and incapable of imposing regulations. The goal of the reform was wrongly considered to be only the rapid expansion of the private sector rather than being also the qualitative development of market institutions.
- The private sector emerged and grew mostly as an informal sector. If we include illegal and criminal activities in the informal economy, then it counts for over 50% of the Albanian economy as a whole. Such a high figure is closely connected with the existence of some specific factors:
 - the under-developed economic culture and mentality of the population;
 - wild and disoriented migration of the rural population towards urban areas post 1990. Because of their low educational and professional level, these people could integrate easily only in the informal sector;
 - the opportunist and shortsighted politics that allowed this exploding bloom of informal and illegal activities to occur, considering them to be a solution to grave social problems like unemployment and poverty. The reality of pyramid schemes is a vivid example of this political irresponsibility.
- The disproportional development of economic sectors, especially the under-development of the banking system and the almost non-existent capital market. The Albanian economy remains even today a cash economy (approximately 60% of the money supply resides out of the banking system) with a rudimentary payments system.
- The incomplete development of some basic market institutions such as property rights and contract law. The slow process of defining and allocating property rights has contributed to the low level of investment and the unsustainability of economic growth. On the one hand, the unsynchronized and even contradictory implementation of the privatisation of agricultural land, restitution and the compensation of former owners, and the privatisation of state property, and on the other hand, a corrupted judiciary, have created a situation characterised by confusion and insecurity as regards property rights and their protection. Almost the same situation exists regarding contractual obligations. The fact

that it is impossible to resolve contractual rights through the courts obliges individuals to seek redress through the use of non-legal instruments.

In this analysis, I have focused upon the period 1991-1997, because developments and events in this period of Albanian transition illustrate clearly and tangibly the strong conditioning of economic reform by the (lack of) efficiency and sustainability of basic democratic and market institutions.

Unfortunately, even today, an understanding of the causes of the 1997 crisis has not provoked any serious and significant intervention aimed at radical improvement. Other political parties that took office after 1997 have tragically repeated the history of their predecessors, to the extent that existing institutions have deteriorated and become submerged.

However, one positive aspect is that donors - in their support programs - are prioritizing the need for radical reform and deeper institutional and administrative restructuring. Maybe the monitoring of such reform to assess its performance, as well as the extent to which aid is conditioned on such performance, should be reviewed and adopted in the light of lessons we have all learned during this decade of transition.

BULGARIA - THE NEW STABILITY

George Prohasky

Director, Centre for Economic Development, Sofia

Introduction

Bulgaria underwent a difficult transition period. The first half of the 1990s witnessed political and economic instability, a lack of comprehensive internal reforms, and unclear foreign policy. That was due mainly to the slow formation of political awareness and popular support for radical reforms, and a lack of leadership.

Bulgaria started market reforms later than Hungary and Poland. The regime of Zhivkov - with the support of Moscow and at the expense of high external debt - managed to imitate some modernization and keep social tension low in the late 1970s and early 1980s. In the late 1980s, the communist regime tried to win the support of the majority by engineering ethnic conflicts and forcing the Turkish minority to emigrate.

The Bulgarian nomenclatura prepared very well for the post-communist era - by infiltrating the opposition and then discrediting it, and by exporting money and creating a strong financial base outside the country. After the internal party coup against Zhivkov, party financial resources were used to start businesses and to create the new capitalist class. The greatest destabilization came from groups connected to the former security police and the intelligence services. These groups quickly concentrated and combined their economic and non-economic power and by using former guards and sportsmen trained in special schools, created mafia-type structures. They profited from big government enterprises, which they drained by diverting most of the income to controlled companies, directly racketeered small businesses and did not hesitate to use criminal methods to achieve their goals.

State banks gave credits without collateral to these groups. A number of private banks were established, which concentrated company and private cash which was then directed abroad or wasted on luxury offices, lavish living styles and support for politicians who supported this process. Given the lack of regulation, financial pyramids were created that wasted and robbed the remaining savings of tens of thousands of people. Obligations to International Financial Institutions were not met and foreign financing was blocked.

This all led to **the economic collapse of 1996** when 15 banks went bankrupt, GDP fell by more than 10%, and industrial production by 11.8%. The exchange rate of the lev reached 487.35 per US dollar at the end of the year compared

to 73.88 leva at the beginning of the year. Average monthly salaries in dollar terms fell at one stage to just US\$30 from up to US\$120 at the beginning of the year. Pensions fell to less than US\$20.

This relative impoverishment finally spurred a **strong movement for radical reform**. The socialist government led by the neo-communist hard-liner Videnov had to step down and new elections were held. For the first time in the recent history of Bulgaria, a new reformist consensus emerged among a very wide circle of the population. This **consensus** was based upon the following points:

- peaceful resolution of the crisis;
- quick economic reforms through privatisation and creating a market economy;
- development of Bulgarian society on the basis of democratic values;
- establishing law and order and breaking organized crime;
- pro-European orientation and a strong effort to become a member of the EU;
- alliance with NATO countries for the preservation of peace and security.

On the basis of this program, the coalition of the **United Democratic Forces** and a government lead by Ivan Kostov came to power in April 1997. Its four year program “**Bulgaria 2001**” was probably the most ambitious program of any government in Eastern Europe. It was based on the idea that the situation in the country did not allow for gradual reform. Social stability, which comes from gradual reform, was not possible for Bulgaria in 1997. We had to go to “**shock therapy**” reform immediately in all sectors of society and in all areas of economic development.

This was an obvious but also risky approach. It relied on the political support of the population and the belief that, although new difficulties may occur in the short term, the positive effects of a newly structured and functioning economy and state will bear fruit and release new energy for moving forward in the medium to long term.

What was achieved and where does Bulgarian reform stand two and a half years later? Is there a danger for new instability or has Bulgaria now become a factor for stability in South-East Europe?

Political Stability

During the crisis of 1996-1997, given the leading role of the newly elected **President Stoyanov**, a new **pro-reformist consensus** in the political life of Bulgaria was achieved. It was initiated by the UDF and supported by the People’s Union (a coalition partner of the UDF in the new government), the Euroleft, the Party of the Ethnic Turks and some circles from the Socialist Party, who put the interests of the nation above the interests of their party and rejected the mandate to form a new government within the old Parliament. All these political parties agreed that new parliamentary elections would be held in the spring of that year and that a currency board would be introduced.

After the elections, the UDF took over 50% of the seats in the Parliament and with their coalition partner, the People's Union, they have almost 60% of the seats. These two parliamentary groups form the existing government of Bulgaria which has been in power for almost two and a half years without change, the longest period of political stability in Bulgaria since 1989.

When this government came into power it presented before Parliament the **Bulgaria 2001** program which covered all aspects of economic and social life in Bulgaria. This comprehensive document was the first of its kind in Bulgaria and, after two years of implementation, has already been fulfilled in most of its key aspects.

An important part of political stability is the ongoing **administrative reform**, which in its essence means the transformation of the classic administrative state into a state of public management and, at the same time, the harmonization of legislation with the European norm. In concrete terms, we already have in place a new Law on Administration which fixes the structure of the public administration and outlines the concrete powers of the bodies of government and the main principles of its functioning. The Council of Ministers also adopted a strategy for building a modern administrative system in Bulgaria. The government is already in the process of launching an automative system for management of information flows within the administration.

Developing the **judicial system** is another aspect of political stability in Bulgaria. This system, according to our laws, is totally independent from executive power. But with the reformist majority in Parliament, changes were carried out which made the system more effective, more decentralized because the Courts of Appeal were introduced, and the whole legislation concerning these issues underwent changes to harmonize Bulgarian rules with European norms.

Economic Reforms

Achieving financial stability

The change in the principles governing the functioning of the Central Bank has been the major and most powerful pro-stabilisation factor since mid-1997. With the amendments in the **Bulgarian National Bank (BNB) Act** setting up the **Currency Board Arrangement**, new principles for the functioning of the Central Bank were introduced. From the traditional monetary policy instruments, the BNB can now only use the rate of required reserves whereas money issuing depends upon the dynamics of foreign exchange reserves (the assets of the Issue Department).

The financial crisis in late 1996 - early 1997 was to a great extent due to both imperfect banking sector legislation and inefficient bank supervision. The amendments introduced in the new Law on Banks passed in June 1997 aimed at strengthening BNB's supervision of commercial banks and provided for better

protection of the interests of both creditors and depositors. These changes in legislation, made before the introduction of the Currency Board, had a strong positive impact on the banking sector by strengthening financial discipline.

There has been a considerable improvement in the liquidity position of banks since mid-1997. This was due to several factors. Among the most important were the aid and loans from international financial institutions; the large trade surplus; privatisation receipts, and last but not least, the increase in deposits in the banking system. Structural reform in the banking sector was launched by the sale to foreign investors of two-thirds of the capital of one of the biggest state owned banks (United Bulgarian Bank). The underlying goal of the reform is to minimise state participation in the capital of commercial banks so as to achieve more effective management.

Bank privatisation made good progress in 1998 and 1999. The government's strategy is to privatise the state-owned banks, with the purpose of attracting additional capital and the expertise needed to build a sound and competitive banking system. Two state banks have now been privatised and three out of the four remaining state banks are expected to be privatised by the end of the year. Significant steps have also been made in implementing necessary improvements to the regulatory and supervisory systems and in developing the capital market. Measures have been taken to strengthen banking supervision and improve the efficiency of the sector. As a result, the banking system is relatively sound and highly capitalized.

The stability achieved with the introduction of the Currency Board and all the other measures mentioned above have now contributed to a **return of confidence** in the banking and financial sector in Bulgaria and established the basis for the government to proceed with further reforms in the sector.

In order to help contain the external current account deficit, **fiscal policy** has been tightened and the overall deficit target for 1999 has been reduced to 1.5% of GDP from a programmed 2.8% of GDP. The first half of the year was marked by a stronger than expected fiscal balance surplus of 0.5% of GDP compared to a programmed deficit of 1.25% of GDP.

This strong fiscal performance is a guarantee that the currency board will continue to provide a **solid foundation for stabilization and reform** despite the adverse external environment. The fiscal reserve account has ample resources, having increased slightly to US\$1.2 billion in the first half of the year. Gross official reserves remain comfortable and amounted to over six months cover of imports of goods and non-factor services at end-June. With that level of gross official reserves, the fixed exchange rate is stable and not vulnerable to attack. Interest rates remain low and stable.

Macroeconomic Stability

Macroeconomic conditions in the country are **stable** and create a possibility for **economic growth**. Despite the unfavorable external impacts of the Asian, Russian and Kosovo crises, macroeconomic developments in Bulgaria have remained largely positive since the beginning of 1998. Economic activity has recovered from the depressed levels of early 1997, inflation has been reduced to low levels and the currency has remained stable. In 1998, Bulgaria achieved its highest GDP growth (3.5%) and lowest inflation (1%) since the beginning of transition.

Overall stabilization and growth outlook **continue to be positive in 1999**, despite the adverse external influences. Preliminary GDP data indicate some growth in the second quarter of 1999 and an overall growth of 0.5% in the first half of the year.

The level of **inflation** (1% in 1998) is similar to the average level in EU countries and is very close to the inflation rate of Germany (0.5%). The main factors that contribute to low inflation are a stable currency, a stable money supply, a small share of goods with controlled prices, and a fall in the international prices of basic groups of goods. As a result of the establishment of the fixed currency rate, protected by the Currency Board, the average monthly rate of consumer prices decreased considerably and for 1998 it was extremely low at just 0.08%. The macroeconomic policy now pursued together with the program for reducing the range of controlled prices will help to keep inflation low.

At the beginning of 1999, **consumer prices** remained close to their late 1998 levels. The cumulative CPI inflation rate in June 1999 was 2%. The rise in electricity, diesel and gasoline prices brought about an increase in the CPI in August and resulted in a cumulative CPI inflation of about 2%.

Foreign direct investment inflows are expected to reach US\$700 million in 1999. The expected finalization of some big privatisation deals such as the sale of Telecom, together with the acceleration of bank privatisation, would provide the additional capital flows needed to counter a widening current account deficit. During the first half of the year, external financing was underpinned by the successful completion of the second review of the Extended Fund Arrangement and the disbursement of two tranches for 1999, together with a JEXIM loan, altogether amounting to US\$242 million.

Table 1 - Key Economic Indicators 1995-1999

	1995	1996	1997	Q1-98	Q2-98	Q3-98	Q4-98	1998	Q1-99	Q2-99
Real Economy										
GDP Growth (%)	2.9	-10.1	-7.0	16.8	2.6	-1.8	1.2	3.5	-0.7	1.6
CPI Inflation (%)	62.1	123.0	1082.3	76.7	23.0	8.0	3.0	22.3	-1.3	-3.7
Exchange Rate (leva/US\$)	67	178	1674	1819	1795	1766	1662	1760	1743	1852
Unemployment (%)	11.1	12.5	13.7	13.7	11.4	10.7	12.2	12.2	13.2	12.8
Monthly wages (US\$)	129.5	56.0	107.6	104.4	111.4	122.1	127.9	127.9	120.6	116.9
External Sector, (million US\$)										
Exports, fob	5,345	4,890	4,940	1,125	1,104	1,020	1,050	4,299	870	875
Imports, fob	5,224	4,703	4,559	1,158	1,152	1,160	1,288	4,757	1,092	1,195
Trade Balance	121	187	381	-33	-48	-140	-238	-458	-222	-320
Current Account										
Balance	-127	-82	427	-120	33	-99	-190	-376	-317	-231
Gross Forex Reserves										
Reserves	1,236	518	2,121	2,219	2,540	2,401	2,679	2,679	2,428	2,417

Creating the Basis of a Competitive Market Economy

Privatisation

Structural reform became the focal point of government policy. **Privatisation** was named as goal number one. The results of the privatisation process in 1998 were considerable. The cumulative share of divested long term assets of enterprises increased from nearly 20% at the end of 1997 to 41% by end-August 1999. The authorities have set themselves the ambitious target of privatising all commercial enterprises, as well as several utilities, by the end of 2000. This would represent about 70% of all fixed assets subject to privatisation. Significant progress has already been achieved in recent months, with the successful privatisation of Expressbank, Hebrosbank, Kremikovtzi steel mill, Balkan Airlines, Himko Fertilizer plant, Agropolichim, and Neftochim - the largest oil refinery in the Balkans.

Progress with enterprise privatisation in 1998 was hampered by the reduced interest of **foreign investors** in emerging markets. The government tried to stimulate the inflow of direct investment by proposing several amendments to the Privatisation Law which were adopted at the end of 1998. These amendments aim to limit the preferential treatment of management and employee buy-outs and allow the reduction or writing off of some company debts. The government accepted the idea that in some cases it should sell companies for just US\$1.

With regard to **enterprise reform**, Bulgaria has achieved good progress in limiting the losses of state-owned enterprises and promoting their restructuring

by isolating the major loss-makers from the banking system. Measures have also been taken to strengthen financial discipline in state-owned enterprises. The government decided that incomes policy regulation should comply with economic results and for this purpose the wage bills of loss-making state-owned companies were frozen in the first half of 1999.

Financial discipline has been recognized to be a key structural issue, and commitment has been demonstrated by adopting a multi-pronged approach to install financial discipline in the state-owned enterprise sector. The Bulgarian government is making efforts to introduce **hard budget constraints** by:

- pushing ahead with privatisation;
- restructuring state monopolies that will remain in state hands;
- reducing enterprise arrears by accelerating restructuring and the privatisation of some of the new companies (Bulgargaz - the gas monopoly, and NEK - the electricity monopoly, have both started an ambitious restructuring and financial rehabilitation program);
- improving and simplifying liquidation and bankruptcy procedures that would lead to the faster closure of inefficient enterprises;
- expanding the scope of incomes policies for state-owned enterprises by including the state monopolies in the list of monitored companies.

As for **the agricultural sector**, liberalization and reform gained considerable momentum. Recent legislative amendments are designed to accelerate the creation of a functional land market. The first priority has been to complete land restructuring and the creation of title-deeds by the introduction of a free of charge procedure for issuing legally binding titles. By April 1999, over 80% of eligible land has been restituted, and 24% of eligible land titled. The government is committed to completion of this process, with all eligible land restituted and titled by the end of 1999.

As a result of the progress made in privatisation and enterprise restructuring, the **private sector** has raised its share in GDP to over 60%. The building of a prosperous private sector and guaranteeing the rights of private property is a very important part of the present policy of the Bulgarian government. The intention is to strengthen the reform process by accelerating privatisation, making the process more transparent and dynamic and supporting the accumulation of gross added value in the private sector.

Trade and price liberalization

The existence of a **functioning market economy** is a major precondition for the accession of Bulgaria to the EU. That is why the authorities are committed to a **liberal economic policy** under which prices are freely determined by market conditions, not by administrative controls. Since 1997, direct controls and retail price ceilings on a number of food products have been replaced by a system of monitoring of contracts to ensure honesty in the transactions between

producers and marketing intermediaries, while allowing more flexibility in price determination. Direct food subsidies from the budget of the central government were also abolished.

The process of liberalization of **retail prices** was completed recently with the abolishment of the system for monitoring contracts. The last vestige of price controls was the minimum price for wheat, which was put in place because of a fear that criminals were engaging in extortion to force farmers to accept prices below a true market value. This was abolished and the government now maintains only a support price system. Farmers are free to sell to others at whatever price is mutually agreed.

All temporary **import duty** exemptions for food and agricultural inputs and outputs have now also been eliminated, and all taxes on the export of food and agricultural products have been revoked. The only exemptions to the general policy of abolishing non-tariff measures and export taxes are those needed to comply with international agreements (e.g., textile and clothing quotas); those needed for reasons of conservation (e.g., licensing for protection of endangered species); or licenses needed for sanitary controls and the protection of public health and safety.

Bulgaria has continued to liberalize its **foreign trade policy**. Together with the new Customs Code, a new trade policy regulation entered into force from the beginning of 1999 reducing licensing requirements and abolishing all export quotas. As an associate member of the EU, Bulgaria is working on the harmonization of its customs legislation. The average customs tariff rate has decreased to 8.02% since 1999, and will continue to fall until it reaches that of the EU. The new customs legislation is largely identical to the Community Customs Code and further amendments are foreseen to obtain full compliance. As from the beginning of 1998, Bulgarian industrial goods have duty-free access to the European market.

In January 1999, Bulgaria became a full member of **CEFTA**. The main consequence has been the abolishment of duties for about 80% of industrial exports. Also in January 1999, a free trade agreement with **Turkey** entered into force, providing for full liberalization of trade in industrial goods from 2002 and for the granting of mutual concessions for trade in agricultural goods. The first step towards achieving bilateral free trade has been the abolishment of duties for about 90% of industrial exports. According to the free trade agreement with **EFTA**, in force since 1993, full liberalization of trade will be achieved by the end of 2002. A new free trade agreement was signed with the **former Yugoslav Republic of Macedonia*** in 1999 which entered into force in January 2000, after which 87% of industrial goods will be traded duty-free. Bulgaria is also conducting negotiations for liberalization of mutual trade with Lithuania, Morocco, Israel, and others.

* Turkey recognises the Republic of Macedonia with its constitutional name

Bulgaria grants duty-free treatment to imports of most commodities from developing countries and supports the WTO Comprehensive Program for rendering technical assistance in trade with developing countries. As a **member of the WTO**, Bulgaria has undertaken obligations not to impose non-tariff barriers on imports, and not to raise tariffs above certain bound levels. It is expected that maximum industrial product tariffs will be lowered in January 2000.

Developing a Modern Social Sector

Broad economic reforms need special measures in the **social sector**. The development of a modern social sector, improvement in the quality of life, and adapting human resources towards new economic conditions are all priorities of government policy.

Maintaining the level of employment

Since the beginning of 1999, **unemployment** averaged about 13%, and this will remain one of the most important problems in the years to come. Efforts to maintain the employment level will be made in parallel to the acceleration of the privatisation process and restructuring of the economy, especially the closing down of some loss-making enterprises. A growing private sector will play a positive role in this direction and it will continue to create new employment opportunities.

The **Labor Law** and the **Unemployment Protection and Employment Promotion Act** cover in general the EU provisions. In parallel, a number of employment programs are being implemented in the public sector. A business start-up program was launched at the beginning of 1999 to provide training and financial assistance to the unemployed. Social dialogue is one of the basic instruments used in the development and implementation of regional employment programs.

Adequate income policy

Income policy is aimed at compliance with implemented economic policy, compliance with policy in the sphere of employment and limiting the level of unemployment, and surmounting the significant fall in the purchasing power of the population.

Health and safety

Development of a healthy environment for life and work (health protection and social care, occupational safety and health) is a government priority. New legal texts have been adopted that include provisions on the structure and the activities of the **General Labor Inspectorate**, on the functions and tasks of

the officials and specialized services in the enterprises engaged with professional hazard protection, and on the training of the representatives on Committees dealing with working conditions. The **Health Insurance Act** was adopted in June 1998. Following this, the **National Health Insurance Fund** started to operate in March 1999. The regulations on the structure and functions of the fund are effective as of August 20, 1999.

Creation of an effective pension system

Legal and institutional reform in the field of social protection has to ensure the introduction of the three-pillar pension system, including legislation regulating both voluntary and occupational pension funds. Rules on the application of the **Social Assistance Act** were adopted in November 1998 and the **Additional Voluntary Pension Act** was published in July 1999. The Social Security Code will be passed by Parliament soon and will be enforced from January 2000.

Overview of Bulgarian Progress with Transition

While generally good progress on reform has been made in 1998 and in the first half of 1999, the Bulgarian government is aware that efforts should be made to maintain the momentum. Generally, commitment has been demonstrated to remove the deep-seated structural impediments in order to safeguard macroeconomic and financial stability under the unfavorable external environment. The steadfast implementation of the adjustment program during the Kosovo crisis played a major role in the rapid resumption of foreign direct investment after the end of the war.

Bulgaria Now Meets the Criteria to Start Negotiations with the EU

A basic priority in Bulgarian foreign policy and international economic relations is its **accelerated accession to the European Union**. Transforming Bulgaria into an integral part of stable and prosperous Europe will be a prerequisite for reaching a sustainable peace and security in the South-East of Europe. The efforts for full membership are an additional catalyst of the dynamic processes in the country. Bulgaria's accession to the EU is a global process, which comprises changes in political, economic and social life.

The EU is the **main trade partner** of Bulgaria. The structure of Bulgarian foreign trade confirms a primarily European orientation. In the first half of 1998, Bulgarian exports to EU countries represented 50% of total exports, while in the first half of 1999, this share increased to 55%. Imports from the EU rose at the same rate, from 45 to 50% of the total. This is strong confirmation of the rapidly increasing trade integration between Bulgaria and the EU.

As a whole, macroeconomic stability and consensus about economic policy enhance the performance of a functioning market economy. Trade liberalization, a well-developed financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of the economy. This is the opinion of the European Commission. Besides, the liberalization of the Bulgarian economy is in tune with the worldwide process of strengthening competition and stimulating effective production.

Preparation for NATO Membership

Bulgaria is a **reliable partner of NATO** and we have applied to become a NATO member. To achieve this, the Bulgarian government has prepared a Plan for National Security up to the year 2004. The aim of this Plan is to fulfill the objective of achieving sufficient defense potential to guarantee the sovereignty, security and independence of the state; to defend its territorial integrity in case of aggression; and to support effectively its foreign policy for peace, security and stability. Thus will the perceived goals of national strategy for integration with the EU and NATO be achieved. On the basis of this Plan, an Annual National Program for the implementation of the **NATO Membership Action Plan** has been developed.

Regional Co-operation

The Kosovo crisis created a new reality in South-East Europe and influenced the relations of Bulgaria with the other Balkan countries and with the EU. The continuous 10-year period of political and economic instability in the Balkans and the resulting problems for both the international community and the EU highlight the need to find better ways towards co-operation and assistance between neighboring countries in the region. They also identify the urgent need to expand Euro-Atlantic structures through political and economic integration of countries in the region. The accomplishment of rapid economic growth and prosperity, the development and improvement of regional co-operation, and the development of democracy and civil society are vital to the achievement of sustainable stability.

Bulgaria has the ambition to play a significant role in the formulation of proposals, together with other Balkan countries, for the preparation of **regional development plans** with a wide participation of the EU and its member countries. Economic and political stability, the successful progress of the democratic process, and the ethnic balance in Bulgaria create the conditions for it to become a major factor in the dialogue with the EU and NATO on the processes of recovery, development and integration in the Balkans.

Bulgaria has signed the **Stability Pact** which aims to establish sustainable peace and good neighborly relations in the Balkans based upon well functioning

market economies, the promotion of regional co-operation, and faster integration with the EU. In order to achieve these goals, countries in the region should unite their efforts and implement a policy oriented to the development of entrepreneurship and the attraction of foreign investment. At the same time, Balkan countries expect the international community to support the integration process through investment to build-up the general infrastructure of the region. This implies identifying priority areas, instruments and mechanisms for the development of regional co-operation in the Balkans, and for its integration into the EU and the global economy.

Bulgaria has initiated a number of meetings between ministers for promoting some important initiatives for the development of the region and co-operation in the context of both the Stability Pact and the **South-Eastern Europe Cooperation Initiative (SECI)**. The Stability Pact, however, only gives the general framework for regional co-operation. A **long-term regional program** for economic reconstruction, development and integration has still to be elaborated, along with an adequate management infrastructure for the implementation of this program. Coordination of economic policy and joint action to establish and institutionalise new forms of regional economic development and integration in the Balkans will be necessary for further co-operation between the countries in the region.

One of the ideas in the Pact is to focus initial efforts on the consolidation and commitment to **establish stability zones in the region** that have achieved substantial success with democratisation and economic reform. Some Balkan countries do not have sufficient experience with market transition, neither have they established the conditions for stable growth. Some countries face macroeconomic instability with severe financial and currency problems that they could avoid by liberalization and strict financial discipline, which would in turn attract foreign investment. They should also improve the situation by developing a scheme for bilateral and multilateral agreements, aiming at a new, sustainable basis of regional co-operation which would transform the Balkans into an integral part of the democratic community of Europe. This is the area where Bulgaria is doing an active job.

The major role of **trade**, both regional and with EU countries, is identified in the process of stabilization and association undertaken by the EU. The Stability Pact identifies as a priority the upgrading of the region's infrastructure. This means modernising the already existing transport arteries, the building of European corridors, upgrading of the water and air port links, investments in the energy sector, restructuring of the energy sources, and the building of telecommunication links.

The Next Steps

The main priorities for the future development of Bulgaria are expressed in the **National Development Plan 2000-2006**, whose objective is the achievement of sustainable low-inflation economic growth as a precondition for increasing incomes and improving living conditions in preparation for further integration into the European economic and social structure. Achievement of this main objective requires the successful implementation of the following steps:

- finalization of **structural reform** - improving the functioning of the market economy;
- improvement of the **institutional system**, harmonized with European legislation;
- increasing the **competitiveness** of the economy through the rapid construction and improvement of basic infrastructure - transport, energy, and telecommunication;
- improve the quality of **manpower** and **human resources** by adapting to new economic conditions - continue the trend towards maintaining employment, improving education and qualifications, and reform in healthcare and social insurance;
- increasing the **production capacity** of the economy through the identification and development of key export-oriented sectors with good long-term prospects.

Prerequisites for the achievement of the main objectives and the related strategic priorities are the maintenance of macroeconomic stability, the overall improvement of the economic and investment climate, the establishment of competitive markets, and the limitation of state interference in the economy.

Economic stability will bring additional political stability and international recognition. It will allow Bulgaria to play a stronger role as the new stability factor in South-East Europe.

THE ROLE OF INTERNATIONAL ORGANIZATIONS IN CONTRIBUTING TO ECONOMIC SECURITY : RECONSTRUCTION OF THE BALKANS

Spiros Voyadzis

Manager of the Brussels Office, The World Bank

I am very pleased to represent the World Bank at this NATO Colloquium. The Balkans is a very important region both for the European Union and the world as a whole. The World Bank's role in the Balkans is of course in support of the affected countries, but also totally in support of the Stability Pact objectives as well as of the activities of the EC and of the EIB. I wish this to be very clear from the start. I also wish to explain that I take the region of SE Europe to include all the countries of ex-Yugoslavia, plus Bulgaria, Romania and Albania. Turkey and Greece are not included.

Key Messages

- Reconstruction and economic recovery are key to peace and stability in the region.
- Economic activity for all countries of the region may be much more important than the additional opportunities offered by reconstruction. In order to achieve sustainable economic recovery, these countries need to follow market-oriented reforms, and the international community should stand ready to improve conditions for trade, encourage direct foreign investment, and provide assistance to help reduce the evident development gap. Since eventually it is the private sector which will be the engine of economic growth, it is especially important that the countries of the region pursue policies that promote private investment.
- Parallel to the importance of economic activity and productive investment, what is of paramount importance is **human capital reconstruction** - investment in social sectors in its widest meaning - **and institutional strengthening** - by-laws, regulatory frameworks, etc.
- Integration of the region into the rest of Europe, especially the EU, will be a key aspect of long-term recovery and regional stability. Furthermore, there are important opportunities for regional cooperation in transport, energy, and trade facilitation.

- Helping the region to catch up with the rest of Europe requires a concerted and sustained international effort. And we need to be realistic - this will be a long process with ups and downs. But fortunately, there seems to be enough political will, as demonstrated by the strong support behind the Stability Pact, to make this happen.
- Finally, without the development and integration of the FRY, the rest of South-East Europe will likely not develop and integrate, as shown by the experience of the last 10 years.

Economic Outlook and Short-Term Financing Needs of the Countries in the Region

Countries around the FRY

Six countries around the FRY (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the former Yugoslav Republic of Macedonia and Romania) have been hardest hit by the economic and social fall-out of the Kosovo crisis. As a result, budget and current account deficits have widened and average economic growth in the region is estimated at minus one percent in 1999. Things seem to be changing for 2000 with projected growth of 3.25%.

Context: the countries have a total population of 55 million -15% of the EU; a GDP of US\$50bn in 1998 or 0.7% of the EU; average GNP per capita is some US\$1,800 (no more than 10-15% of the EU average) ranging from US\$4,250 for Croatia to US\$750 for Albania; agriculture is very important - 20-30% of GDP (5% in the EU) - as is trade and transport.

Donor Response has been Quick

- Country-specific donor meetings were held in April-May for Albania, Bosnia and Herzegovina, Bulgaria and the former Yugoslav Republic of Macedonia, co-chaired by the European Commission and the World Bank. Significant incremental resources have been raised, and, as of today, the financing gaps have been largely filled. From April through May 1999, Donors Meetings mobilised the following amounts: Albania - US\$200 million; Bulgaria - US\$275 million; former Yugoslav Republic of Macedonia - US\$252 million. This money was in all cases advanced to meet costs arising from the Kosovo crisis, as well as to assist in maintaining economic stability and continue economic reforms.
- The World Bank made available more than US\$200 million in total incremental assistance in 1999; total new lending to these six countries was close to US\$1 billion in 1999 and is expected to amount to about US\$900 million in the year 2000 (in such areas as infrastructure, agriculture, education and

health, small and medium enterprise development, economic and institutional reform).

- Aside from the existing, well-functioning, country-specific donor coordination mechanisms, a new region-wide donor-coordination mechanism has now been put in place, jointly led by the World Bank and the European Commission. This is to support region-wide impact assessments, donor mobilisation and support for regional cooperation and integration, in close coordination with the Regional and Working Tables under the Stability Pact. As part of this coordination effort, a joint EC-World Bank Coordination Office has been set up in Brussels.
- Hopefully, several regional initiatives can be proposed and refined in the next several months, allowing an early convening of a regional conference. This would permit an early start on making the goal of fostering regional integration and cooperation in South-East Europe a reality on the ground. At the recent Stability Pact Economic Round Table meeting in Bari, the WBG was asked to formulate a comprehensive regional economic recovery strategy, in cooperation with the EC and others.

Apart from the IBRD and IDA activities described above, the **International Finance Corporation (IFC)** is increasingly launching regional risk capital funds and microcredit banks, supporting mainstream banks, investing in industries and enterprises, and developing important partnerships with the private sector. The IFC is also launching a new program of small and medium scale enterprise developments in the Balkan Region. Six main activities are proposed:

- enterprise level support - pre- and post-financing;
- training and education, with heavy emphasis on utilising and developing private sector service providers;
- business environment - property rights, collateral/mortgages, corporate governance, etc.;
- information/knowledge networking and dissemination;
- special Kosovo initiatives - microcredit, sector and legal studies;
- other initiatives - private health care, sector studies, contract TA management and portfolio monitoring for IFC, etc.

The IFC is also looking at the legal framework for leasing arrangements in the region and carrying out market survey studies for leasing potential since there seems to be promise for a big development of leasing companies in the Balkan region.

In addition to IFC's work, the **Foreign Investment Advisory Service (FIAS)** of the World Bank has been working in some of the countries of the region and has a program over the next year or two to get to all of them. This agency is looking at the current business climate using a well tested methodology, which has been successful in many countries of the world, to evaluate the barriers that businessmen face in trying to do business in the region. They are then designing remedial programs to simplify the business environment. Sometimes

it seems that rules and regulations are designed to prevent things from happening rather than facilitating the proper implementation of business activities. I believe that the FIAS program will be a useful contribution to all of our efforts.

Kosovo

We face five main challenges in our efforts to rebuild Kosovo:

- it is imperative to address the human challenge. It is not only the burned houses and destroyed schools that have to be fixed, but also people's psychological wounds that have to heal;
- UNMIK needs the full support of the international community to establish an efficient interim administration in Kosovo and lay the foundation for a future local administration;
- our efforts to help rebuild Kosovo must be comprehensive and not limited to the reconstruction of damaged economic assets. Much of the challenge will be rebuilding an economy that had already fallen into substantial decline prior to the latest crisis, and ensuring a sustainable economic recovery based on transition from a socialist to a market-oriented economy;
- international assistance to Kosovo needs to be quick to respond to the most urgent humanitarian needs and the funding requirements of the civil administration. Assistance must also be sufficient to allow Kosovo's economy to achieve a sustainable growth path, and should be additional in order to avoid the diversion of aid from other countries of the region;
- effective coordination of international assistance will be critical to the success of this complex undertaking.

The World Bank will provide US\$60 million during the next 12-18 months for the reconstruction and development of Kosovo. It will also play a major role, together with the European Commission, in the formulation of reconstruction and economic recovery programs, as well as in resource mobilisation and aid coordination.

Federal Republic of Yugoslavia

As for the FRY, there clearly has been a lot of physical damage from the crisis and the number of refugees and displaced persons is substantial. Ten years of economic blockade and mismanagement also have left a legacy of economic decline and impoverishment. As a result, there are major but as yet not fully known humanitarian, reconstruction and longer-term development assistance needs.

It is premature to talk about a donor assistance strategy in view of unsettled political questions regarding future donor involvement. However, there is an immediate need for humanitarian assistance which we should focus on. The

World Bank's scope for involvement is limited by the FRY's non-membership and sizeable loan arrears.

An early revival of the FRY economy, a normalisation of economic relations with its neighbours and integration into the broader economy of South-East Europe will be essential for lasting economic recovery and stability in the whole region.

Next Steps

- On November 17, 1999, a Second Donors Meeting on Kosovo was held.
- In early 2000, the first Regional Conference will be held.

Conclusion

The reconstruction and development of South-East Europe presents major opportunities both for the **countries of the region** (prospects for growth and economic prosperity from reconstruction, economic reform, and integration with each other and with the rest of Europe) and for the **international community** and the **private sector** (prospects for peace and stability in an historically unstable region of Europe, with a well-coordinated and generous external response). If we are to realise these great opportunities, special efforts and a flexible response by all concerned will be required. The World Bank stands ready to do its part.

DEVELOPING THE ECONOMIES OF SOUTH-EASTERN EUROPE

*Harry Cohen**

*NATO Parliamentary Assembly, Sub-Committee on East-West Economic
Cooperation and Convergence, Chairman (United Kingdom)*

Last year's conflict in Kosovo has had a plethora of strategic and political ramifications which are recasting the very purpose of key institutions governing European political and economic life. The conflict was an unfortunate consequence of long-standing and worsening regional instability and, more specifically, of the hideous policies of the Milosovic regime which have done so much to exacerbate regional tensions. Yet, it has also served as a wake up call to the trans-Atlantic Community and a blaring reminder that flitting attention to the problems of South-Eastern Europe's transition has been a self-defeating policy. The continent is too small, borders are too porous, and economic forces and technology have galvanized the process of integration to such an extent as to make it impossible to contemplate the notion that what happens in the Balkans does not really matter. All of this seems perfectly self evident today. But until recently, the Western approach to the region was largely one of crisis management and short-term measures designed to quell overt violence, but inadequate to the task of promoting the kind of integration that will bring long-term peace and stability to the region.

Throughout most of this decade, the European Union was largely consumed with ensuring the successful adoption of the Euro, extending membership to the Union to a limited number of states, and undertaking the kinds of institutional reform that would allow the Union to manage that process. In the wake of the conflict in Kosovo, it has placed the development of a much sharpened foreign policy and security identity squarely at the centre of its agenda. Coping with the emergency situation in much of South-Eastern Europe and ultimately fitting that region into the institutional and economic life of the continent has accordingly emerged as one of the top priorities for Europe. By virtue of its distance and the already considerable sum it has expended in fostering a higher degree of regional security, the United States has happily conceded the lead to Europe in this field, while nonetheless recognizing the importance of its own economic and security engagement there.

The economic, political and institutional challenges the region faces, however, are extraordinarily daunting, and those helping to meet these are girding themselves for a decades-long commitment and the likelihood of a fair share of setbacks

along the way. Much of the Balkans never underwent free market oriented economic development, and thus the challenges lie not only in garnering resources, but fundamentally altering political practices, reorienting civil societies, building integrative infrastructure, and recasting legal structures. A comprehensive and fresh set of approaches to regional economic revitalization is therefore essential. In the past, the West tended to treat issues and countries in the region separately. By narrowing its collective imagination to such conceptual boxes, it was not sufficiently prepared to identify the broad region-wide challenges that have long demanded political attention. In this sense, Western policy itself was “balkanized”. In the wake of the recent conflict, however, the trans-Atlantic community of nations has finally begun to articulate a broader regional approach in which security, democracy and economic reconstruction are organically linked.

Before examining the region wide challenges to economic development and integration, however, it is first essential to sketch out the critical economic circumstances several of the region’s countries confront. The Balkan states are hardly homogenous; to the contrary, the economic and political landscape is so variegated as to make absolute generalizations of little use.

The Situation in Kosovo

Political stability is the handmaiden of economic development, and sustainable economic growth is impossible without a legitimate state capable of establishing the rule of law, coherent administration, economic rules of the game, and, even more fundamentally, civil peace. To varying degrees and in different ways, many of these fundamental conditions are not being met in any of the three regions of the FRY.

Although many pundits were tempted to characterize the end of the conflict in Kosovo as a new beginning, the situation in that strife weary province gives an almost false ring even to expressions of cautious optimism. That most of the hundreds of thousands of Kosovars who were expelled have returned home seems almost extraordinary. That there are emergency services in place granting the population the food, shelter and energy it needs to survive the winter reflects the rapid mobilization of governments, international organizations and NGO’s to respond the dire situation as does the fact that repairs to basic infrastructure have begun. But for those looking at longer term prospects, the news is not good.

First of all, if military conflict in the province has been put to end, violence remains a serious problem. Nine years of grotesque repression at the hands of the Milosovic regime has left the Kosovar Albanian population, and particularly the younger people who have no real recollection of ethnic co-existence, in a vengeful frame of mind. In the oft-times lawless climate in certain parts of the province, dozens of innocent ethnic Serbs have been murdered, and thousands have felt that they had no alternative but to abandon the province or move to

Serb enclaves. Kosovar Albanians in predominantly Serb regions have also suffered terrible retribution. The capacity of KFOR troops and still undermanned police forces (only 2000 of an expected 6,000 international policemen have been deployed in Kosovo) to provide blanket protection to exposed minorities is obviously limited, but in certain areas, anything short of such protection invites ethnic attacks.

In this environment, the lofty goal of achieving ethnic reconciliation in Kosovo has given way to a much diminished aspiration to furnish basic protection to those living under threat of ethnic reprisal—ethnic Serbs, Slav Muslims and Roma, and in the Serb majority area, Kosovar Albanians.¹ Yet, even this is proving a genuine challenge. There is no effective justice system in place, and many of those arrested for criminal activities are invariably released. KFOR troops are under enormous pressure to contain ethnic hostility in areas like Mitrovica where grave tension gave way to serious violence in February.

The ethnic divide has critical economic consequences. Kosovo not only must recover from the horrible violence carried out by the Yugoslav army and military groups, but also it has to overcome the legacy of nine years of exploitative Serbian rule in which the Kosovar Albanian majority was denied a voice in government and utterly marginalized economically and socially. Kosovar Albanian schools were shut down, farmers were denied seed and other basic inputs and Kosovar Albanian workers were expelled from state-owned companies. The collective damage to basic physical and human capital as a result of these policies is almost incalculable.

Not surprisingly, the restoration of order and the creation of a working state apparatus represent key immediate priorities for the international community. The thinking is that once these are in place, the difficult task of fostering some degree of ethnic co-existence can begin. UNMIK has recently taken steps to rationalize Kosovo's administrative structures and to ensure some degree of domestic political control over it. The new governing body oversees 14 governmental departments which were previously operating without sufficient coordination.

As of January 31, 2000 a joint administrative structure has been in place, led by four members of UNMIK and three political representatives from Kosovar Albanian parties. The provisional government of Hashim Thacsi and Ibrahim Rugova has had to merge into this structure.² Importantly, the Serb party, which was invited to participate, is boycotting the project, claiming that the new administrative system represents a step towards Kosovo's secession from the FRY.

The latest reports, however, suggests that these important steps have done little to improve the governability of the province. The stand-off in Mitrovica is only the most visible manifestation of the myriad problems besetting UNMIK, KFOR and the donor community. Bernard Kouchner has complained that despite significant aid pledges, he still lacks the resources to create a functioning government apparatus and is spending an increasing amount of time simply

trying to secure needed funds. UNMIK requires \$325 million to cover basic public services and government workers pay, and teachers and refuse collectors must be paid. Failure to cover those costs will only place greater burdens on KFOR troops,³ and it is also creating a certain degree of trans-Atlantic friction which could erode much-needed Alliance solidarity as far as the approach to Kosovo is concerned.

The sources of Kosovo's economic crisis are not dissimilar to the roots of its great political predicament. Kosovo's banking system is virtually non-existent; the Serbs had simply eradicated all Kosovar Albanian credit institutions in 1990. Accordingly there are no solvent banks operating in Kosovo and no effective regulatory framework exists to facilitate their emergence. Not surprisingly, the few foreign investors attempting to conduct business in Kosovo face an array of barriers beyond the general instability. Corporate law is virtually non-existent and companies operate in a kind of legal limbo where what is permissible and what is not is a matter of guess work. The communications network is extremely unreliable; truck queues can last up to seven days on the borders and public financing is now secured with a prohibitively high import duty of 26%. Organized crime, the flip side of a weak state, poses a serious impediment to an economic take-off. Finally the agricultural system is seriously degraded. This has particularly serious consequences in a province where 70% of the population lives in the countryside and to varying degrees directly depends upon the farming sector. Direct Serbian rule resulted in a serious degradation of rural investment, and production fell 50-70% throughout the last decade. Land mines now litter the countryside and this too makes a rapid agricultural recovery all but impossible.

Kosovo's woeful infrastructure poses another set of problems. According to one UNMIK official in January, the power supply for Kosovo has deteriorated over the course of the winter, and the province desperately needs new power generating capacity. The Serbian power industry has curtailed its daily supply of 75 megawatts of electricity, and in January, Pristina was enjoying only six hours a day of power.⁴ Neither the telecommunication system nor the postal service were functioning at the war's end, and both were seriously degraded due to years of neglect and low or no investment. Water is in poor supply and of low quality, and pipe leakage's cause water supply losses of up to 50% in some towns. Finally, the basic public health system is in very poor condition—something made apparent in demographic statistics. The UN Population Fund and the World Health Organization recently reported that none of the maternity wards in Kosovo meet basic reproductive rights standards, and there are 54 deaths per 1000 births as opposed to 5.6 in the EU.⁵

The Aid Effort, Priorities and Problems

How to turn around this disastrous economic situation represents one of the great challenges facing the World Bank and the EU which are jointly leading

the economic aid effort. A serious problems for donors to Kosovo has been the lack of a strategic framework and the many obstacles to coordinating aid particularly on the ground. Kosovo is highly unstable, and even to say it is now in a post-conflict phase is somewhat misleading. Moreover, the problems are not simply due to last year's conflict but can also be traced to a decade of purposeful economic neglect and political marginalization at the hands of the Milosevic regime, decades of inefficient Yugoslavian economic policy, as well as a history of underdevelopment. UNMIK and the long list of international organizations and NGO's operating in Kosovo today must cope with this fundamental reality, which not only burdens the economy but penetrates deeply into the fabric of Kosovar society. With KFOR providing overall security, the UN High Commission for Refugees dealing with resettling issues, UNMIK overseeing public administration, the OSCE in charge of elections and media and the EU coordinating the aid effort, the task of aid and development integration has proven extremely trying.

UNMIK itself is organized along four pillars covering humanitarian issues, civil administration, democratization, institution building and economic development, the last of which, the EU is managing. The immediate requirement has been to meet the basic needs of a population living in dire circumstances and to coordinate the efforts of various donors in this critical area. But over the long-term, the EU will seek to lay the foundations of a modern well functioning market economy supposedly by generating the resources needed for basic public institutions, the construction of a payments system, and well regulated financial, utility and telecommunications systems. The Commission has created an Agency for the Reconstruction of Kosovo to prepare and implement reconstruction programmes and to coordinate it own efforts with those of other organizations.

The modalities of underwriting and administering aid to Kosovo has generated no small amount of controversy within the EU. The Commission, for example, has earmarked Euro 500 million for Kosovo's reconstruction but has had to engage in some budgetary slight of hand to reach this number. The Council recently proposed an across the board cut in other external policy programmes to fund this initiative, but the European Parliament has strongly opposed this and even threatened to withhold funds for reconstruction to pressure EU Finance Ministers to increase overall funding for foreign policy initiatives. Parliamentarians are particularly irritated that the Commission had committed to multi-year financing at the Kosovo Donors' conference, but did not reflect these commitments in its budget proposals.⁶ Agriculture Commissioner Franz Fischler has agreed to reduce his Directorate's budget for 2001 by 300 million Euro to underwrite the EU's Balkan initiatives, but the debate has given a sense of how difficult it is for the EU to shift resources from heartily defended internal budgets to fashionable but more politically exposed international programmes even though member governments have made CSFP a top institutional priority for the Union.

Although there has been a significant promise of aid to Kosovo, much of the money has yet to be spent. The Commission has encountered bureaucratic delays disbursing funds, and this is partly due to new and stricter spending procedures. On the Commission side, the problem not only involves cumbersome financial controls but also inter-Directorate rivalries and a shortage of personnel. The other half of the problem, of course, is that the quality of public administration in the region itself is not impressive, and financial controls are very lax.⁷ Finally, aid distribution has become a critical source of political patronage in Kosovo, and control over these levers is granting some rather undemocratic figures growing political clout.⁸ Concerns about aid misappropriation are therefore entirely justified, and close scrutiny is essential.

Nevertheless spending delays have fomented a certain degree of trans-Atlantic tension. Secretary of State Madeline Albright recently hinted at American frustration with the aid effort in Kosovo, saying, “Here, as with the region as a whole, it is vital that our partners join us not only in pledging generously, but also in disbursing promptly”.⁹ The Commission now recognizes the problem and has set up a special task force for the Balkans to cut through the red tape which heretofore had slowed up assistance payments. The Americans have welcomed this, but at the same time U.S. officials and members of Congress continually allude to a tacit *quid pro quo* by which the Americans, who shouldered the greatest share of the military burden, now expect the Europeans to take the lead in Kosovo’s rehabilitation and economic construction effort.

Montenegro’s Quest for Autonomy

Uncertainty regarding its sticky relationship with the FRY is complicating long-term economic development in Montenegro. The Republic’s President, Milan Djukanovic has publicly flirted with putting Montenegro’s status within the FRY to a referendum, but for the moment, his government appears to have shelved this risky course. The immediate goal now is to secure greater autonomy from federal authorities and to distance the Republic from the consequences of that regime’s economic and political policies, but even this is fanning the flames, and many now speak of an almost inevitable military conflict between the two Republics.

The Montenegrin economy has declined substantially over the last decade and is beset by criminal activities like smuggling and trafficking in stolen goods.¹⁰ Montenegro’s uncertain status weakens its capacity to pursue autonomous economic policies, establish normal economic relations with the outside world and attract foreign investment. Moreover, there are few guarantees that economic aid to and commerce with Montenegro will not directly or indirectly benefit federal authorities. This poses a trying dilemma for Western leaders who must craft a policy which rewards Montenegro’s apparent commitment to democratic freedoms and European integration but nonetheless continues to penalize Milosevic’s

Yugoslavia. Moreover, Western governments prefer that Montenegro remain in the FRY and become a force for democracy within the Federation; secession opens a Pandora's box of potential horrors into which no Western government wants to peer.

The Montenegrin government, however, has only widened the gulf between itself and Serbia. On November 2, 1999, the government declared that the D-Mark would henceforth act as a parallel currency to the Dinar. A new central bank and monetary authority were established with price stability to constitute the central object of policy. This was not simply a play for independence; the Federal Republic of Yugoslavia has been struck by sky-rocketing inflation that price controls have yet to quell, and Djukanovic wants to insulate his Republic from the nefarious effects of hyper-inflation. Needless to say, the Milosevic regime strongly opposes the notion of Montenegrin monetary sovereignty, in part, because it means that Serbia can no longer purchase goods from Montenegro at artificially reduced prices. The FRY's Constitutional Court recently declared Djukanovic's monetary strategy illegal - a ruling which was made without the two Montenegrin judges on that court.¹¹ Belgrade is now holding up all payments to that Republic and denying it access to subsidized food. In March, Serbia imposed a full economic blockade on its fellow Republic and significantly tightened up border controls.¹²

Montenegro has been tightly integrated in the Serbian economy, which normally accounts for some 70% of its trade.¹³ President Djukanovic is looking to Europe to compensate for the loss of trade with Serbia, and the EU has responded with Euro 14 million in aid this year.¹⁴ The President also hopes to participate actively in the Stability Pact and even begin the long process of joining the EU. There is certainly scope for Montenegrin participation in Stability Pact programmes, but without sovereign status and given the fact that the federal government is now an international pariah, Montenegro's imminent participation in, for example, the Stability and Association Agreements, is highly unlikely.

In January 2000, the government outlined its immediate economic goals. Achieving price stability remains the cornerstone, and the government has vowed to launch a broad voucher-stye privatization in April 2000. The question here is whether institutions are sufficiently resilient to prevent the corruption of the sale of state-owned assets. The government has forecast a growth rate of 5% in 2000 and expects a sharp increase in exports, but both will be difficult to achieve in the current climate.¹⁵

Dealing with the FRY - Carrots and Sticks

The West confronts a particularly trying dilemma in forging a policy toward the FRY. Western imposed isolation alone will not solve the problem of that country's political and economic transformation. If anything, total isolation could strengthen Milosevic's hand, and in the minds of some Serbians, justify

his claim that the West is the true enemy. Milosevic's family and cronies have managed to flourish despite and perhaps even because of the many sanctions regimes that have been imposed on that country over the last decade. Moreover, the longer Serbia remains in its current limbo, the greater the challenge will be to rehabilitate it politically, morally and economically.

The country is an economic disaster with inflation running at nearly 50% per month, very high unemployment, and pervasive corruption, all of which make it impossible to imagine positive change, particularly given the regime's economic policies and the resources it has at hand. At the same time, the West cannot carry out business as normal with a regime whose leader and chief lieutenants stand accused of war crimes. Thus efforts are being made to reach out directly to the democratic forces in the country and to use targeted, humanitarian assistance as a means to differentiate democratic from authoritarian political forces. The idea has been to prevent the total isolation of Serbia while nonetheless cutting off Milosovic.

The West must now mark out a path for the Serbian people toward participation in the institutional and economic life of Europe while conveying that the way will remain blocked as long as the current regime maintains its grip on power. Ideally, the policy should seek to encourage the highly fragmented opposition to make Europe both a political rallying point against the current government and a central feature of its agenda for change. In this sense, the Croatian case could be instructive. The fact that the doors to Europe are cracking open for Croatia demonstrates to the Serbian people that there is a pathway to a democratic future. The process will not be easy either for Croatia and especially for the FRY as both countries must achieve some reckoning with their grave responsibilities for the disasters and crimes which have beset the region. Finally, the Serbian people must understand that they will be left behind economically and in terms of European integration if they fail to undergo democratic change soon.

In the immediate term, efforts to differentiate democratic forces in Serbia are essential. Serbia remains ineligible for unilateral trade preferences and the Phare programme, and the EU will never consider a Milosovic-led Serbia to be eligible for a Stabilization and Association Agreement. EU co-operation is limited to humanitarian aid, to support for democratization and to certain assistance measures, like the Energy for Democracy Programme, that bypass central authorities.¹⁶ That programme has been one of the more notable examples of this attempt to differentiate between the democratic and authoritarian strains of Serb political-culture. The FRY initially blocked consignments of heating oil at the border with the former Yugoslav Republic of Macedonia, but protests in the towns of Nis and Pirot compelled the government to relent. The EU is now looking to expand the programme to Novi Sad, Subotica, Sombor Kraljevo and Kragujevac. Again, the virtue of such initiatives is that they make it more difficult for Milosovic to suggest that the West is to blame for the ills that have beset the FRY. Indeed, they demonstrate that Europe is willing to assist the forces of democracy in Serbia and to play a defining role in the country's revitalization.

According to the UN, Serbia is spending \$1 million dollars a day importing electrical power, and in January, the Serbian electricity debt was estimated to stand at Euro 10.2 million.¹⁷ The regime recently struck a deal with Gazprom and has managed to import sufficient supplies of Russian oil and gas to stave off an energy panic. Serbian debt to Russia is mounting as a result. Nor is it clear how Serbia is financing its energy imports, although a \$300 million Chinese loan extended with fairly generous repayment terms has certainly helped.

The Centre for European Policy Studies (CEPS) has advocated that the European Union begin to prepare itself to provide substantial support to a post-Milosevic FRY. Any new government there would simply not be able to generate the resources needed for reconstruction and transition. The CEPS study sees eventual Western support for rebuilding the bridges of the Danube as essential, but argues that no public funds should go into rebuilding large factories which were loss-makers and which would continue to draw away precious resources into unprofitable ventures. At best, it might provide some income support to those who have lost their jobs.¹⁸

The federal government has sought to put the best face on a dismal economic situation. Television news in Serbia focuses on successfully rebuilt roads and plants which have returned to production. But the regime cannot hide the economic disaster for which it is largely responsible. A decade of tyranny, corruption and war have only hastened economic decline.

The ruined bridges on the Danube continue to pose problems and not only in Serbia. Romania has paid a high price as a result of the river's closure, and many Bulgarian ships are also stranded north of the FRY. Thousands of river workers have been laid off and many private shipping companies stand on the threshold of bankruptcy. Russian and Ukrainian ships carrying fuel to Yugoslavia, however, have been allowed to bypass the blocked portions of the Danube through an extensive network of canals and waterways. For months, the government of Slobodan Milosevic has refused to allow a clean up without Western cash to rebuild the fallen bridges, and Yugoslav officials maintain that the clean-up alone will cost \$33 million dollars. A provisional pontoon bridge has been erected in Novi Sad, but it will have to be removed if river traffic is to recommence. The 11 member Danube Commission has proposed that the EU underwrite a clean-up of the debris with a tender, upon which Yugoslav companies would be forbidden to bid.¹⁹ After months of attaching conditions to proposed clean up projects, the FRY agreed to accept this proposal, but there are no guarantees at this juncture that it will go forward. The City of Vienna has offered a temporary bridge to Novi Sad, but even this would require an exemption on the current sanctions regime.²⁰

Croatia

Croatia's recent elections results have injected a degree of optimism regarding its long-term prospects, suggesting to those who have despaired of democracy's shallow roots in the Balkans, that even those living under the region's more authoritarian states can find a way to build democratic and tolerant government. The lesson is particularly important for the Serbian people, who ultimately must decide if they will construct an alternative to the Milosevic regime.

The West has long said that improved relations with Croatia hinge on rapid dismantling of the county's anti-democratic structures, an end to Croatian interference in Bosnian internal affairs, a return of Serb refugees and cooperation with the International War Crimes Tribunal. Progress is now evident on all these fronts. The new Croatian President Stipe Mesic, whose inauguration was attended by 12 European heads of state and the American Secretary of State, has been quick to make overtures to the West, suggesting that his country will henceforth be more cooperative with the International War Crimes Tribunal. That said, the government of Ivica Racan recently unannounced its displeasure at the Tribunal's harsh sentence of Bosnian Croat General Tihomir Blaskic and may sponsor an appeal. On the positive side, members of the Croatian Parliament are looking at ways to end the unlawful financing of Bosnian Croats, and governing party leaders have stated that henceforth assistance will flow through normal channels.²¹

Croatia's new spirit of cooperation has been duly noted in Western circles, and a sea change is underway in Western policy toward Croatia. The EU has already begun an important political dialogue.²² But it wants to see better compliance with the Dayton peace, improved cooperation with the International Criminal Tribunal for the former Yugoslavia, and greater willingness to allow a return of Serb refugees who left during the war before it makes important concessions like opening the Phare programme to Croatia and considering it for Stability on Association talks.²³

The new government is also moving promptly to implement much needed liberalization measures. The Tudjman regime had long avoided serious restructuring and thereby bequeathed the current government a series of structural problems that will likely consume a great deal of political energy over the coming years. The former government's profligate spending has resulted in serious budget and current account deficits, both of which were exacerbated by last year's security related tourism collapse. The current account deficit for 1999 alone will approach \$2 billion. Although the D-Mark is now acting as a parallel currency in Croatia, external deficits have sparked a currency depreciation which, in turn, has fueled inflation. One of the first measures of the new government of Ivica Racan was to cut official salaries by 40%, a move which both marks an important symbolic break with the style of the previous government and sends a signal that fiscal rectitude will be a priority for the new government.

Unemployment stands at 20%; yet even this rather daunting figure does not adequately reflect real unemployment levels.²⁴

The state's critical need for financial resources to cover debt service has advanced the pace of privatization, and the new government is committed to moving quickly on this front. Croatia's most important insurance company and its three largest banks are all on the auction block.²⁵ Mesic has also promised to investigate past privatizations which many analysts believe were rigged to reward Tudjman's cronies - a practice which has likely cost Croat tax payers billions of dollars and left the economy in the hands of a number of unworthy managers.²⁶ Some arrests have already been made.

Croatia appears to have turned a political corner. The new leadership seems generally committed to undertaking the kinds of reforms that will make possible its eventual integration into Europe. Indeed, President Mesic has promised to bring Croatia into the European Union within five years - a rather optimistic prognostication, but one which nevertheless reveals a strong Croatian aspiration for integration in European institutions. Its possible future participation in NATO's EAPC should not be discounted either. The key will lie in the leadership's capacity to manage a tough economic transition while engaging in an historical reckoning that may not be popular but will nonetheless be a *sina qua non* for participation in the institutional life of Europe.

Bosnia-Herzegovina

The Bosnian economy stands at an important cross roads. Last year's conflict was particularly unsettling given the country's delicately poised ethnic balances, and the still fundamental institutional problems that need to be sorted out. Bosnia-Herzegovina is still plagued by the lack of consensus regarding a common state structure, very weak state institutions, organized criminal networks which have flourished in the absence of effective state institutions, and a civil society which is not highly articulated and remains splintered by ethnic tension. The country's ultimate economic situation will hinge, in part, on the degree to which the current political stalemate can be transcended, deeper cooperation among the republics secured and the government's capacity to wean itself from foreign aid reinforced. Foreign aid levels to the country are slated to fall. All of this challenges its divided political and economic leadership to move hastily from a condition of aid dependence to one of economic self sufficiency. That will not prove easy, but as the High Commissioner Wolfgang Petrisch has repeatedly warned, the huge influx of aid money and the construction boom associated with national rebuilding simply cannot persist indefinitely.

On the bright side, progress in refugee return and legislation on judicial and economic reform is moving ahead. The currency board, which pegs the Marka to D-Mark, has kept the lid on inflation, and the federal authorities have managed to enact important budgetary cuts. But state finances continue to depend on

foreign aid which is also underwriting an imposing trade deficit. That deficit, in turn, has been exacerbated by recently imposed Croatian tariffs and, course, by the utterly degraded Yugoslav market.

At the micro-level, voucher privatization began in September 1999, and one-third of state owned companies are slated for sale in 2000. The rest are to be disposed of through cash privatization. These sell-offs began in the Republika Srpska in July, but by mid-September, only 10 of the initial 350 firms had been purchased. The prospects are rather poor at this juncture that banking privatization will proceed as planned.²⁷

The lesson of Bosnia have been particularly instructive to the international community as it cobbles together a general development and integration framework for South-Eastern Europe. The aid effort in Bosnia has demonstrated that genuine development cannot be achieved in a geographical and conceptual vacuum. The countries of the region are simply too small and isolated. That ties throughout the region must be reinforced is now generally understood to be a precondition for genuine economic, infrastructural, cultural, and institutional transformation. The Bosnian case also stands as a warning against the hazards of aid dependency. Simply funneling assistance through underdeveloped state institutions has increased the scope for corruption and clearly worked at cross purposes with the goal of building market economies. As a result, Europe now appears committed to making regional assistance conditional both on internal political and economic reforms as well as deeper regional integration.²⁸ It is presently recognized that until coherent state structures and efficient and reasonably uncorrupted financial practices are in place, and only after the myriad barriers to trans-border commercial flows are torn down and access to European markets extended, will private foreign investment, the most powerful agent of economic development, begin to flow into the region.

The Stability Pact

All of this is more easily said than done. The Balkan region is utterly fragmented politically, institutionally and economically and is characterized by enormous insecurity. Moreover, there are powerfully entrenched groups that have managed to profit from this situation and thus tended to defend a status quo which has been immiserizing for the great majority of the region's peoples. The great challenge for the international community and particularly for the European Union, which has a high stake in a positive outcome, is to quell the great fears that have militated against regional integration and to do so through the promise of deeper economic and ultimately political integration with Europe.

The Stability Pact is the organization charged with coordinating various assistance programmes to South-Eastern Europe. It seeks as its primary goals to develop existing economic and trade relations with and within the region; build upon existing economic and financial assistance to buttress democratization,

civil society, education and institution building; foster greater cooperation in the area of justice and home affairs; advance inter-regional political dialogue and deepen the relationship between the European Union and the region.²⁹ The work of the Stability Pact's three round tables consequently reflects a recognition that political and economic reform in the context of greater overall regional security are all interdependent phenomena and that no strategy will be successful if not region-wide in scope. It is worth noting as well that while the FRY has not been invited to participate, there are efforts nonetheless to reach out both to the democratic government of Montenegro and to democratic forces in Serbia itself.

The Stability Pact is actually an umbrella organization in which regional aid initiatives in political, economic and security sphere are coordinated but not funded. Its own staff is skeletal and works with few financial resources and characterizes their mission as being a catalyst to action by other organizations and states. Indeed, the Special Coordinator, Bodo Hombach, has recently found himself prodding participating states to grant more generous financial concessions to the region. He has urged both the United States and the EU, for example, to raise export credit guarantees to South-Eastern Europe, arguing that such schemes will encourage private capital to flow into a region where risk premiums have been very high over the last decade. At the same time, Mr. Hombach has promulgated the idea of establishing a revolving fund that would collect debt repayments on behalf of the Paris Club of official creditors and use the moneys to finance projects in the region.³⁰ None of these initiatives will be administered by the Pact itself; yet, each will nonetheless fit into the broad panoply of initiatives it is coordinating.

Twenty-nine states are currently engaged in the Pact including EU member states, nine countries from South-Eastern Europe excluding the FRY, the United States and Russia and a number of international organizations. The current division of labour seeks to assign to various institutions tasks in which they enjoy a comparative advantage.

The World Bank, for example, has developed a credit programme, the Public Finance Structural Adjustment Programme, which will underwrite the development of public financial institutions like autonomous national auditing agencies, while undertaking initiatives to strengthen tax collection methods, enhance the capacity of regional actors to disburse public funds in an efficient and transparent manner, support central government's ability to manage and structure external debt as well as develop efficiently managed, low cost, social safety nets. This credit will total \$91 million which the Swiss and Dutch government are helping to underwrite.

The EBRD is concentrating on private sector development and particularly guarantee facilities for trade finance, credit for small and medium enterprises, micro-finance, equity funds, risk guarantee funds, and financial support facilities

for local contractors. It is also exploring the feasibility of underwriting infrastructure projects in the areas of transportation, energy and environment.

The OECD has worked with the governments of the United Kingdom and the United States to develop an Investment Charter to create common rules of the game and standards that will ultimately help foreign investors to operate in the region's markets. The countries of the region, with the exception of the FRY, have signed the Charter and see it as a means to encourage inward investment. The effort is supported by a Business Advisory Council of business leaders from the region and participating countries.

The Role of the EU

Of all the partner states and organizations supporting the Stability Pact, the European Union is clearly playing the most pivotal role. It is providing the bulk of development assistance, and for the period 2000-2006, it envisions 5.5 billion Euro of spending on regional programmes, although where these funds will come from is not yet clear. When development, macro-economic and humanitarian assistance as well as bilateral contributions from member states are counted, the EU has pumped in an estimated Euro 17 billion to the region since 1991.³¹ The Union has now made the ultimate integration of the region into Europe a guiding principal in its regional strategy, and with that lofty goal, it has set upon its most ambitious and high stakes foray into the conduct of a common foreign policy.

The inauguration of the EU's Stability and Association Agreements makes explicit the link between the current endeavour to stabilize the region and the longer-term goal of ensconcing it safely in the heart of Europe's economic and institutional life. The link is a natural one insofar as laying the economic, political, institutional and security based foundations for sustainable development, regional integration and international openness will invariably also move the countries of South-Eastern Europe closer to meeting the criteria for joining the Union.

The problem is that even securing agreement on these fundamental principals will be difficult. In fact, the Commission currently maintains that much of the region is not even prepared to begin this negotiation process.³² The one exception at this juncture is the former Yugoslav Republic of Macedonia which will begin talks in March - a testament to the great sacrifices that country has shouldered in recent years and its impressive contributions to regional security and inter-ethnic reconciliation in a period of grave crisis. It should be noted as well that Romania and Bulgaria are not part of this initiative even though their stakes in the process are very high. Both of these countries, in fact, are already part of the club of 10 countries engaged in the pre-accession process.

At present, 60-90% of exports from the countries which were part of the old Yugoslavia go to the EU. And according to the Union, more than 80% of

exports from Albania, Bosnia and Herzegovina, Croatia and the former Yugoslav Republic of Macedonia enter the EU duty free. The EU estimates the value of preferential trade concessions at Euro 100 million Euro per annum. But many analysts believe that the barriers to more open trade, including the dearth of export credit finance, poor transportation infrastructure, restricted access to Europe's agriculture markets, and regional border controls continue to make it very difficult to sell in the central markets of Europe. For its part, the Clinton Administration has sent draft legislation to Congress both to grant \$398 million in bilateral and regional funding (excluding Kosovo which will fall under a separate appropriation) and to provide unilateral duty free access to the US market for goods from South-Eastern Europe over five years. These concessions would include imports of sensitive products like footwear, iron and steel. Madeline Albright has urged the EU to move in this direction as well.³³

The EU is apparently looking at ways to link further opening to European markets to progress in breaking down regional barriers to trade and transportation. The Commission has announced that the Stabilization and Association Agreements will contain the objective of concluding regional cooperation conventions that would establish a free trade area with other countries that have signed such agreements with the European Union. This makes very explicit the link between liberalization and integration at the regional level and integration at the pan-European level. The European Union is the largest integrated market in the world, and granting the Balkans more liberal access to its market will be critical to the development of the region's economies. The combined GDP of Albania, Bosnia, Bulgaria, Croatia, Yugoslavia, the former Yugoslav Republic of Macedonia and Romania is roughly \$108 billion or 1% of that of the EU.³⁴ As a point of departure, therefore, granting that kind of access to European markets is unlikely to have a dramatic impact in the EU itself.

Most economists agree that as a first measure, a free trade area should be established among the successor states of the old Yugoslavia which would eradicate all tariff barriers among them. Once this is in place, and that will hardly be an easy task, the effort could turn toward building a customs union with a common external tariff, an arrangement which might make it easier to forge a common economic area with the European Union.³⁵ Currently high barriers to regional commerce are grossly complicating the immediate reconstruction effort as well as long-term development.

The CEPS study advocates an even more drastic approach by which Balkan states would be rapidly integrated into a customs union with the EU. The EU, in turn, would compensate the region for the foregone tariff revenues because tariffs are currently a primary source of public finance throughout the region. The rationale here is that the Balkans are so poor, that regional integration alone will not be sufficient to generate any kind of momentum for economic development. To ease the impact of increased competition, the Union should also provide some income supports, but not funds which could be used to subsidize loss-

making industries. When it is politically and diplomatically tenable, this programme could be extended to Serbia as well. Finally, the CEPS study suggests that because of border corruption and administrative delays, once a free trade area were in place, the countries in the region might be best off farming out customs controls to private international companies. Such proposals suggest that in an era of globalization, the countries of the region should be prepared to accommodate themselves to a more limited view of national sovereignty to facilitate their integration into European and global markets. The problem, of course, is that many of these countries have only just attained that sovereignty, and it is not always politically palatable to forgo newly acquired national powers after long struggles to secure them.

While it is obviously not feasible to extend the CAP into South-Eastern Europe, the EU could contribute greatly to regional development both by offering tariff free quotas for agricultural goods and even by allowing the region to impose countervailing duties on EU food imports that effectively mirror EU subsidies. The latter could thus become a means simultaneously of generating government revenue and mitigating the price distortions of EU subsidies. In this way, according to CEPS, EU agricultural export subsidies, which already have undercut South-Eastern Europe's vital agricultural sector, would become transfer payments. The EU now exports 20 times more food from region than it imports.

Obviously opening agriculture markets will be politically difficult to manage in Europe. Yet, South-Eastern Europe's agricultural capacity is far smaller than Europe's as a whole, and the impact upon West European farmers of granting such access consequently is not likely to be substantial. Moreover, there are already numerous political, budgetary and international pressures to liberalize the European agricultural system; granting South-Eastern Europe greater access to that market should be made part of the greater reform effort that Europe certainly needs to undertake.

The Monetary Dimension

Achieving monetary stability in the region is a fundamental precondition for sustainable growth and development. High inflation profoundly distorts business practices, skews inward investment and discourages foreign investors from entering local markets. A certain amount of progress has already been achieved on this front as the former Yugoslav Republic of Macedonia, Kosovo, Montenegro and Bosnia Herzegovina are using the D-Mark as a parallel currency. But there are questions as to whether current arrangements are sufficiently resilient to the kinds of shocks to which the region has been susceptible. It may be that an even tougher anchor systems is needed to prevent speculative attacks and to make the stand against inflation fully credible. The risk of a possible exchange peg collapse could well discourage investment flows, particularly after the recent

East-Asian experience in which so many international investors were scorched when the Thai Baht, previously thought to be tightly anchored to the dollar, collapsed.

There are many suggestions now that full monetary “Europeanization” may be the best way to counter this risk. This could be accomplished through the creation of currency boards like the one which has been set up in Bulgaria. Currency boards would effectively eradicate the most important features of monetary sovereignty and effectively make the European Central Bank the central bank for the region. Some analysts suggest that to ensure the complete invulnerability of a currency board to political intervention, they also seat non-national experts - yet another explicit suggestion that part of the solution to the region’s economic crisis may lie in voluntarily suppressing certain traditional elements of national sovereignty. CEPS has proposed that the EU should back the board’s reserves with a 0% interest loan that would equal the amount of currency in circulation (the amount of currency in circulation in any given economy is usually equal to 5-10% of GDP, and the region’s GDP is very small relative to that of the European Union.) Bosnia-Herzegovina, the former Yugoslav Republic of Macedonia and Kosovo would accordingly require collectively Euro 3 billion in cash for Euro-backed currency boards. That loan could be raised on private capital markets, and the cost to the EU would lie in covering interest payments on the loan.

Once this system is in place, old cash could be exchanged for new notes and coins, and any seigniorage, the earnings that accrue to the European Central Bank as a result of inflation, would invariably fall to the ECB. But the benefits of lower inflation and the inability of the political class to interfere in monetary matters would clearly outweigh the cost of lost seigniorage. Finally, without a lender of last resort, banking reform would be an essential element of any such system. Full liberalization and privatization of the banking system would therefore have to follow. The expectation would be that large international banks would begin to enter the market either directly or through the acquisition of local banks. Either way, their presence would be instrumental to bringing in foreign capital.³⁶

The Environmental Dimension

Environmental assistance to South-Eastern Europe is essential, particularly over the medium- to long-term. But there are also hot spots notably in Pancevo and Novi Sad, Serbia³⁷ which demand immediate attention regardless of the current sanctions regime. To neglect consideration of the environment in the construction and development process will only burden the region with long-term problems and costs. What has happened recently in the Tisza river clearly reveals existing deficiencies in the region’s regulatory structure, the inherently international nature of environmental problems, and the huge costs that will

accrue if an adequate, region-wide environmental regulatory framework is not established quickly. This demands Western financial and technical assistance to develop environmental policy tools and conduct environmental impact assessments. At the same time, cooperation among the states in the region will be essential to setting up this framework.³⁸ The Environmental Action Programme (EAP) Task Force, which engages environmental ministers from the OECD and Central and Eastern Europe countries is particularly well placed to assist in framing an environmental reconstruction strategy for the Balkans. Bilateral assistance can also help. Some of the more successful transition countries in Central Europe for example, are using their experience to assist the region's governments develop local environmental action plans, legal and institutional structures, investment strategies and tools for policy implementation.³⁹

But civil society at large must feel that it too can participate in a meaningful way to ensure sustainable and environmentally friendly economic and political development. Environmental rehabilitation and the development of democratic institutions are closely intertwined, and the importance of this relationship has been recognized in the UN/ECE's Convention on access to information, public participation in decision-making and access to justice in environmental matters (the so-called Aarhus Convention). Environmental cooperation can foster international and inter-ethnic reconciliation particularly given the inherently shared set of interests at play. Obviously NGO's have a vital role to play in this regard, and they must insist on transparency in decision-making and on dialogue with governmental decision-makers and industry.

Fostering Infrastructure Links among Regional Actors

Another critical aspect of deepening regional integration will involve the very practical task of building trans-border infrastructure networks to solidify links among the region's actors. The state of South-Eastern Europe's transportation, communication, and energy infrastructure is currently very poor and has been degraded as a result of the old Yugoslavia's break-up and the Balkan wars that ensued. Improved transport and communications networks are virtually a precondition now to restoring economic ties among the region's states and to lowering the cost of conducting business across those borders. There are a number of initiatives under the guise of the UN/ECE, the South-Eastern Co-operative Initiative (SECI) and the EIB to assess the communications and transport infrastructure needs of the region. A coming donor's conference will seek to raise funds for the "Corridor 8" highway system across the Balkans - a project which includes modernization of the Albanian port of Durres.⁴⁰ In April, a Memorandum of Understanding was signed in Athens by the region's transport ministers, under the aegis of SECI, to liberalize regional road transport, harmonize procedures, rationalize charging policies, and upgrade information systems regarding these

charges. Such initiatives must be followed up and funding should be made available to carry them to completion.

Restoring navigation on the Danube will also be vital, particularly to countries like Romania and Bulgaria, which see that waterway as key transportation link to Central Europe. The Stability Pact Special Coordinator, Bodo Hombach, played an important role in a mid February agreement between those two countries to construct a new bridge across the Danube, a project that could also be granted priority funding at the March donor's conference which is to select roughly 130 cross-border projects for funding.⁴¹ Representatives from the former Yugoslav Republic of Macedonia, Montenegro and Albania have also agreed to cooperate more closely to plan road, rail, telecommunications and power links among themselves, again with an eye on gaining much support from the international community. Ultimately, however, there will be significant improvement to regional transportation links without Serbia. Its pariah status and the destruction of numerous road and rail bridges that traverse it have had a terribly adverse impact on trade among Balkan states, and with the rest of Europe. This obviously remains a delicate political problem that the West must navigate with great care.

Finally, the question of infrastructure cannot be separated from the anti-competitive practices of the region's utilities companies, many of which enjoy monopoly status. Eradicating these monopolies and driving prices downward can be most efficiently achieved through well-supervised privatization and by opening up the region's utilities to European energy grids. This is a priority area for a number of the organizations operating in South-East Europe, and the Greek government is now working with seven other countries to integrate the region's energy markets.

Conclusions

For all the good intentions of the West and despite the emergence of more liberal and dynamic governments in countries like Croatia, the Federal Republic of Macedonia and Bulgaria, as well as in Montenegro, great optimism as this juncture would be misplaced. The institutions of the Federal Republic of Yugoslavia, a country which sits astride the vital cross-roads of the Balkans, are still under the control of a regime whose leader has been indicted for war crimes and with whom cooperation is well nigh impossible. The security situation in Kosovo itself remains explosive, and this as well as the open question of its final status, its tattered social fabric, and the decimated condition of its infrastructure make it difficult to envision rapid and well entrenched economic progress. Persistent regional insecurity continues to run up against the economic and political imperative for deeper regional integration. Such integration demands a high degree of mutual trust, which at this juncture at least, is not in evidence. Weak state structures are everywhere apparent; criminal groups and black marketers

have inevitably filled the void, and in some cases have permeated state structures. Finally, the machinery of Western support is hardly running smoothly and it is an open question whether Western funding will match the promises that have been made.

On the other hand, there is at least now a general recognition that aid and restructuring efforts need to be better coordinated, much better funded, region-wide, market-oriented, and contractual in nature. The terms of the region's ultimate membership in the Europe's economic and political institutions are being spelled out, and Europe has acknowledged its obligation to assist regional actors begin in meeting those terms. The EU can trace out a path leading to a higher degree of economic development and reduced ethnic tensions. Ultimately, it will have to do even more, and indeed both Europe and North America must quickly lower existing barriers to trade even in sensitive sectors like textiles and agriculture to help this region help itself.⁴² In the short-term, however, more financial support is urgently needed, particularly to stabilize Kosovo and to ensure the day-to-day running of its public administration and basic social services. Continuing high profile Western and local efforts will be needed to foster inter-ethnic dialogue and reconciliation.

In the final analysis, there is no one-off solution to the great challenges the region faces. No single appropriation of aid funds or set of locally implemented policies will alone foster peace, democracy, a cleaner environment and prosperity. Rather, the Western community needs to think in terms of an ongoing process that engages not only the region's leaders, but also their shaken civil societies and the shattered institutions which have so eroded state authority. Above all, there will be no solutions unless some degree of societal consensus can be formed around a broadly shared vision for the future. Ultimate European integration, with all the political and economic choices implicit in that aim, should lie at the core of this consensus.

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** A longer version of this report will be presented to the NATO Parliamentary Assembly's Economic Committee at its May, 2000 Session in Budapest, Hungary.

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MAKING A DIFFERENCE IN THE BALKANS: THE EAST-WEST INSTITUTE ACTION NETWORK FOR SOUTH EASTERN EUROPE

Vera Budway

Director, Action Network for South Eastern Europe, Prague

Background

South Eastern Europe remains one of the most volatile regions in Europe today. The conflict that erupted with the disintegration of Yugoslavia exacerbated decades-old ethnic and political tensions inherent in the countries of the region. The international community has conceived a plethora of initiatives in an attempt to abate hostilities and to foster a spirit of peace and cooperation in the region.

Yet bringing peace and stability to the region requires more than an end to the conflict, emergency refugee assistance and rebuilding destroyed infrastructure. The international community now has a rare opportunity to address the core issues that have brought instability and conflict to this part of Europe.

The EastWest Institute (EWI), with nearly 20 years of experience working at both the grass-roots and top policy levels in the region and throughout Central and Eastern Europe, has launched a multi-year initiative designed to promote peace, stability, economic revitalisation and integration of South Eastern Europe into the Euro-Atlantic community. The initiative - the Action Network for South Eastern Europe (ANSEE) - incorporates clusters of projects which are cross-border in nature.

Goals and Objectives

The impetus behind ANSEE is to encourage regional, cross-border approaches to economic and civic development in South Eastern Europe. Projects will address issues concerning private sector development, foreign assistance and investment, strengthening democracy and civil societies, and transfrontier co-operation. ANSEE will involve indigenous actors to build a local capacity for economic development. It will also work closely with grass-roots initiatives to develop policy strategies for long-term, sustainable growth.

ANSEE will endeavour to facilitate close co-operation among the governments of the region and create new channels of communication among policymakers, regional and non-governmental players. The most important objective of ANSEE

is to help prepare the countries in the region for integration into larger European structures.

Methodology

EWI will work closely with local partners and select private and public sector leaders from the region and the international community to develop viable and implementable reconstruction strategies. EWI encourages the involvement of other regional initiatives such as the Southeast European Cooperative Initiative (SECI), the Southeast European Co-operation Process (SEECOP), the Central European Initiative (CEI), the Black Sea Economic Co-operation (BSEC) and the Royatimont Process. Institutions with a regional focus are also welcome to contribute to ANSEE.

EWI furthermore invites all European industries and private sector leaders to contribute their expertise to individual projects or groups of projects in the framework of joint co-operative action. In implementing the goals and objectives of ANSEE, EWI hopes to forge close co-operative ties with the European Commission. EWI will also rely on the expertise and experiences within the Commission in project implementation.

Participating States

ANSEE activities will target the following countries in the region: **Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Federal Republic of Yugoslavia, the former Yugoslav Republic of Macedonia, and Romania.** Responding to the pressing demand to become engaged, the EastWest Institute has developed four major areas of involvement, which form the cornerstone of ANSEE's programmatic activities:

- **Reintegration of the Federal Republic of Yugoslavia into a civilised relationship with its neighbours and the global community.**

Peace with and within Serbia is a precondition for long-term stability in South Eastern Europe. The international community must avoid creating "second-class" countries or nations in the region. An isolated Serbia will only bring more instability and suffering to its own people and to those nearby. At the same time, it is necessary to build democracy and a free market within the FRY to assure its active participation in the post-war reconstruction process and its reintegration into the global economy.

In the framework of ANSEE, EWI will involve key pro-reform FRY leaders in regular dialogues - both internal and with the international community - evaluating the situation in Yugoslavia and preparing basic strategy documents for future reconstruction aid. The first such dialogue took place in Bratislava on July 21-22, 1999 in the framework of a conference entitled "The Future of the Federal Republic of Yugoslavia in the Context of the Post-War

Reconstruction.” The Conference, which was organised by EWI in co-operation with the Ministry of Foreign Affairs of Slovakia, brought together high-level officials from the international community, academics, businessmen and investors from the region, other Eastern European countries, Western Europe, Russia and the United States.

One of the recommendations of the Conference was that pro-democracy forces within FRY should establish a **Community for Change** rather than unity around leaders. Another recommendation called for the international community to establish a New International Partnership with the people of the FRY. As a result, a **Task Force on the Future of the Federal Republic of Yugoslavia** was established in order to promote this new international partnership. The Task Force will evaluate programmes of different organisations and individuals belonging to Community for Change and will recommend that support be given to those programmes that are beneficial for building democracy in the FRY. The Task Force will also serve as an important link between members of the Community for Change and the international community. Finally, it will provide assessments and recommendations on policies for social and economic transformation and development in the FRY. The Task Force will operate in the framework of ANSEE.

- **Championing regional voices in strategies for sustainable economic development.**

The international community has produced a plethora of projects, proposals and initiatives for South Eastern Europe. In spite of this, the region still lacks a viable, result-oriented strategy for overall sustainable economic development, which is practical and non-academic in its approach. In response to this need, EWI has launched a **Task Force on Economic Strategy for South Eastern Europe** under the auspices of ANSEE.

The Task Force will prepare concrete policy recommendations for stimulating foreign investment and developing the private sector in South Eastern Europe. It will analyse the business-operating environment in the region and will propose strategies for economic growth. Particular attention will be paid to local participation in post-war reconstruction, integration in the European economy and development of the SME sector in the region.

The Task Force will also contribute to developing a viable strategy for the implementation of the goals and objectives outlined in Working Table Two of the EUs Stability Pact for South Eastern Europe. The strategy needs to reflect the priorities of the region as articulated by the key actors and decision-makers in the region. These proposals will be compiled in a strategy paper which will be disseminated to the European Commission, the Office of the Stability Pact Co-ordinator, EU governments, IFIs and other international organisations involved in the reconstruction effort. The paper should serve as a policy guideline for further action.

To strengthen the economic prerequisites needed for peace and stability in South Eastern Europe, EWI will work with local partners and government officials in the region to support indigenous private sector development and the growth of small and medium enterprises. EWI will co-operate closely with the **Business Advisory Council** to SECI in order to develop and implement strategies for making efficient use of outside assistance in conjunction with local businesses.

- **Building local capacity and leadership for sustainable peace and prosperity.**

Reconstruction and development in South Eastern Europe cannot take place without the determined efforts of strong local institutions working together with reform-minded parliamentarians. To address this issue, EWI has begun to work with key local NGOs, government and private sector representatives to strengthen their capacity and expertise, and to help them create critical mass through coalition building between the three sectors.

Furthermore, the Institute will form an **MP Network** in the region that will offer direct practical information on democratic development issues, inter-ethnic relations and leadership development practices. This network will create a forum for open dialogue among reform minded MPs, train the group in leadership development to ensure that these leaders create a stable, market-driven and democratic government for future generations, and create a practical network for South Eastern European parliamentarians to work together towards implementing the principles outlined in Working Table One of the Stability Pact for South Eastern Europe. In creating this network, EWI will closely co-operate with the European Parliament, the Council of Europe, the European Commission, the OSCE, SEECP and the Royaumont Process.

- **Embedding transfrontier co-operation in South Eastern Europe.**

Border areas in South Eastern Europe are the “friction plates” of the region. They are the areas where different ethnic groups and religions meet, and thus are prone to potential future conflicts. EWI has a ten-year history of promoting transfrontier co-operation in Central and Eastern Europe, and will respond to requests to help revive cross-border co-operation between Hungary, Vojvodina and Romania (the Danube-Tisza-Maros Euroregion) where such cooperation was interrupted by the war. It will also encourage new efforts between Bulgaria, Macedonia and Serbia, and between Montenegro, Croatia and Bosnia-Herzegovina.

Transfrontier co-operation is also essential for the development of the region’s infrastructure and adequate means of financing and management structures for oversight and control need to be elaborated. This is an area where partnership between the public and private sector is required. EWI will work to facilitate such partnerships among these regions and work to establish new “euroregions” in South Eastern Europe in co-operation with the EU, regional and sub-regional initiatives.

Implementation

In implementing all activities, EWI will work closely with the key international actors, the EU states and institutions, UN, OSCE, the Southeast European Cooperative Initiative, and the Council of Europe.

To address the needs and guide the projects outlined above, EWI will create two Advisory Boards: an Advisory Board for Policy and Strategy which will guide ANSEE and develop policy strategy for top-down projects in the region; and an Advisory Board for Local Initiatives which will co-ordinate bottom-up approaches using local resources and focusing on co-ordination of private and volunteer activities between countries in the region and their immediate neighbours.

These advisory boards will work in close co-ordination and consultation with the ANSEE Leaders Network, the Economic Strategy Group, and the Task Force on the FRY. In launching ANSEE, EWI hopes to embark on a wider co-operative effort which will combine the Institute's vast experience and proven track record in East Central Europe and Russia with the experience of regional initiatives such as SECI, Royaumont, BSEC and CEI, as well as the expertise in international organisations such as the UN/ECE and OSCE. Most importantly, EWI has to make sure that it is involved in any discussion that the EU might have concerning any regional stability pact/plan. In light of all the proposals ensuing from the EU states and institutions, OSCE, US, and individual countries and institutions in the framework of these groupings, it is imperative that no new structures are created but rather that all existing organisations, institutions and groupings are able to maximise their full potential. Through ANSEE, EWI is ready to work within the parameters of the Stability Pact and implement the principles contained within.

ECONOMIE, SECURITE ET STABILITE EN RUSSIE: DES ENCHAINEMENTS FATALS?

Gérard Wild

*Centre d'Etudes Prospectives et d'Informations Internationales (CEPII),
Paris*

Tous les Etats sont soumis, à tout moment, à des menaces internes et externes qui tendent à mettre en cause plus ou moins radicalement leur intégrité fonctionnelle, voire leur identité; en un mot, à les déstabiliser au point de troubler leur sécurité. Les manuels modernes de science politique dressent une liste longue des facteurs, notamment économiques, susceptibles à la fois d'effriter les cohésions internes et d'affaiblir les protections externes.¹ Appliquer les grilles de lecture fournies par ces ouvrages à la Russie d'aujourd'hui fait de celle-ci un des Etats du monde où la question de la sécurité, au sens le plus profond du terme, se pose avec la plus grande acuité: les évolutions politiques et économiques semblent n'y obéir à aucune autre "logique" que celle de l'anomie. La crise longue que traverse le pays, rythmée par des crises conjoncturelles dont chacune paraît être annonciatrice d'un cataclysme définitif, est une sorte de "cas d'école" de la spirale descendante qui relie économie, stabilité et sécurité. A cette aune là se dessine pour la Russie - et par contrecoup pour le reste du monde - un avenir de plus en plus gris.

Deux schémas classiques d'analyse sont le plus souvent mobilisés pour rendre compte de la situation particulièrement inquiétante de la Russie (pour elle-même et pour son environnement international proche ou lointain) du point de vue des relations entre économie, stabilité, et sécurité. Ils sont largement complémentaires, et les auteurs qui analysent l'évolution russe en terme de dérive fatale les manient ensemble. Néanmoins ils renvoient à des logiques explicatives distinctes. La première approche met au centre de sa critique la stratégie économique libérale, lancée en 1992, qui a mis à mal le tissu productif et bouleversé le système de propriété: en ce sens, elle fait de l'économie le chaînon conducteur de la question sécuritaire. La seconde approche met la spécificité russe au cœur de son analyse: en ce sens elle est de nature "culturaliste" et fait de l'économie un champ de vérification d'une hypothèse plus large.

Il faut reconnaître cependant que ces cadres d'analyse courants, qui débouchent le plus souvent (depuis près de dix ans) sur des prospectives de dérive, voire de chaos, auxquels la Russie semblerait inéluctablement vouée, ne suffisent pas

à rendre compte de façon totalement satisfaisante du lien entre économie, sécurité et stabilité. Ce qui se déroule en effet dans ce pays est un basculement radical de l'ensemble des référentiels sociaux. Le "choix", amorcé au début des années quatre-vingt-dix, d'un nouveau système d'allocation des ressources et de nouvelles modalités de répartition des pouvoirs est aussi celui d'une nouvelle conception de la sécurité globale du pays. Il y aurait, dès lors, une cohérence dans les mouvements qui affectent la Russie: stabilité, économie et sécurité seraient liées dans le cadre d'un processus de construction par ajustements successifs des divers éléments du système en création. Que la Russie parvienne à réaliser cette construction n'est certes pas assuré: du moins cette lecture-là de la trajectoire ouvre-t-elle d'autres perspectives pour la compréhension et l'accompagnement de la transformation du pays.

La politique économique russe et ses implications pour la sécurité

Le lien qu'on établit le plus généralement entre l'économie, la stabilité et la sécurité passe par le rappel des performances économiques, puis par l'analyse de leurs conséquences sociales et politiques, enfin par l'examen des conditions dans lesquelles cet ensemble de caractéristiques de l'évolution interne affecte la relation avec l'étranger, et donc la sécurité externe. La Russie, de ce point de vue, fournit une occasion particulièrement "riche" pour vérifier l'existence d'une spirale dépressive par laquelle une politique économique donnée semble avoir enclenché une instabilité croissante et une dégradation marquée de la sécurité globale.

Crise structurelle et crises conjoncturelles

La Russie traverse depuis 1992 - date de la mise en place de ce qu'il est convenu d'appeler la thérapie de choc - une crise économique sans précédent: il suffit, pour la caractériser en un chiffre, de rappeler qu'elle a conduit en dix ans à réduire de moitié environ le niveau de production.² Cette crise structurelle interminable a été abondamment commentée, et le propos ici n'est pas d'en proposer une description supplémentaire. Ce qu'il convient de souligner par contre, c'est que les solutions proposées pour mettre fin à l'effondrement de la production nationale ne semblent avoir pour seul résultat que de l'aggraver, et de conduire le pays de crise conjoncturelle en crise conjoncturelle de plus en plus aiguë. La dernière en date, celle du mois d'août 1998, est apparemment révélatrice de l'incapacité à stabiliser l'économie par des recettes inscrites dans la même logique macro-économique que celle qui est réputée avoir provoqué le cataclysme productif. Elle paraît avoir démontré en outre que la privatisation semblait plus se signaler par des effets pervers que par une amélioration de l'efficacité générale des entreprises. A peine a-t-on réduit l'inflation et amorcé

la stabilisation du produit national que les finances extérieures se dégradent; pense-t-on avoir trouvé un remède à cette dérive qu'il apparaît pire que le mal, débouchant sur une nouvelle poussée inflationniste et une nouvelle baisse des productions. On se trouverait ainsi devant une sorte de spirale descendante justifiant une remise en cause radicale de la stratégie adoptée initialement. Macro-économie et micro-économie sont déconnectées, de même que sphère réelle et sphère financière. C'est la stratégie dans son ensemble qui paraît devoir être condamnée, et revue. Et dès lors que cette stratégie a été élaborée en liaison avec les institutions financières internationales - sous leur pression disent certains - ce sont elles aussi qu'il convient de récuser, sous peine de voir le pays continuer de glisser vers d'autres crises et un chaos de plus en plus prononcé.

Crise et sécurité interne

Une crise économique d'une telle ampleur et d'une telle durée ne peut conduire qu'à faire peser des risques graves sur la sécurité interne du pays. Pour une part la crise joue à la façon d'un révélateur: elle favorise le creusement de fissures sociales préexistantes à la crise économique elle-même. Ainsi, elle exacerbe le potentiel conflictuel qui résulte du caractère multinational de la société russe. La crise tchéchène n'est certes pas à mettre principalement au compte de la situation économique - les passions se nourrissent dans ce cas, et dès l'origine, d'un passé tsariste et soviétique lourdement chargé - mais on peut penser qu'elle n'eût pas prit le même tour dans un contexte moins dégradé. De la même façon, les tensions entre le centre et les périphéries républicaines (le Tatarstan en particulier) doivent vraisemblablement beaucoup à la crise économique et à la volonté qu'ont les autorités locales de protéger leurs populations, de préserver leur pouvoir dans la répartition des ressources.

De tels comportements caractérisent aussi les "sujets" russes de la Fédération, au point que certains scénarios d'éclatement du pays, évoqués dès le début de la transformation et renouvelés à l'occasion de chaque crise, ne les distinguent guère de ce point de vue des "Républiques ethniques". A tout le moins, l'hétérogénéité des contrats liant le Centre et les différents éléments de la périphérie en matière de répartition des pouvoirs - dont celui de l'allocation des ressources - est lié à la différenciation des situations de crise, tout autant qu'à la volonté de construire un fédéralisme moins formel que celui qui régnait en U.R.S.S.

Plus profondément encore, la crise économique, par ses effets négatifs sur la sécurité des individus et l'accès, de plus en plus inégal, aux ressources, nourrit l'échappement d'une grande partie de la société et de l'ensemble de ses acteurs à la volonté du centre, fragilisant toujours plus le pouvoir et la légitimité de ce dernier. La triple question de la fuite des capitaux, du non-paiement des impôts, et du développement de l'économie parallèle en témoigne avec évidence. Enfin, et la crise du mois d'août 1998 l'a à nouveau montré, c'est la vie politique qui se trouve de plus en plus profondément déstabilisée, et radicalisée. L'économique,

le social et le politique semblent ainsi liés dans une autre spirale régressive, dont l'aboutissement, à moins de considérer que l'instabilité et l'insécurité croissantes puissent être des caractéristiques durables d'un système social, ne peut être en effet qu'un désordre sans cesse croissant.

Economie et sécurité externe

Une liaison tout aussi néfaste part de l'économie pour mettre en cause cette fois la sécurité externe. Elle passe bien sûr par la réduction considérable du potentiel de défense, que ce soit du fait de la destruction ou du mauvais fonctionnement d'une partie des industries militaires. Elle passe encore par la démoralisation qui touche les personnels des armées, logés en grande partie à la même enseigne que le reste de la société. Il suffit de rappeler, pour évaluer d'une certaine façon l'affaiblissement de la capacité à assurer, ne serait-ce que par le moral des troupes, la sécurité externe (et à certains égards, comme le suggère l'affaire tchéchène, la sécurité interne), que la moitié des électeurs dépendent d'une façon ou d'une autre des forces armées (militaires, travailleurs du complexe militaro-industriel, retraités, ainsi que leurs familles).³

Mais là peut-être n'est pas le risque le plus marqué qui pèse sur la sécurité externe: à nouveau un enchaînement se met en place qui, conduit à exacerber les dangers, pour la Russie et pour le monde extérieur. On renvoie ici au sentiment de menace que la perte du statut de puissance internationale majeure de la Russie engendre dans la société et dans ses élites politiques: au point que l'étranger - l'Occident - finit par être suspecté d'avoir été et d'être le fossoyeur conscient du pays par les conseils prodigués et les conditions formulées dans le cadre de son "assistance". Une fois de plus, la crise de l'été 1998 doit être évoquée pour illustrer le caractère circulaire du mécanisme de méfiance réciproque qui s'installe entre la Russie et les pays et institutions occidentales. Et on ne saurait évidemment sous-estimer les logiques de raidissement croissant de la relation avec l'extérieur: la crise du Kosovo a démontré que la tentation en était forte. La question de l'élargissement de l'OTAN relève d'une logique similaire de renforcement des postures conflictuelles. L'effondrement économique de la Russie semble bien être la cause centrale de la moindre capacité du pays à peser sur les relations internationales. Il peut être également perçu comme la raison principale du rétrécissement géographique de sa sphère d'influence, y compris vis-à-vis des pays les plus proches et, par conséquent de l'extension de celle des pays occidentaux.

Nombre d'observateurs, russes ou occidentaux, appliquent au cas russe cette analyse simple mais robuste de la relation entre sécurité, stabilité et économie, où cette dernière apparaît comme la base matérielle du désordre actuel et du chaos à venir, et où se trouve mise au cœur de la "fonction de sécurité" la stratégie économique engagée en 1992 et poursuivie avec une certaine constance depuis lors. La pertinence de cette thèse, formulée dès le départ de la transition,

et qui donne au “niveau des forces productives” (symbolisé par la croissance) et aux “rapports de production” (résumés par le mode de propriété) un rôle explicatif majeur, mérite cependant, malgré sa robustesse, d’être vérifiée, et à tout le moins d’être complétée.

L’irréductible spécificité de la Russie

Une interprétation qui ferait de l’économie le *deus ex machina* des risques qui pèsent sur la sécurité de la Russie (jusqu’à menacer son existence même) ne suffit pas en effet à rendre compte en totalité de la relation entre économie, stabilité et sécurité. Il est à cela des raisons d’ordre général, qui valent pour tous les pays qui sont engagés dans des logiques profondes de changement, et notamment les pays en transition. Elles conduisent à prendre en compte la dimension socio-culturelle de la transformation. Mais les contempteurs de la stratégie économique mise en œuvre en 1992 en Russie vont plus loin: ils soulignent dans leurs analyses les spécificités radicales du pays de ce point de vue. Le lien entre économie et sécurité y devient alors si particulier qu’il semble rendre la Russie irréductible à toute stratégie ayant pour objectif d’y instaurer la double logique du marché et de la démocratie.

Société et économie

Les champs social et politique ne peuvent être considérés, c’est banal de le dire, uniquement en tant que lieux d’observation de l’impact de chocs survenus dans la sphère économique. Ils sont aussi des facteurs déterminants de l’évolution économique: chaque société se caractérise par un ensemble de pratiques et de représentations héritées du passé qui influent à la fois sur l’acceptation, l’orientation, et la réussite de toute stratégie économique novatrice. A ce titre déjà, ils jouent un rôle à part entière dans la montée ou l’atténuation des risques d’insécurité. L’économie étant en relation de complémentarité circulaire avec le social et le politique, il était donc naturel que ce point prenne sa place dans l’analyse du changement en Russie. Et ce qui rendrait ce pays particulier, dans cette perspective, c’est d’abord la dimension dramatique de l’évolution de l’économie, donc des conséquences sociales, donc des risques pesant sur la sécurité par effet cumulatif.⁴

Il semble qu’il y ait accord entre la plupart des observateurs de la transition russe sur le fait que l’économie est source d’insécurité, et sur le fait que le social et le politique jouent un rôle aggravant dans la crise. Ce qui est moins communément admis par contre, c’est de considérer que dans son cas, le lien croisé de l’économie et du social ne puisse conduire qu’à l’insécurité absolue⁵: la remise en cause de son existence, à tout le moins sa capacité à maintenir une trajectoire de transformation pacifique.

Or il est suffisamment de pays où - contre toute attente si on veut bien se souvenir des nombreuses mises en garde énoncées dans le passé et fondées sur

des analyses proches de celles qui sont faites à propos de la Russie - les enchaînements fatals ne se sont pas produits pour qu'on puisse imaginer qu'ils n'ont pas plus lieu d'être dans ce pays que dans les autres. Ou alors il faut admettre que le cas russe se distingue par des pesanteurs particulièrement prononcées, des particularités irréductibles pour qu'on affirme à son sujet que l'issue de la tentative faite pour y instaurer la démocratie de marché ne peut y être que négative. C'est en effet ce que nombre d'analyses tentent de mettre en évidence.

Sécurité externe et choix de développement

Ces analyses, il est vrai ne manquent pas d'arguments. Il est indéniable que la Russie a hérité d'un ensemble de caractéristiques fondamentales qui éclairent sous un jour largement spécifique la question du rôle que doivent jouer la sécurité et les représentations que la société s'en est forgée au fil du temps dans le choix des stratégies et des politiques économiques, dans la configuration même du système social qui lui convient. Rappeler ces caractéristiques peut en effet ébranler toutes les éventuelles certitudes qu'on peut avoir a priori concernant l'excellence des règles du jeu libéral, du point de vue économique comme du point de vue politique, pour la Russie. Ainsi est-il pertinent de mentionner des facteurs aussi fondamentaux que la dimension d'un pays, sa localisation, sa géographie interne, son peuplement, comme des données pesant sur les représentations que peuvent avoir ses habitants et ses dirigeants concernant les orientations économiques et politiques à adopter pour satisfaire des impératifs de sécurité.⁶ La Russie, cet espace particulièrement vaste, sans barrières "naturelles" vis-à-vis des communautés humaines denses et nombreuses qui le bordent, par contraste peu peuplé (et en outre de façon hétérogène), est de tous temps confronté à une sorte de fragilité structurelle - que l'histoire a permis de vérifier à de nombreuses reprises - imposant une attention particulière aux exigences de la protection externe et à la mise en place d'un système de défense ambitieux (jusqu'à la conquête de "glacis" toujours considérés comme défensifs), et coûteux. Cette propension a valu pour l'empire tsariste, puis pour le système soviétique, au point de fournir une grille de lecture tout à fait satisfaisante de l'histoire longue du pays: la contradiction séculaire entre le désir de modernité et d'occidentalisation d'une part, la nécessité de la puissance et de l'isolement protecteur d'autre part.⁷

La logique du marché et de l'internationalisation ne fait pas que heurter de plein fouet les structures productives - ce point a déjà été évoqué - du fait de l'importance des industries liées à la défense: elle remet aussi profondément en cause les représentations sociales de la sécurité externe. Le fait que nombre de Russes vivent désormais à l'étranger semble ne pouvoir qu'exacerber le complexe sécuritaire et rendre inacceptable plus qu'ailleurs l'adoption d'une telle logique.

Sécurité et système social

Quant à l’empreinte de l’histoire et la géographie sur les conditions de réalisation de la sécurité du point de vue interne, elle est pour une grande part liée à l’impératif de sécurité externe. Comme dans tout empire de grande taille et hétérogène, les risques externes semblaient imposer, à l’intérieur, un contrôle rigoureux des autorités centrales, ainsi qu’une prise en charge par l’Etat de nombreux aspects du développement économique et social. Et en ce domaine encore, la période soviétique a largement renforcé cette propension, en instaurant sur la base d’une certaine idée préalable de l’organisation sociale, un système de prise en charge des citoyens qui a fortement contribué à façonner et ancrer des habitudes de sécurité et de stabilité personnelle.⁸ Et la transition a profondément bouleversé du point de vue des individus ces habitudes, en débouchant sur l’accroissement des inégalités, sur l’affaiblissement de la protection sociale, sur l’augmentation de l’insécurité personnelle.

En vérité, il n’est que peu d’épisodes historiques susceptibles d’être appelés à la rescousse pour atténuer l’idée que la Russie a en matière de démocratie et de marché aussi peu de prédispositions - sans même parler d’appétence - qu’elle n’en a à l’égard de l’ouverture internationale. Certains d’ailleurs accumulent les arguments de type “culturaliste” pour enfoncer encore le clou de l’irréductible spécificité de la Russie face aux implications effectives du changement en cours. Parmi elles, on rappellera bien sûr celles qui font état de “l’âme russe”; de sa double nature, européenne et asiatique; du rôle joué par l’orthodoxie ou le souvenir du “joug mongol”. Mais il y a aussi celles qui se réfèrent à l’empreinte cumulative laissée par le soviétisme, en matière de propension au collectivisme, au rejet de l’inégalité par l’argent (voire de l’argent lui-même), à la passivité, etc...⁹ Là encore, la stratégie en cours serait d’une certaine façon “contre nature”, conduisant inévitablement à la montée victorieuse de “forces de rappel”.

Il y aurait donc, au cœur de l’instabilité russe, une relation à double sens, fondamentalement spécifique, entre économie et sécurité, qui renvoie à des caractéristiques identitaires construites au fil d’une longue histoire. Elles expliquent la permanence de la nostalgie de l’ordre ancien dans une grande partie de la société et des élites. Pour beaucoup d’analystes occidentaux, mais surtout russes, elles condamnent par-là même le projet de transformation économique et sociale en cours: l’écèlement simultané de l’empire et de l’utopie ont débouché sur un vide, que le modèle de démocratie marchande serait, selon eux, incapable de combler.

Cette constatation, souvent, débouche sur l’expression d’un regret: que les dirigeants précédents, mal appuyés par l’Ouest dans leur tentative de réforme, aient échoué à préserver l’Union soviétique et les valeurs qu’ils continuaient, malgré tout, de proclamer comme leurs. Parfois, elle sert à justifier sinon un véritable retour en arrière (une sorte de contre-thérapie de choc), du moins une extension de l’économie administrée, une renationalisation des rapports de

production, et une rupture avec les institutions et les règles du jeu “occidentales”. Enfin, et de plus en plus, elle vise à expliquer à l’avance une dérive autoritaire d’un nouveau type qui aurait pour légitimité d’être la conséquence d’une politique économique mal avisée.

Logique et réalités de la transition

En fait, nul ne doutait, dès l’origine, que l’engagement vers la démocratie et le marché serait pour la Russie d’une complexité toute particulière. L’exemple de pays qui avaient tenté peu avant elle de prendre le même chemin avait montré que les logiques de changement qui y étaient été mises en œuvre posaient avec acuité, au moins pour un temps, la question des risques encourus, pour eux-mêmes et pour l’environnement international. Il était clair que pour la Russie héritière de l’URSS, la difficulté à opérer le changement serait plus grande encore. Comme on l’a dit, la critique de la stratégie de transition au nom même des phénomènes qu’on savait devoir survenir, de même que l’annonce de la dérive et du chaos potentiel, datent du début même de la transition russe.

Le rappel de l’ancienneté de cette critique ne vise pas essentiellement à souligner la faible capacité prédictive des analyses qui la sous-tendent. Après tout, à l’échelle d’un processus socio-économique de cette ampleur, les quelques années qui viennent de s’écouler ne suffisent pas à juger de la pertinence de scénarios “noirs”.¹⁰ Cependant, les chocs qui ont frappé la Russie sont d’une telle intensité qu’on ne peut pas ne pas s’interroger sur les raisons expliquant le maintien, tant bien que mal, de la trajectoire de transition. On ne peut pas ne pas tenter de formuler d’autres hypothèses que celle de l’irréductible spécificité russe, d’autres logiques que celle de l’enchaînement fatal pour rendre compte et du présent et du futur de la Russie. Les réponses de l’Occident à la crise russe doivent tenir compte de ces autres hypothèses.

La remise en cause de l’ancienne cohérence sécuritaire

On oublie trop souvent que la stratégie de transformation adoptée par les dirigeants russes en 1992 prend sa source dans un désordre général qui mérite plus le nom de chaos que celui qui caractérise le pays aujourd’hui. On voudra bien se souvenir que la chute des productions dans l’espace soviétique a commencé dès 1990, et que la pente du déclin approchait, fin 1991, 20%. Il n’est pas inutile de rappeler également que les pressions inflationnistes - larvées tout au long de l’histoire de l’Union soviétique - s’étaient aggravées à la fin des années quatre-vingt, sous la forme d’une exacerbation des pénuries et un allongement des files d’attente, pour déboucher, fin 1991, sur des formes plus ouvertes frisant l’hyperinflation. Enfin, il faut également mentionner l’ampleur qu’avaient prise, dans les mêmes années, les logiques de fragmentation et d’échappement

généralisé (républiques, régions, entreprises, citoyens) à l'emprise des autorités centrales.

Ce n'est pas ici le lieu de dresser un tableau détaillé de l'état de l'économie et de la société à la veille de la thérapie de choc. Ce n'est pas non plus le moment de débattre des erreurs commises en ces années-là. L'intérêt d'un tel rappel réside uniquement dans la mise en évidence d'un fait trop fréquemment occulté: la prise de liberté par les agents économiques et les citoyens date d'avant l'octroi de ces libertés dans le cadre de la stratégie de transition. La transition et sa logique "libérale" ont pris naissance "en bas", et les mesures prises au début de 1992 ont eu en fait pour objectif principal de guider un mouvement irrépressible, de l'accompagner, par des mesures aussi adaptées que possible. La stratégie de transition, pas plus en Russie qu'ailleurs, n'est l'invention d'ingénieurs sociaux éduqués à l'étranger; elle est le résultat endogène d'une évolution sociale.¹¹

Quant au sens de cette évolution, dans la perspective qui est la nôtre, il est suggéré par la négligence même de la société soviétique de la fin des années quatre-vingt à l'égard des implications des événements du point de vue de la sécurité, personnelle et collective, interne et externe. Ce que cette société remet en cause par son mouvement, au travers du désordre qui se crée dans les champs politique, social, économique, c'est aussi le système de sécurité qui structurait l'ensemble de ces champs. C'est l'obsession sécuritaire qui est radicalement contestée, et ses implications en matière d'organisation sociale, celle-ci n'ayant pas permis au fil du temps de satisfaire une partie des objectifs sociaux et économiques au nom de quoi elle avait été instaurée.

La logique de la transition

La transformation de la Russie apparaît dès lors comme un changement qui concerne en parallèle le champ de la sécurité et celui de l'allocation des ressources. A un système caractérisé par le contrôle de l'Etat-Parti, mobilisant un système d'allocation de ressources - le plan - au nom de la sécurité, se substitue un autre système fondé sur la libéralisation de l'activité des acteurs sociaux et l'ouverture. Ce système, a priori, n'est pas moins producteur de sécurité et de stabilité à terme que l'ancien: l'exemple des pays occidentaux et d'autres pays en transition en témoigne. Mais il est vrai que les implications concrètes d'une telle transformation sont difficiles à assumer.

Surtout, elle bute sur un problème crucial: celui du décalage dans les délais de maturation des différents éléments constitutifs du changement. Ainsi, pour ce qui est du système économique, il y a un premier décalage: entre la mise en place des outils de l'allocation des ressources (prix, monnaie, taux de change...) d'une part, et la construction des institutions disposant du pouvoir d'allocation (Etat, régions, banques, entreprises...). Le délai de maturation de ces dernières est inévitablement plus long que celui nécessaire à l'introduction

des outils de base du marché. Il y a un autre décalage tout aussi délicat à maîtriser: celui qui s'observe entre les deux éléments du système d'allocation qui viennent d'être mentionnés d'une part (outils et institutions), et une troisième composante, l'attitude sociale, tant les référentiels sociaux acquis sont en effet remis en cause par l'introduction du marché.

Il en va de même pour ce qui est des questions de sécurité: les outils doivent changer (système de protection et de contrôle social, nature et quantité des forces de sécurité...); de même que les institutions et les relations qu'elles entretiennent entre elles et avec les autres institutions (armée, police, Etat...); de même enfin que les référentiels sociaux (attitude à l'égard des autorités et de l'Etat-providence...). Et là aussi les délais du changement sont plus lents et plus difficiles selon les segments, les attitudes et les pratiques sociales étant les plus longues à se modifier.

Cette logique générale de la transformation permet de comprendre la dialectique qui est en œuvre en Russie, et qui est semblable à celle qui prévaut dans tous les pays en transition. Elle semble donner raison aux critiques de la solution "libérale", qui reproche à cette dernière d'avoir négligé la construction préalable des institutions d'une part, la mise en place d'une pédagogie sociale active d'autre part. Mais en réalité, on voit bien que l'état de la Russie à la veille de la transformation n'a guère laissé de temps pour cela. On voit aussi que les institutions et la culture nouvelles ne peuvent être instaurées ex ante (par copiage ou par invention d'en haut) pour peu qu'on les souhaite adaptées aux spécificités de la société. La transformation ne peut se faire que par un processus inductif, la libéralisation des outils guidant la construction institutionnelle et la modification des référentiels sociaux, au travers d'un ajustement incessant entre les différents champs du système.

Un autre scénario pour la Russie

C'est cette logique d'apprentissage, amorcée dès la fin des années quatre-vingt, qui est à l'œuvre en Russie, avec toutes les difficultés, et tous les risques, que l'on sait: apprentissage d'une nouvelle identité, c'est à dire d'une nouvelle vision de soi et du monde (les référentiels); apprentissage d'une organisation sociale (les institutions); apprentissage de guides de l'action individuelle et collective (les outils). Rien n'assure encore que ce processus débouchera sur des "monstruosité" dont certains craignent que la Russie n'accouche. Rien ne garantit non plus que la Russie se banalisera dans une perspective proche: les spécificités du pays, on l'a vu, sont indéniables. Mais on peut trouver dans l'évolution de ces dernières années tout autant d'éléments prêchant en faveur d'une vision plus sereine de la construction en cours que de points confirmant les scénarios catastrophistes qui depuis plusieurs années circulent volontiers. Il faut se souvenir pour cela du chaos qui menaçait l'espace post-soviétique à l'aube des années quatre-vingt-dix, et de l'intensité des crises, politiques et

économiques, qui ont frappé la Russie depuis sa réapparition en tant qu'Etat sur la scène internationale. Elles ont pour la plupart été surmontées, se révélant ainsi, jusqu'à présent, plus comme des crises de maturation que comme des soubresauts annonciateurs de l'écroulement final. Rien n'autorise à dénier a priori à la Russie la capacité de produire "sa" démocratie, "son" capitalisme, "son" système de sécurité, "son" fédéralisme.

Cette interprétation ne néglige certes pas les phénomènes "pervers", particulièrement visibles dans ce pays comme les délits d'initiés, la corruption, la fuite des capitaux, les trafics d'influence, la confusion des genres..., - toutes choses rassemblées dans son cas sous le nom de "dérives mafieuses". Elle ne néglige pas non plus l'insuffisante maturation des politiques publiques, qui témoigne de la difficulté à trouver le bon positionnement de l'Etat dans le jeu social (plus qu'à restaurer son omnipotence). Mais tout en donnant à comprendre que la dimension de ces faits, plus que leur existence même, révèle la spécificité russe dans la transition, elle suggère malgré tout la possibilité de leur dépassement, conformément à la logique profonde qui vient d'être énoncée.

Ce dépassement, d'ailleurs, sera d'autant plus "aisé" que l'Occident maintiendra le rôle qu'il a jusqu'à présent tenu, celui de pourvoyeur public de moyens (avant que le secteur privé prenne, là comme ailleurs, la relève), de pédagogue (sous conditions), de partenaire (toujours vigilant). Au fond, l'Ouest lui aussi est, face à la transformation russe et au niveau paysage international qu'elle a instauré, devant un phénomène économique politique et social auquel il doit lui-même s'accoutumer, après l'avoir longtemps souhaité. Son action est caractérisée elle aussi par des erreurs tactiques liées en grande partie à la nouveauté des situations à gérer. Il a à tenir compte de ce que son propre horizon économique, politique et sécuritaire s'est trouvé considérablement modifié par la transition russe, et que la stabilité du monde et la sienne propre passe, d'une certaine façon également, par un apprentissage.

Notes

- 1 De Senarclens, Pierre. *Mondialisation, souveraineté et théories des relations internationales*. Paris : Armand Colin, 1998. 218 p.
- 2 La Commission économique pour l'Europe indique, concernant le Produit Intérieur Brut, pour une base 100 en 1989, un niveau de 55,9 en 1998. On sait que l'année 1999 sera à nouveau le théâtre d'une baisse. Depuis 1989, seule l'année 1997 a été une année de croissance (de 0,8 %). CEE/ONU. *Economic Survey of Europe*, 1999 N°2. Genève : ONU, 1999.
- 3 Chkolnyi, Alexeï. "Le débat sur le budget de la défense en Russie". *Politique Etrangère*, 1996 (n° 4): pp. 791-802.
- 4 Notons d'ailleurs que même à s'en tenir à cette liaison circulaire entre l'économique et le social, on n'est pas autorisé pour autant à mettre en cause radicalement les principes généraux de la stratégie économique suivie depuis 1992. On peut aussi arguer de ce que l'évolution russe est due surtout à l'application insuffisamment convaincue de préceptes qui en eux-mêmes ne sont pas contestables dans leur pertinence
- 5 Sapir, Jacques. *Le chaos russe. Désordres économiques, conflits politiques, décomposition militaire*. Paris : La Découverte, 1996. 329 p. Sapir, Jacques. *Le krach russe*. Paris : La Découverte, 1998. 139 p.
- 6 Voir entre autres sur ce point : Gottman, Jean. *La politique des Etats et leur géographie*. Paris : Librairie Armand Colin, 1952. 228p.
- 7 Sokoloff, Georges. *La puissance pauvre. Une histoire de la Russie de 1815 à nos jours*. Paris : Fayard, 1993. 938p.
- 8 Du moins qui ont prévalu à partir de la fin des années cinquante. Car pour ce qui est de la période de l'instauration du socialisme, on sait que la sécurité personnelle n'en a pas été le trait prédominant.
- 9 Gratchev, Pavel. *L'exception russe. Staline est-il mort?* Paris : Editions du Rocher, 1997. 222p.
- 10 Au moins doit-on reconnaître qu'ils ne se sont pas réalisés, que ce soit celui de l'éclatement de la Russie, celui d'une nouvelle révolution sociale violente, ou encore celui d'une dérive nationaliste et militaire aux conséquences incalculables pour les voisins proches et lointains...
- 11 Bien entendu, il faudrait évoquer plus avant des raisons qui ont conduit les responsables de l'époque à ouvrir les "vannes" sociales.

RUSSIAN ECONOMY: ON THE VERGE OF GROWTH OR STAGNATION?¹

Andrej Klepach

*Senior Researcher, Institute of Economic Forecasting,
Russian Academy of Sciences, Moscow*

The financial crisis, followed by the deep fall of the rouble exchange rate and budget default on internal debt, brought about certain significant changes in the macro-economic situation. After meeting the acute phase of the crisis in August-September 1998, there has been industrial growth in the Russian economy combining relatively moderate inflation and widening money transactions between enterprises. In total, it is expected that this growth in industrial production will be of 8.1%, thereby bringing the economy back to its 1997 level. At the same time the financial crisis laid bare the long-term structural imbalances of the Russian economy: over-dependence of the financial system on world raw materials markets, the state debt crisis, the weakness of the banking sector and its isolated position from real production, the deficit of competitive manufacturing activities, the excessive level of imports, and the run-down state of most production facilities. The Russian economy and society found themselves not only facing the problem of simply switching over to the stable rise of production, but shaping the new model of economic development.

Economy of Overconsumption and Capital Deficit

The process of market transition in Russia has taken nine years to date and has proved to be very painful. Indeed, what has emerged is a market economy of a very specific type, characterised by its openness to the world market, by the predominance of the US dollar in financial turnover, and by a deep crisis in domestic production which features high levels of non-payment and barter. The scale of deformation and expenses incurred in the process of transformation have turned out to be so high that now it is fashionable to discuss the notion that not a market economy, but a “virtual economy” has been created in Russia. But in my opinion, the problem is not in the virtual state of economy, but in the deep structural and institutional disproportions inherited from the Soviet time as well as those acquired in the process of the rapid change towards the market and Western values in general. I now wish to analyse the main structural disequilibrium.

Overconsumption? In spite of the huge scale of poverty prevalent by August 1998, the Russian economy has been characterised by a relatively high (in comparison to the real ability of the country) consumption level.² As industrial production fell by about 50%, household consumption declined by only about 20%. This gap was filled mainly by imported goods, whose share in retail turnover in 1997 jumped to 48%. It is hard to find another country with an economy in transition that allowed import penetration of its home market to such an extent. Multiple rouble devaluation reduced the disbalance slightly and has recently enlivened domestic production and helped to reduce imports noticeably (now just 56% of the peak level reached in 1997). As a result the import share in retail turnover fell to 36%.

Growing incomes from raw material export and capital flight (including hard currency purchase and account opening by individuals) formed the financial basis of these lavish imports. As a result, real personal incomes fell by much less than GDP (approximately 15-18%). The share of personal incomes (money and in kind) in GDP rose from 40% in 1992 to 60% in the first half of 1998. The fall in the price of oil in 1997-1998 not only reduced exporters' incomes, but disrupted the level of personal incomes (especially of the "new middle class") and thereby the ability to import. In 1998-1999, real personal incomes reduced by nearly one-third. The volume of consumption fell by 13%. Under these circumstances, any improvement in people's welfare is focused not on the problem of rising incomes, but on the ability to expand imports and to boost the domestic production of consumer goods.

Capital deficit. The dark side of overconsumption (as well as of capital flight) has been the sharp contraction in investment. Between 1992 and 1998, investment into fixed assets fell by 75% with production capacity falling by around 25%. The average age of plant and equipment reached 16 years, thereby severely affecting the ability to produce quality competitive goods. Even in such industries as oil, it is going to be impossible in the near future to sustain the current level of production without a drastic increase (of at least two-fold) in investment. In agriculture, where investment is currently just 4% of the 1990 level, the decline in production potential has reached such a level as to threaten food security. Under these circumstances, the outlook for economic growth is actively constrained by the inability to increase investment and thus renew capital stock. The current growth potential of stimulating final demand and of utilising existing machines better is estimated as no more than 10-12%.

Devaluation has stimulated a fall in consumption, thereby increasing the rate of national savings. However, the chances of these savings being channelled into investment are not compromised by the state of the budget (since the deficit is now minimal), but by the dynamics of capital flight that now represents around 7-10% of GDP. Thus, the Russian economy is characterised by capital deficit (especially of high-quality capital) rather than by a lack of savings.

Table 1 - Main Macroeconomic Indicators and Forecasts (1997 - 2001)

	1997	1998	1999	2000	2001
GDP, bn. RBL	2 521.9	2 684.5	4 476	5 950	7 100
rate of growth to the previous year,%	100.9	95.4	103.2	103.5	101.5
deflator,%	116.5	111.6	161.6	128.4	117.6
Industrial production, bn					
rate of growth, %	102.0	94.8	108.1	103.5	103
deflator,%	111.0	110.8	164.8	133	121
Agricultural production					
rate of growth, %	101.3	87.7	102.4	102	103
deflator,%	109.7	111.5	188.5	148	116
Investment in Fixed assets, bn 1 000		408.8	402.4	599	810
rate of growth, %	95.0	93.3	101.0	104	105
deflator,%	114.5	105.5	147.6	130	118
Export, bn.\$	88.7	74.8	74.5	80	80
rate of growth, %	97.7	84.3	99.7	107.3	100
Import, bn.\$	71.4	57.4	40.4	44	46.5
rate of growth, %	105.8	80.5	70.2	109	105.7
Retail turnover, bn. RBL	847	1 021	1723	2 250	2 880
rate of growth, %	104.7	95.6	92.3	104	103.5
deflator,%	112	126	183	126	120
Inflation					
CPI (December to December)	111.0	184.4	139	125	118
PPI(December to December)	107.5	123.5	167	130	115

Source: Ministry of Economy, Goscomstat, Development Center estimate and forecast

Reduction in savings due to capital flight. In 1998, the positive balance on both trade and current account fell. This was not compensated for by foreign capital inflow. Foreign investors turned away from Russia because of poorly developed financial markets and the budget crisis. In 1999, the significant positive foreign trade balance has not improved the level of hard currency reserves due to the negative balance on capital transactions.

As a result of devaluation, the rate of state external debt to GDP went up from 32% in 1992 to 121% in 1998. The foreign trade surplus creates more preferable terms for Russia with regard to its foreign liabilities than is the case for most countries in Latin America or South East Asia. Even under the condition of fulfilling all obligations on debt repayments in 1999, these should be only about 23-25% of expected export volume against 35-40% on average in Latin America and 20-30% in South East Asia. That is why the main problem of currency devaluation is on the one hand related to low private capital inflow and high capital flight out of Russia, and on the other hand, the inability of the budget to mobilise adequate resources to service the debt. Although the

debt burden related to exports is not large by international standards, it does exceed all bearable limits regarding the federal budget and hard currency reserves. Annual payments on external Russian and Soviet debts in 1999-2001 will reach 30% of federal budget income (without restructuring, this would be 70%) and exceed gold and hard currency reserves by 1.7 to 1.8 fold. It is clear enough that the Russian financial system is not able to service payments on such a scale.

Table 2 - Capital Flows in US\$bn (1994-1999)

	1994	1995	1996	1997	1998	1999*
Changes in indebtedness resulting from the non-supply of export revenue and import debt services	-3.9	-4.9	-9.8	-11,5	-8,4	-6.8
Purchase of currency, cash	-5.5	0.21	-8.8	-13,4	1	0.3
Net errors and omissions	-0.3	-7.9	-8.6	-7,6	-7,9	-8.4
Capital flight, total	-9.7	-12.6	-27.2	-32,4	-15,3	-14.9
Trade balance	17.8	20.8	23.1	17,4	17,4	34.2
Total: hard currency offers from foreign trade operations	8.1	8.2	-4.1	-15	2.1	19.3

* *Evaluation*

The likely balance of hard currency inflows and capital flight in 1999 has the potential to pay the Russian part of the debt burden (US\$7.5bn) even without international financial credits. However, the failure of the tax system as well as the low level of hard currency reserves make it difficult if not impossible to sustain debt service payments. In this case, the burden of debt servicing falls not just on the budget but on the Central Bank as well. And with all this going on, the Central Bank also needs to increase gold and hard currency reserves to at least US\$25-30bn from the current level of US\$13bn. Reaching this level of reserves would be possible under the condition of capital flight reduction (including buying hard currency cash by individuals) as well as under the reconstruction of the net capital inflow in shape of credits, net and portfolio investments.

In the medium-term, the trade balance is likely to be reduced due to import growth and an expected fall in prices on oil and raw materials markets, caused in turn by a fall in demand in advanced market economy countries. Under these circumstances, even with a coordinated budget and Central Bank help, servicing the Soviet debt burden will constrain Russian economic growth potential since payments on debt combined with capital flight will be equal to investments.

Russia will be forced to reduce imports yet again, thereby reducing levels of individual consumption.

Rouble Devaluation and Perspectives on the Renovation of Russian Industry

Since August 1998, rouble depreciation has exceeded the limits dictated by liquidity supply, price rises or relative losses of raw materials and oil exporters. The relative equilibrium rate corresponding to the stabilisation of the balance of payments would demand a devaluation of not more than 30-50% (e.g. up to 8-9 roubles a dollar). However, the excessive depreciation of the rouble (to 26 to the dollar by the end of 1999) was determined not only by market psychology and the political crisis, but also by the structural problems inherent within the Russian economy, such as the low competitiveness of most industry and agriculture.

The large rouble devaluation has created significant opportunities to boost competitiveness both for exporters and for domestic producers via import substitution. Once again, Russia (as in 1992-1994) has become a relatively cheap state in dollar terms. In 1996-1997 the correlation between the nominal rouble rate and the purchasing-power parity of the rouble (for GDP deflator) was 1.7-1.8. As a result of the rouble's fall, by the end of the first quarter 1999 this gap jumped to 3.6.

Table 3 - Dynamics of Purchasing Power Parity (PPP)

	1996	1997	1998	1998	1999*	2000**
	Average	Average	June	December		
PPP-consumer products	2.11	2.60	3.04	5.38	7.3	9.18
PPP-investment products	3.92	4.32	5.34	6.57	11	14.3
PPP of GDP	2.88	3.35	4.03	5.94	9.00	11.45
Exchange Rate (R to \$)	5.12	5.78	6.18	20.65	27	31
Ratio of Exchange Rate to PPP of GDP	1.78	1.73	1.53	3.47	3.01	2.71

* Evaluation; ** Prediction

Source: Center of Development

Usually after a drastic devaluation, exchange rate dynamics start to fall behind the change in prices. In Russia, in spite of a PPP fall of 28-30% from the exchange rate, filling this gap is proving to be a very slow process. Rouble devaluation against the dollar stimulates a rise in prices (especially for exported goods: oil, metals, timber), while inflation and import price rises stimulate a flight from the rouble thus pushing its exchange rate down. Ergo, devaluation

causes an inflationary spiral. Significant inflationary potential was stored in the real sector of the economy and in the consumer market in spite of the income deficit. The release of this potential is just a matter of time.

Higher inflation is contradicted not only by tight demand constraints from both households and the budget, but also from depressive factors such as the low level of machine utilisation. Perspectives for the gradual reduction between market and PPP rates are real enough, because the weak rouble implies significant costs for society. The first loser is the population whose real incomes decline, forcing them to consume less. Producers of consumer goods of course also suffer from this. If, however, devaluation has cleared the field of imported substitutes, the further progress of the inflationary spiral simply negates this effect. The speed of rouble recovery (not more than 8-10% a year) should be in proportion to the quantitative improvement in market competitiveness of Russian industry. In any other case, a strong rouble would not be of help to Russian entrepreneurs.

Such a strong relationship between Russian industry and devaluation/world market activities is a result of the domination within its structure of export-oriented oil and raw materials industries. The export oriented sector of the economy is responsible for between 1.2 and 1.8 times more basic assets, gross and disposable income, and taxes, than import substitute industries, while having less than one-half the number employed. The level of value added per person in the export-oriented sector was 2.7 times higher than in industries oriented towards the domestic market and import substitution. The high level of employment relative to market competitiveness within import substitute industries determined the low level of gross receipts and wages. Gross receipts brought by one person employed in the export-oriented sector were 3.3 times higher than in import substitution industries, whilst wages were 1.6 times higher.

Table 4 - Structure of Industrial Potential in 1998 (%)

Industries / Indicators	Export-oriented industries*	Import substitution industries**	Others
<i>Productive potential</i>			
Basic assets (book value - end 1997)	44.6	34.6	20.8
Number of employed (average for 1998)	30.7	57.1	12.2
<i>Output and income</i>			
Output	44.4	34.8	20.8
Additional value (output minus direct material costs)	47.3	32.8	19.9
Wages	40.2	45.3	14.5
Taxes	43.6	35.4	21.0

* *Fuel industry, metallurgy, chemistry and petrochemistry and timber/woodworking/cellulose/paper industries*

** *Heavy engineering, lubricating, light and food industries.*

Source: Development Center

The leading position within export industries belongs to the fuel complex, which accounts for 40% of Russian exports and 20% of tax proceeds from enterprises (excluding export duty). The fuel complex also credits customers by means of delaying payment, which accounts for about 40% of inter-enterprise arrears. The financial difficulties of the fuel and indeed the whole export complex due to the fall in world prices (prior to their recent rise) and the stable rouble exchange rate (prior to recent devaluation) disrupted the balance between budget and debtors' crediting.

However, the recent devaluation has restored the financial position of exporters. The export efficiency of primary fuel and raw materials goods jumped from 10% in the first half of 1998 up to 60-80% at the beginning of 1999. On the whole, the expected gain of the export sector from devaluation and the rise in world prices in 1999 is estimated at about US\$15-20bn. For all that, about 80% of this sum accrues to the trusts themselves and intermediate sellers (including offshore accounts).

Enterprises sell their goods to different intermediate trade and trust structures at prices that are significantly lower (c.60%) than domestic market prices (on average and adjusted for purchase taxation), and lower still than export prices. For example, Russian official statistics place oil trusts like Lukoil, Ukos, and others not in the industry sector, but in an "others" category of the economy. At the same time, export as well as sales proceeds in accordance with world prices are concentrated in their hands. Extractive and oil refining divisions of these trusts ship the products at prices that differ from world prices. This leads to substantial under-reporting of the real cost relationships in industry. Under these circumstances, the total potential benefit from the devaluation and from the increase in the gap between domestic and world prices lands "in the pockets" of the vertically integrated trusts and some trade and financial structures tied to them.

One could say that the above state of affairs is an original way of payment for these trusts in that they are the real agents of economy rather than individual enterprises. Therefore, the declared profit of six trusts (Lukoil, TNK, VNK, Surgutneftegaz, Ukos, Komi-TEK) exceeded US\$1.75bn in 1998 (according to the data published by "Kommersant-Den'gi" magazine) whilst at the same time the total profit of the oil industry in 1998 was just US\$0.3bn (according to Goskomstat). According to my evaluation, the difference between real (adjusted to the complete income from exports) and the officially recorded volume of output from these industries reached 50-60% by the middle of 1999. The main part of total export income is concentrated (on our evaluation) in the oil and gas industries (64%), with metallurgy accounting for 24%.

As a result of the recent financial crisis, the Russian economy and society find themselves at the crossroads. One opportunity for their development is tied up with the attempt to extend the role and extent of exports by raising efficiency. However, this does not have any stable middle term outlook because export

incomes are not able to compensate for the curtailment of production focused on the home market, nor are they sufficient to provide a decent level of national savings.

The alternative model of economic development is tied up with the reconstruction of the home market on the basis of import substitution and remonetarisation of the economy which, in turn, would strengthen the budget, help to reconstruct the banking and internal financing systems, and redirect bank credit and public debt to fund domestic production. So far, the revival of production in import substituting sectors has been gathering strength. Heavy engineering and light industry increased production by 9% between January and August 1999, a higher rate than the average for all industry. The number of enterprises (mainly in processing industries) that have become centres of growth and have achieved a relatively safe financial position reached 45-47 % according to REB³ estimation, the highest level since 1992 and almost twice the proportion evident in early 1998.

The quantitative expansion of the number of developing enterprises and the fact that their number now exceeds the number of bankrupt enterprises (still about 30% of the total) allows us to declare that for the first time in Russia, an economic revival has been of a mass character at both the industrial and entrepreneurial levels. A specific “middle class of industry” is being formed. Prior to that, a bipolar structure dominated which featured a wide spectrum of bankrupt enterprises alongside a handful of large profitable enterprises concentrated mainly in the fuel, non-ferrous metallurgy and (some) consumer good industries.

However, further prospects for development are restrained by the weakness of both consumer and investment demand, not to mention the low overall levels of goods quality, working efficiency, marketing and financial activity. In this case, a micro-economic revolution is necessary, but one that would use the effects of rouble devaluation to boost the domestic market rather than inflation.

Debt Economy or Remonetarisation?

The policy of a stable rouble and unitary pricing for exported goods was undermined by a culture of barter and non-payment in the domestic market. The fuel and raw materials sectors failed to increase supply to the home market in spite of its higher economic efficiency in comparison with the world market in 1997 and early 1998, again due to the low level of money payments. In Russia, non-payment and barter are features of what is in effect a *debt economy* that is based not on banking, but on the outrageous development of commercial credit in the real or non-financial sector of the economy. Commercial credit performs firstly as a commodity credit due to the delay in payment to suppliers for goods and services delivered, and secondly as a financial credit in that payment obligations to workers and the budget are delayed. It therefore alters

the distribution of value added and the income of enterprises. The peculiarity of the Russian economy is to a significant extent not one of commodity credit but of financial credit, that by the end of 1999 reached 27% of GDP.

Table 5 - Dynamics of Indebtedness in the Russian economy*
(Relative to GDP in % to the end of year)

	1993	1994	1995	1996	1997	Sept-98	1998
Account payable	27.4	28.5	29.6	43.6	50.3	69.0	66.9
Indebtedness to budget	4.0	5.2	5.7	7.5	9.2	11.7	10.9
Indebtedness to off-budget funds	2.5	3.3	3.6	6.2	8.0	10.8	10.8
To suppliers	16.9	17.1	16.3	22.1	24.3	32.4	31.8
Accounts receivable	25.6	24.6	22.2	30.1	33.0	44.9	44.5
Indebtedness on credits and loans	6.6	7.4	5.6	5.6	6.4	13.5	14.5
Money assets	4.4	2.1	1.3	1.2	1.5	2.0	2.9
Net account payable **	1.8	3.9	7.4	13.5	17.3	24.1	22.4
Commodity credit	8.6	7.5	5.9	8.0	8.7	12.5	12.7
Financial credit	10.5	11.4	14.4	22	26.4	36.6	35.1
Relation between banking and financial credit	101.2	86.3	60.0	41.1	37.4	60.1	67
Level of financial responsibility***	40.91	14.87	8.15	5.28	4.77	3.93	5.72
Money assets to debts to banks	52.3	22.6	18.9	17.9	17.6	10.9	14.6

* *Productive industry: industry, construction, transportation and communication, agriculture.*

** *Net account payable = account payable - accounts receivable, commodity credit = accounts receivable - indebtedness to suppliers, financial credit = account payable - indebtedness to suppliers.*

*** *Relation of money assets to net accounts payable and debts to banking credits and loans.*

In Russia, commercial credit has turned from a subsidiary financial instrument into the central column of the debt economy and it differs greatly from financial systems based on self-finance or a debt economy dominated by bank credit. In the Russian debt economy, non-payment - or, to be exact, commercial credit - has the main and multiple functions of being an instrument of payment, a source of credit to a producer, and as a quasi capital market. Non-payment and barter are thus the reverse sides of the same coin. Non-payment and barter, as substitutes for money in circulation, are unable to become independent quasi money instruments. They speed money circulation (by three- or four-fold) but do not move by themselves because they are not tradable, except in small-scale agreements on debt and accounts receivable.

Russia's specific model of a debt economy should not be viewed as a virtual phantom, where neither prices nor financial markets nor bankruptcy mechanisms work, as suggested by Barry W. Ickes.⁴ The non-equilibrium position induced by barter and non-payment does not destroy value but merely changes the operation of the price mechanism. Price distortion from the equilibrium level on non-money transactions (estimated on average to be plus or minus 20 to

30% or more) is determined not only by specific monopoly-corporate characteristics of the Russian economy, but also serves as a form of correction whereby markets adapt to the low level of monetisation within the economy and the imbalance between money assets and enterprise liabilities (especially to workers and the budget). Moreover, prices also serve as a reference point to barter deals. Significant discounts on Gazprom or RAO UES bills do not falsify payments so much as approximate real payments to their normal level corresponding to energy cost and energy use in the economy. This balances out excessive appreciation during a period of high inflation.

Table 6 - Structure of Payments in Industry (%)*

	1993	1994	1995	1996	1997	Sept-98	mid-1999
Total outgoings	100	100	100	100	100	100	100
Commodity credits	22	17	8.8	14.1	10.6	14.5	12.6
Barter	11.4	21.6	33.4	44.4	53.5	59.5	40
Money accounts	63.9	56.3	55.3	32.4	32.4	25.0	46.4
Others	2.7	5.1	2.5	9.1	3.5	1	1

* *Evaluation based returns on cash receipt on goods and services, growth of accounts receivable and data survey (REB, CEC) on barter deals share.*

In Russian conditions, we may speak not of low, but of the excessive tightness of budget constraints on enterprises. This is reflected in the appearance of a stable gap between potential demand and output. This excessive tightness is indicated by the additional reduction of output, which on average is estimated to be 11-15 percentage points below what would be potentially possible given the level of demand in 1996-1998. On the other hand, much of existing output is supported by the growth of debt and non-payment which changes the financial situation of enterprises. This is manifested by the growth in the gap between the level of potential demand and the situation within enterprises, reflecting their inability to meet demand on their own (in 1997-1998 this gap was estimated at around 40-50%). We may suppose that this gap reflects the lack of equity within enterprises and corresponds to the need for debt financing. The excess of accounts receivable is not able to compensate for the lack of money assets, and this in turn leads to the under-utilisation of production capacity.

Under circumstances whereby there is a close correlation between liquidity and supply of currency (this is up to 60-70% in exporting industries), the recent rouble devaluation has helped to re-monetise the real sector. The real money deposits of non-financial organisations and enterprises in bank accounts have in 1999 risen by more than 20% whilst their share in the structure of money supply (M2) has increased to 30%. Simultaneously, the liquidity of industrial enterprises (also trade firms and holding companies) has been directly strengthened,

as has the structure of settlements between enterprises. The share of money in payments for finished goods jumped from 25% in the autumn of 1998 up to 45-50% today. At the same time (REB evaluation), the share of barter decreased from 54 to 38%, the level of two years ago.

Table 7 - Monetary Dynamics (%)

	1997	1998	1999	2000	2001
Velocity of M2	6.7	6.0	6.4	6	5.3
M2 as % of GDP	14.8	16.7	15.7	16.8	18.9
Velocity of M2X	5.5	4.2	4.5	4.5	4.2
M2X as % of GDP	18.2	23.7	22.2	22	23.8
Monetary Multiplier	1.9	1.9	1.79	1.8	1.7
Monetary Exchange Rate (MER)					
- reserves to MBII	11.4	19.3	31.4	37	48.2
- reserves to Reserve Money	11.6	25.7	43.2	51.5	67.8
- MER to Exchange Rate	191.5	93.3	116.4	119.3	142.2

Table 8 - Structure of Monetary Aggregates

	1997	1998	1999	2000	2001
M2	100.0	100.0	100.0	100.0	100.0
M0	34.9	41.9	39.2	36.1	35.5
Enterprises Deposits	27.2	25.0	30.9	33.3	32.7
Household Deposits	37.9	33.1	29.9	30.7	31.8

Source: Bank of Russia, Development Center.

This phenomena of re-monetarisation (a result of rouble devaluation) begins to wane once domestic prices start to rise towards global prices. The increase in money deals between enterprises is blocked by the inability of the budget to make payments in money which leads to an increase both in bank credit and in commercial credit between enterprises.

State Debt Crisis

As was shown by the 1998 crisis, the Russian budget system has exhausted all its chances of survival using borrowed current assets, as it has effectively done for the past four years. The attempt to solve all current budget problems by changing the main source of borrowing (from Central Bank to IMF, then to state bonds, then Eurobonds and finally the World Bank) led to a fast

accumulation of state debt and related interest payments. This burden proved to be unbearable for the budget under the extant conditions of weak tax collection.

The problem for Russia became not only the volume of state debt (66% of GDP by summer 1998) and not only the related service payments (c.5.3% of GDP) but the massive gap between these payments and the volume of federal revenue collection. In the first half of 1998, service payments and debt repayment on state debt reached 120-150% of federal budget current income. The government's inability to solve the problem of low revenue receipts led to over-borrowing from both domestic and foreign creditors, most of whom lost their money when Russia effectively declared itself bankrupt on August 17, 1998.

At the moment, the increase in the tax burden on exporters combined with the decrease in payments on the external debt (achieved through rescheduling and the receipt of IMF credits) has allowed the budget situation to stabilise. Federal budget income increased by up to 13% of GDP in the middle of 1999 and the primary deficit reached its target level of 2% of GDP. At the same time, talk about getting over the crisis is premature. According to government projections, consolidated budget expenditures are to be not less than 33-37% of GDP. This target includes both the service of external debt which accounts for 4-5% of GDP, and increases in state defence expenditure (in order to stop the degradation of national security) and the safety net (necessary to maintain and improve human capital). It is clear that these demands cannot be met by the existing levels of tax collection, especially given the current balance of power between the state and other interest groups. Discussions on state spending should not be limited to concepts of "liberalism", but be centred on the very survival of the Federation itself and the social development of its people.

It is impossible to escape these contradictions by further reducing non-interest expenditure. On the contrary, to stimulate industrial growth and renew human capital it is necessary to increase spending by borrowing more money both from domestic and foreign sources.

Bank Crisis and Reconstruction of Banking System

The most vivid manifestation of the banking crisis was the real bankruptcy, meaning the non-fulfilment of obligations, by the largest banks, such as SBS-Agro, Imperial and Inkobank. This started long before August 17, so the GKO-OFZ freeze did not hurt them a great deal because they had invested only a small part of their assets into state rouble bonds. Each defaulting bank had its own particular problems relating to indebtedness and bad management. However, the crisis of individual banks and the crisis of the banking system in general (the first one transformed into the second after August 17) have common patterns.

The banking crisis did not start during the high inflationary period of 1992-1994, but at the period of transition to limited investments into state bonds, an

increase in bank loans to the economy (both in operational significance and in the share in assets) and a growth of the number of individual depositors. However, these positive trends led to a conflict between the higher level of reliability and efficiency within the banking system and the poor level of management and excessive indebtedness of individual banks. So the appearance of new risks connected to the devaluation of the rouble resulted in additional losses.

The retail banks with a well-developed branch system were not able to adjust to the high expense of working with individuals. This resulted in the closing of branch offices. The debt crisis of a number of banks - especially those involved in financial/industrial groups - resulted from the debt crisis of enterprises or (to be exact) their holding companies (such as Ukos and Lukoil). A specific "industrialisation of bankers", i.e. changing the leading positions in the banks to the heads of manufacturing holding companies (Hodorkovski, Potanin), led to the situation whereby the banks were crucified by the crisis. The wildcat credits of many banks (SBS-Agro, Inkom) to the regional authorities (who refused to pay them back) reflected the political ambitions of the oligarchs as well as the unprejudiced necessity to redistribute resources from Moscow to the regions. Without this, it is impossible neither to transform Moscow banks into nationwide structures nor to enhance the economic and territorial integrity of Russia.

Thus, the bank crisis (especially during the first mainly hidden phase) acted as an incubator for the more recent and complicated reality of economic crisis in general. The state debt crisis followed by the hard currency crisis transformed the crisis of individual banks into a systemic crisis of the entire bank sector.

The 1998 crisis was a result of financial shocks (state bankruptcy, sharp devaluation of the rouble and financial market collapse) outside the bank system as well as being a result of the structural weakness of the Russian bank system itself (bad management, low level of capitalisation, unequal risks evaluation, weak development of banking business itself). Russian banks losses in the second half of 1998 are estimated to have been about 50-60% of the banking system's capital (equal to around 2-3% of GDP, or double this if one includes the banks whose licenses were withdrawn).

At present, the most acute problems related to the crisis (the troubles with clearing and the depositors flight out of the banks) are over. However, this does not mean that the crisis is over too. The Russian bank system is in the process of transition from stagnation to recovery. It has to solve not only the problem of quantitative recovery of the lost capital, but also the problem of qualitative replacement of management and the relationship between lenders and borrowers.

In the short-term, the main "painful points" for the bank system will be the problems of foreign liabilities, the deficit of own capital and the limits on working assets. Russian banks have to solve these problems under conditions

of low foreign financing and the limited growth of individual deposits (limited by distrust in the banking system as well as the fall in real incomes). The main difficulty for the banks is not only the lack of own capital and debt capital, but the limited areas in which profits can now be made. Under the circumstances of stagnation and the lack of public borrowing, it may take four to five years to restore the pre-crisis level of banking system capitalisation.

The Russian bank system is at the turning point between two choices of development:

- The first would be to go back to the currency-issuing type of development by which banks actively credit the budget and thereby restore their asset base. The main source of income would be hard currency operations, because when currency assets exceed liabilities, the fall in interest rates (corresponding to the fall in inflation) brings net excess profit. Under this scenario of high dollar dependence (about 60% of deposits) and capital flight, the further devaluation of the rouble would allow the banking system to maintain its general level of assets.
- The second would be an industry-oriented type of development, characterised by a more energetic crediting of the real sector under conditions of moderate inflation. Banking sector income would depend on the success or otherwise of the industries it lent to, and thus in all probability be lower than under the first option above. Thus this scenario would require a significant reduction in costs and expenses, and the sale of non-performing assets. In spite of the expected stagnation in banking liabilities in 1999, the reduction of investment into state bonds would release credit into the real economy to the tune of 14-18% of GDP. The prospects for this scenario depend upon the achievement of real industrial growth based on import substitution and the development of new corporate financial entities, and also upon the development of mature markets for both debt and equity.

Table 9 - Dynamics of the Banking System: 1996-2000 (% of GDP)

End of Period	1996	1997	1998	1999	2000
Total Assets	28.4	30.3	39.0	35.1	35.8
Liquidity	5.0	4.1	6.4	7.6	7.7
Credit to the economy*	8.2	9.6	12.5	10.4	11.8
Claims on government	6.0	6.5	6.7	4.9	4.3
Deposits	12.1	12.6	15.8	16	16.1
- household	6.9	6.8	7.8	6.8	7.2
- firms	5.2	5.8	8.0	9.3	8.8
Equity	6.37	5.59	5.55	4.13	4.16

* *Net of arrears.*

Source: Bank of Russia, Development Center

Where is the Russian Economy Going?

The devaluation and the collapse of domestic public debt market have given time for either the Russian economy to be reconstructed or for inertia to continue. Even if the government and elite do nothing, the existing stock of competitive prices along with the temporary easing of the debt burden will stimulate an increase in production of about 1.5 to 2% over the next two years. In contrast to 1999 when export growth and import decline have been the leading factors of nascent growth, one might expect the slow recovery of real incomes and investment to contribute thereafter.

However, growth in the production of resources has its limits, whilst the reduction of production capacity as well as the overall fall in social welfare may set off an explosion of economic and social contradictions around 2002-2003 that may be followed by stagnation or even a new fall in production. The enterprise survey (REB - Russian Economic Barometer) shows that managers do not expect the economic crisis to end for another eight years, e. g. by 2007-2008. By the end of the crisis, they clearly mean not only a switch over to GDP growth, but the formation of a new institutional system and closer links entrepreneurs, society and state. One indicator of current mutual alienation may be the degree of managers' aversion to the current macroeconomic policy. The number of those who do not understand or do not approve of the current economic policy rose once again up to 51% and 61% (respectively) of those surveyed. In the first half of 1999, the corresponding figures were 45% and 49%.

It is not possible to solve the problems relating to the deficit of resources, capital, trust and cooperation of and between all the main economic actors in Russia simply by allowing time to pass - "Laissez faire, laissez passer". At the same time, projects to mobilise economic restoration have neither mass assistance nor corresponding financial support. Now Russia is looking for - in a relaxed manner - its new place in the world and its own original mix between state and private methods of economic development. This will allow Russia to combine its history and its Soviet heritage with the demands of the new era.

Russia has built up a large but mainly useless growth potential based upon the mobilisation of internal resources and the deepening of institutional restructuring. But the likely limits for this type of development are in the order of 2-3% GDP growth per annum. To achieve intensive industrial and social modernisation - with a sustainable growth rate of 5-7% per annum - Russia needs massive foreign investment and institutions that are merged into Western society.

Notes

- 1 We used in our report analytical materials of Macroeconomics analysis and short term forecasting Center (headed by A. Belousov) of IEF RAS and Development Center (Headed by S. Alexashenko).
- 2 For the analysis of the structural disproportions of Russian economy, see A. Belousove. Unsustainable stabilization. What further? Problems of Forecasting, 1996, N° 1.
- 3 REB - Russian Economic Barometer
- 4 Clifford G. Gaddy and Barry W. Ickes. Russia's Virtual Economy. Foreign Affairs. September/October 1998.

RUSSIA'S LABOUR MARKET: ADJUSTMENT WITHOUT RESTRUCTURING

Rostislav Kapeliouchnikov

*Senior Researcher, Institute of World Economy
and International Relations,
Russian Academy of Sciences, Moscow*

Persistent differences between labour market models evolving in Russia and other countries of Central and Eastern Europe (CEE) are one of the most intriguing puzzles challenging students of transition economies. These differences became evident almost as soon as market reforms started in Russia and revealed a unique “Russian” way of labour restructuring.¹

At the start of systemic transition, both government experts and independent analysts provided gloomy predictions of an explosive rise of unemployment to a level comparable with that in the US during the Great Depression. However, these forecasts were wrong and no catastrophe occurred in the Russian labour market. Instead, unlike the labour markets of most CEE countries, it exhibited a surprisingly high degree of mobility and flexibility. Gradually, it became evident that the Russian labour market is conducive to the proliferation of various “non-standard” behavioural patterns that either do not exist in other economies or play a minor role. Such spontaneously developed adjustment mechanisms as administrative leave, involuntary work on shortened hours, widespread multiple job-holding, massive wage arrears, and “shadow” labour compensation proved to be a real surprise for those who expected that the Russian labour market would respond in a “standard” way to the shocks of systemic transition. Indeed, for an outside observer it may look like a “collection of paradoxes”.

In this brief comment, I'd like to provide some descriptive statistics on developments in the Russian labour market, highlight its most salient features and sketch a general framework which may help the reader to understand a number of its peculiarities.

Let us first consider basic statistical data on the Russian labour market under transition. In Russia, employment reaction to the shock of transition was visibly weaker than in CEE. While GDP shrunk by 39% from 1991 to 1998, employment fell by less than 14%. In other words, each percentage point of output contraction was accompanied by approximately 0.35% of employment reduction. In CEE countries, employment dynamics followed output dynamics more closely, in that a 25-30% fall in GDP caused a 10-30% fall in employment. Therefore,

although in Russia the crisis was deeper and more protracted, job losses were approximately the same or even less than in CEE.

Unemployment was changing in Russia in a rather atypical way. In CEE, the start of market reforms triggered a sharp increase in open unemployment. Almost everywhere it immediately exceeded 10% and in some countries even 15-20%. However, unemployment in Russia has been increasing slowly and gradually. Only by the seventh year of market reforms did the rate of general unemployment pass the 10% level and approach the level attained by CEE countries after their economies started to recover. At present the general unemployment rate in Russia is about 12% whilst registered unemployment still remains unbelievably low at less than 2%.

From this it follows that in Russia **general** unemployment as defined by ILO/OECD has been 3.5 to 5.5 times higher than **registered** unemployment. Such a disparity has never been observed in CEE countries. Moreover, in most of them the ratio was inverse: registered unemployment was 10-70% higher than surveyed or general unemployment. The huge gap between registered and general unemployment rates in Russia signals that the majority of jobless believe that the benefits of official registration do not outweigh the costs. Ergo, they prefer autonomous job seeking.

The proportion of long-term unemployed also remained rather moderate in Russia. The share of this group among surveyed unemployed amounted to 41% in 1998 and among registered unemployed, just 19%. In most transition economies, 40-60% of all unemployed have been seeking jobs for longer than one year.

One of the most prominent features of the Russian labour market is the relatively modest role of layoffs in forming the pool of unemployed. Almost throughout the 1990s, the number of unemployed who quit their previous jobs exceeded the numbers of those who were dismissed. Only in 1997 was the share of the first group among surveyed unemployed slightly lower than the share of the second (15% against 34%). However, among registered unemployed, quitters still outnumbered those laid-off (in 1998, 1 to 0.73). This pattern is quite unusual. For example, at the initial stage of market reforms in Poland, the ratio between “voluntary” and “involuntary” unemployed was 1:7, and in Romania, as high as 1:60.² The high share of quitters is a sign that many workers were quite optimistic about their prospects of finding new jobs.

The Russian labour market was distinguished by an extremely high labour turnover. The gross worker reallocation rate defined as the sum of the accession rate and the separation rate reached 40-45% in the economy on the whole and 45-50% in the industrial sector. By the intensity of labour turnover, Russia was visibly ahead of CEE countries. This high mobility of Russian workers is confirmed by data on transition probabilities between various states in the labour market, i.e. employment, unemployment and inactivity. This data suggests that, compared to employees in CEE countries, Russians were less attached to their jobs and each year a larger part of them became unemployed. Thereafter, they

more easily and quickly found new jobs, thereby moving quite rapidly from the labour force to inactivity and vice versa.

Thus, notwithstanding the unprecedented deepness and longevity of the transition crisis, Russia experienced neither a sharp employment reduction, nor an explosive increase in open unemployment. Its general unemployment rate has not reached a level characteristic of the peak of transition crisis in CEE countries. The registered unemployment rate has fluctuated around the 2-3% mark; the average unemployment duration has remained rather moderate; dismissals have not become widespread; and enterprises have been actively hiring new employees.

How did and indeed does Russia maintain relatively stable employment and high labour mobility within an overall economic situation of deep crisis? To answer this question, let us turn to the specific adjustment mechanisms, which can be considered a “visit card” for the Russian labour market:

- Involuntary part-time employment has become widespread. During the period under examination, 3-7% of employees worked on shortened hours and 1-3% more were on involuntary administrative leave.
- Simultaneously, secondary employment has been gaining ground: multiple jobholders amounted to not less than 5-7% of all employees.
- Delays in wage payment have been used as a unique adjustment strategy. This phenomenon is almost unknown in other market economies both mature and in transition. On average in 1996-1997, the previous month's wages of 50% of all employees had not been paid on time. After the August 1998 financial crash, the proportion of employees with delayed wages for the previous month grew to an enormous 71%. By the end of 1998, total wage arrears had reached about 77bn roubles (then worth US\$4bn), equal to 11% of the total annual wage bill.
- Another no less specific adjustment option could be viewed as “shadow” compensation. This does not refer to non-registered income from small businesses or illegal activities, a phenomenon well known to many economies in the world. Russia's specifics consist in the fact that large and medium-size enterprises in the legal sector account for the major part of “shadow” compensation. They either disguised wages under other forms of remuneration (interest on bank deposits, insurance payments etc.³), or paid them in cash on the basis of informal agreements with employees. Whereas in 1993, “shadow” wages amounted to 20% of the “shown” wages, in 1996-1998, this proportion had increased to 45-46%. Therefore, one-third of total compensation was carried out in “shadow” forms.

All these adjustment mechanisms have one important feature in common - they are informal or semi-formal. It is therefore natural to enquire as to what extent they promoted structural change.

At first, the adaptive potential of the “Russian way” was assessed in the positive, on the assumption that it offered opportunities to directly reallocate labour from stagnating sectors to expanding ones without generating high open

unemployment. Moreover, the adjustment costs are distributed over a wide group of people: the jobless, the partially employed, and the partially paid. As a result, the hazards of such problems as youth or long-term unemployment are mitigated and the economy is relieved of a significant part of the costs involved in supporting unemployment. At the same time, delays in wage payments enable enterprises to maintain a higher demand for labour and shadow compensation leads to the same result by relieving employers of indirect labour costs. Finally, low wages in the traditional sectors facilitate labour reallocation in favour of the new private sector, whilst the costs of recruiting workers from enterprises in the traditional sectors appear to be smaller. All this was supposed to speed up restructuring and diminish related costs.

It would be interesting to see how correct this assessment proved to be and what was the pace of labour restructuring in Russia and CEE countries:

- A structural shift of high importance is the growth of a new private sector. According to the findings of various surveys, Russia's new private sector accounts for 20-25% of all employment. This means that it is less developed than in CEE where the corresponding figure is 35-60%.
- The portion of self-employed grew in Russia from 4.3% in 1991 to 10.5% in 1996. In this respect, Russia fell behind most CEE countries where self-employment reached 13-49%.
- Correcting the sectoral composition of employment inherited from the centrally planned system is one of the cornerstones of systemic transition. The intensity of sectoral labour reallocation can be estimated by standard deviation of annual rates of change of employment across sectors. In CEE, it varied from 9% in Hungary to 20.9% in the Czech Republic throughout 1989-1996. By way of comparison, in Russia it amounted to 6.4%.
- Job creation and job destruction rates are further important characteristics of the restructuring process. During the transition period, 12-16% of jobs were destroyed and 1.5-6% were created annually within the industrial sectors of CEE countries. In Russia, the similar indicators amounted to 11.5% and 1.2% respectively. At the same time, as already revealed, Russia led in labour turnover. A comparison of these findings reveals that while in CEE labour reallocation was conditioned mostly by job movements, in Russia it took the form of "churning". Whereas in CEE countries the share of "churning" in the gross worker reallocation equalled 20-60%, in Russia it reached 70%.

This suggests a rather paradoxical conclusion, namely that, notwithstanding the deeper imbalances inherited from the centrally planned system along with a higher flexibility and dynamism within its labour market, structural shifts were less intensive in the Russian economy than in other economies under transition.

How could such a puzzling combination of high labour mobility and flexibility with slow restructuring emerge? In my opinion, one clue is the de-institutionalised character of the Russian labour market, by which I do not exclusively mean

the lack of powerful groups with special interests, such as trade unions or entrepreneur associations, whose active presence in the Russian economy would probably further hamper transition and paralyse even the adjustment mechanisms which have evolved spontaneously. No, there is a more fundamental reason, namely the lack of clear and effectively enforced “rules of the game” that would otherwise direct interaction between economic agents. This does not imply that the Russian economy operates without any standards or rules, only that informal arrangements and institutions take precedence over formal ones. It seems that in all segments of the Russian economy, implicit rules and unwritten agreement prevail over contract provisions and other formal obligations.

In a certain sense, the prevalence of informal transactions over formal ones was predetermined. In critical situations, any rigidity of laws and other formal rules might often become a hindrance to a society’s survival and may provoke additional social tension. In such cases, informal arrangements and institutions (embodying such concepts as solidarity and reciprocity) come to the fore. That is why one cannot overestimate the role of such informal or semi-formal patterns of economic behaviour (such as barter, administrative leave, shortened hours, secondary employment, and the development of an unofficial sector) in alleviating the social costs of transition, especially in the early stages.

As short-term shock absorbers, informal arrangements have visible advantages. However, although informal institutions secure a “safer fall”, they do not guarantee a “swifter rise”. Unlike short-term adaptation, restructuring cannot be carried out without clearly defined and effectively enforced formal “rules of the game” which make it possible to plan economic activity with a long-term perspective. Moreover, a shift from formal arrangements and institutions to informal ones makes the transactional foundation of the economy more primitive. Russia’s economy seems to have fallen into an institutional trap. On the one hand, the end of informal transactions would paralyse its performance, whilst on the other, their prevalence reduces the chance of ever overcoming the transition crisis.

The de-institutionalised Russian labour market is a part of the de-institutionalised Russian economy. It has proved to have had a significant adaptive capacity and has for some time blocked the emergence of such hard-to-cure problems as long-term unemployment and high youth unemployment, which hit CEE countries as soon as transition began.

However, implicit contracts have a serious drawback, namely, that because they are formulated in vague terms and are not backed by reliable enforcement devices, it is difficult if not impossible to control their implementation. As a result, they provide vast room for abuse and opportunistic behaviour (widespread delays of wage payments may serve as the most striking illustration). It is this absence of transparent general rules and reliable enforcement mechanisms aimed at minimising abuses and opportunistic behaviour that results in the personification

of transactions in the Russian labour market, whilst also creating the conditions that allow ineffective forms of employment to survive.

More than once has the Russian labour market demonstrated its high capacity to mitigate shocks. In this respect, it is indicative that the August 1998 financial crash had a very limited impact on employment. However, the Russian labour market is not conducive to deep economic restructuring. By combining an initially ineffective employment structure with a net of informal relationships, it promoted its conservation rather than renewal. With a little exaggeration, its main operational principle may be defined as “adjustment without restructuring”.

Nevertheless, it is quite plausible that having been helpful in avoiding many serious problems in the short-run, the “Russian way” has created problems for the long run. Although slow restructuring has prevented the growth of open unemployment during the initial stages of market reform, it may contribute to persistently high unemployment in the years to come.

Notes

- 1 R. Layard and A. Richter. Labour Market Adjustment - the Russian Way. In: A. Aslund, ed., Russian Economic Reform at Risk. London: Penter. 1995.
- 2 Unemployment, Restructuring and the Labour Market in Eastern Europe and Russia. Ed. by S. Commander and F. Coricelli. Washington: World Bank, 1995, pp.80, 264.
- 3 To do this, enterprises opened for their employees fictitious accounts with unreal interest rates in “friendly” banks. In a similar way, they acquired for the employees fictitious policies in the “pocket” insurance companies that guaranteed unreal insurance payments.

COMMENTS ON THE PAPERS OF GERARD WILD, ANDREJ KLEPACH AND ROSTISLAV KAPELIOUCHNIKOV

Silvana Malle

Head of Division, Economics Directorate, OECD, Paris

The papers presented in this session all point to the peculiarities of Russian transition to the market compared to other countries in transition in Central and Eastern Europe. The efforts to single out the specifics of Russia and understand better her comparative failures in macro-stabilisation and structural reforms is stimulating both Russian and foreign experts to unravel the complicated mechanisms through which the Russian economy has managed to survive, while prospects for sustainable growth remain gloomy. Several studies have been circulated and published which focus on political developments, sociological roots, economic policies and structural adjustment. Few have attempted to look at the interaction between all these factors. An interesting attempt is that of Gérard Wild, who portrays possible scenarios that link economic developments and their perceptions in Russia, security matters, and also cultural factors.

Although demand for a multi-disciplinary approach is high, supply is scarce, understandably, since science in any field proceeds along the specific paradigms of the field and through small incremental insights, until a genius eventually puts the bits and pieces together providing a reasonable and consistent theory. Waiting for a theory of Russia's involution to emerge, the bits and pieces of serious research, which is reflected also in the papers presented in this session, are useful contributions to a better understanding of Russian failures, and, hopefully, improved transition management policies. My comments will concentrate on the structural obstacles to transformation towards the market in Russia and the present policy options.

Mr. Kapeliouchnikov's paper focuses on structural issues through the prism of labour market developments and concludes that Russia compared to other European transition countries has undergone lesser structural change. The paper argues that a high degree of labour mobility and labour market flexibility has not translated into structural shifts, because of informal arrangements between employers and employees, which distort the market's rules of the game. Since, from the start of transition to date, the amount of net labour shedding has been far lower than the fall in output, it would follow that total labour productivity has decreased and is continuing to fall.¹ The problem with this type of analysis

- which gives useful insights into the working of the labour market in Russia
- is that aggregate data are not very revealing. The high number of resignations over dismissals suggests that mobility also may have to do more with labour regulations, policy arrangements between employers and employees, and seasonality than with effective labour turnover. In particular, one should explore further whether, given the high share of insiders that dominate enterprises (see below), much of the labour market flexibility is only apparent.

The bottom line of Mr. Kapeliouchnikov's valid argument is that, in the absence of effective rules of the game, informal arrangements such as administrative leave, shorter worktime, multiple job-holding, wage arrears and unrecorded wage payments, cannot lead to sustainable recovery and growth.

From a different approach, after overviewing macroeconomic and structural developments, Mr. Klepach also concludes that the prospects for growth in Russia are slim. His main argument, however, is that Russian output potential and sustainable recovery are hampered by shortage of capital and very tight budget constraints for enterprises. The re-monetisation of the economy, which has been stimulated by the devaluation of the rouble and reflected in higher enterprise banking accounts and lower shares of barter deals, is slowing down due to a combination of domestic price pressures and a lack of credit. The way out of this scenario lies, according to Mr. Klepach, in the strengthening of import substitution industries and the development of a corporate equity market. He also notes that for the first time in Russian transition, the revival of industry is generalised and if conditions develop that allow for a further strengthening of domestic industry, this will provide support to the budget and to the recovery of the banking and financial markets.

While both papers raise interesting insights into how the Russian economy is working and its weak potential for recovery, some crucial links are missing. In particular, an analysis of the crucial role of public and corporate governance. While public governance has an impact on trust and credibility, corporate governance affects managerial decisions, equity raising and structural adjustment. In both areas, Russians have not fared well. On the corporate side, the structures of corporate governance that have developed in the course of transition reflect different patterns of privatisation. The trade-off between wages and job rights is peculiar not only to Russia, but also to the Czech Republic, which until end-1997 had an unemployment rate of 4.4% (ILO methodology), while in all other transition countries the unemployment rate rapidly shot up to two-digit figures. Both Russia and the Czech Republic chose (voucher based) mass privatisation methods which opened the way to insiders' control. One can discuss whether mass privatisation has led to management or employee-controlled enterprises and the relative effects of either development on the allocation of factors of production. However, there is a high likelihood that in both cases the workforce has a disproportionate voice on decision-making, particularly when this affects job rights.² This state is not propitious for a smooth opening of corporate

structures to outsiders and strategic investors. Mr. Kapeliouchnikov argues that the combination of high labour market flexibility with low restructuring reveals the de-institutionalised character of the Russian labour market. One could argue, alternatively, that Russian enterprises, at least a large part of them,³ have become a species apart working on their own set of rules and codes of behaviour.

While in advanced market economies labour market flexibility contributes to higher productivity and continuous restructuring in response to market demand, in Russia, the result has been the opposite. This raises the question of whether the informal arrangement so well described by Mr. Kapeliouchnikov in his paper are, indeed, vehicles of stickiness rather than flexibility in the labour market. An apparent high level of labour mobility, whose complicated mechanisms need to be carefully studied at the microeconomic level, is likely to conceal a high level of protection of job rights through implicit labour contracts at the level of the firm, and stickiness in the re-allocation of resources, including labour.

Another important explanation for such diverse outcomes is that economic incentives are also different. In fully-fledged market economies, the re-allocation of resources, including labour, is the result of profit incentives, with investment moving from loss making to profit-making enterprises. In Russia, owing to the dominance of insiders in decision-making, profit incentives have a weaker role whilst the structure of corporate governance matters in the allocation of resources. Insider controlled enterprises will preferably use any profit⁴ for wage increases or re-investment, regardless of better investment opportunities in other companies or sectors. At the same time, outsiders are not attracted by these corporate structures. On the one hand, insider-controlled enterprises do not offer sufficient guarantees for the distribution of profit and minority shareholders' rights are not sufficiently protected. On the other hand, the low monetisation of the economy does not provide sufficient knowledge of comparative returns on investment in different companies and branches.⁵ Excluding other types of payment (offsets, securities, barter, etc.) cash counts for 43.4% of total payment in large firms and natural monopolies, and is as low as 14% in machine building.⁶

While a different set of incentives in insider-dominated enterprises explains the low level of restructuring, explaining their survival is more complicated. A number of factors enter into play: limited competition, concealed subsidisation, tax payment practices and barter arrangements are the most important. While entry in the market is free, exit is constrained. Even after the approval of a modern bankruptcy law in March 1998 (which is well described in Keith Bush's paper), the number of bankruptcies is small compared to the number of loss-making companies. This means that creditors' claims against firms are not well protected. According to official statistics, the number of loss-making enterprises in Russia has been variable, but altogether high, between 55 and 60% across sectors.⁷

How do loss-making companies survive? Ingenuous accounting no doubt helps to conceal profits and sustain tax evasion. But years of output and

productivity falls suggest that the effective number of loss-making companies is, indeed, high. The explanation lies in the continuation of subsidies. The losses accumulated by the enterprises are borne by other sectors of the economy. Contrary to what Mr. Klepach suggests in his paper, Russian enterprises are not subject to tight budget constraints but to soft ones because they pay lower than market prices for necessary inputs, energy in particular, and often they do not pay at all. Under government instruction, energy suppliers cannot interrupt their supplies to a large number of companies, either because they are strategic companies or because they have a “political” role. Defence industry, coal mines, transport, as well as other companies which can justify their social role as providers of high employment and social services have no incentives to pay for energy. Tax payment arrears are also a form of subsidy. At both the federal and local government level, tax payment arrears have continued to accumulate over the years with only occasional and localised spells of tax compliance. In spite of increased liquidity and improving performance of the industrial sector, total tax arrears to the federal budget have increased 37% (13% in real terms) since January 1999.⁸

The increasing indebtedness at all levels of the economy prompted the use of a system of clearing mutual debts (offsets) between enterprises and tax offsets between companies and the state. The amount of enterprise arrears (payables in all sectors of the economy) reached 659 trillion roubles in the second quarter of 1998 and was up to 853 trillion roubles a year later. Although lower in real terms and dollar value, this amount kept increasing in 1999 in spite of higher liquidity. Since the incentive to delay payments increases with inflationary expectations, the improvement in the payment of arrears observed in November and December of 1998 due to increased liquidity did not last. Offsets in large-scale enterprises and natural monopolies are very high, ranging in some sectors such as machine building and electricity from about 40% to 50% respectively.

The practice of payment by tax offsets raises the issue of public governance, meaning that set of institutions that govern the choice of public policy. In this area the Russian government has failed to build the necessary level of trust which is required for implementation and law enforcement. Resorting rather often to the practice of sequestration of expenditures, the Russian government (at all levels) has shown disregard for its commitments towards society and disrespect for the rule of law. The practice of payment arrears extends from central government to local governments and off-budget funds. It exacerbates people’s distrust in public administration, while at the same time justifying complacent behaviour towards several categories of tax delinquents, namely those companies and sectors that are creditors to the state. While tax offsets have been eliminated by the central government in 1999 and all tax is collected in cash, this practice is still common at the local level. The share of non-cash receipts at the local level went up to more than 50% of total tax revenues in 1998.

Against this background and on a more general level, developments since August 1998 raise issues about the effective potential of the Russian economy, alternative policy choices and their future implications. The revival of industry hints that there are positive forces at work. Industrial output increased by 7% in the first three-quarters of 1999 year-on-year, led by import substitution and some export-oriented sectors, such as chemicals, wood and paper, and ferrous metallurgy. Internal demand re-oriented towards domestic products giving a boost to food-processing and light industry. Structural shifts, that, as pointed out by Mr. Kapeliouchnikov, had not been remarkable until now, were probably much more pronounced in 1999 than in any year before. Unemployment fell a couple of percentage points, down to close to 12%. In spite of frequent and overall unexplained political changes, monetary and fiscal authorities have been able to keep track of reasonable policies in their respective areas. In the context of rapid recovery, modest positive growth is expected in 1999.

So far the monetary authorities have managed keep inflation under control, while aiming at a slow disinflation. The real effective exchange rate started to appreciate in the first half of 1999. Commodity prices have contributed to positive fiscal developments. Tax collection has improved in the second quarter of 1999, and has been driven partly by higher oil prices. However, there are serious concerns about the sustainability of both trends. Although the current account surplus has rapidly improved, also due to positive oil price developments, capital outflows are still strong. Preliminary data put them at about US\$11bn in the third quarter of this year. The level of reserves is low, partly because they are used to finance the public deficit. Foreign currency reserves (excluding gold) cover about two months of imports. The appreciation of the real effective exchange rate halted in August. Since then, the rouble has continued to slide. Oil prices in 2000 could be less favourable than expected. Moreover, with falling real incomes, poverty has increased, putting pressure on the local budgets that bear the bulk of social expenditure. On the structural side, the re-capitalisation of the banking system is jeopardised by a combination of wishful thinking and a lack of resources.⁹ Fixed capital investment has not recovered from the tremendous fall in 1998. A further concern is the outflow from government posts of leading reformers, whose authoritative presence in the main financial agencies offered until recently the main guarantee for the continuity of reform orientated policy, even though such policies have not always been effective.

Russia is now at the crossroads. On the one hand, as discussed above, adequate market institutions, incentives and budgetary constraints are not in place. On the other hand, the factors behind rapid recovery from the 1998 financial crisis, namely the kickback from the devaluation of the rouble, are waning. This faces the authorities with a dilemma. They may choose to continue to pursue the goal of macrostabilisation, let the rouble appreciate in real terms under the positive pressure of the current account surplus, and tighten further the federal budget. This policy should provide support to re-negotiation and rescheduling

of the payment of foreign debt, help to restore confidence in the currency and, in time, the confidence of foreign investors. However, to be credible, this policy should be backed by convincing structural reforms and the introduction of effective budget constraints at all levels of the economy. The positive outcomes of this policy choice will materialise in the medium-term and could, *ceteris paribus*, provide for sustainable growth.

A possible, and worrying, alternative is that the authorities will release both monetary and fiscal policy to increase domestic demand and continue to sustain industrial growth while refraining from structural reforms. There are strong pressures to move in this direction coming from industry, the military sector, and the poor and social agencies, which have found sympathy among some exuberant pro-Keynesian scholars.¹⁰ The budget for 2000 has been approved, apparently resisting demands for increased expenditures, but is hardly sustainable without support from the IMF and the World Bank. With parliamentary and presidential elections coming closer, pressures to increase public spending will get stronger. Monetary financing of the budget will jeopardise progress in macroeconomic stabilisation and stimulate further capital outflow. A slowing down of reforms, and even reversal in some areas, could follow. There are already signs that the state grip on monopoly sectors, in particular energy where the stake of the state is high, is strengthening. In this scenario, economic growth could continue for a while at the expense of macroeconomic stabilisation. But sooner or later, all the elements for a new crisis will re-appear.

Nevertheless and in spite of frequent government changes, a catastrophic scenario - which was possible in the wake of the August crisis - has been avoided. The result of parliamentary elections on 19 December will be crucial for the fate of the Russian economy in the years to come. None of the main political blocks which are running for parliamentary elections under well-known figures wishes to reverse the course of market-oriented policies. However, none has put forward comprehensive economic programmes, which would justify confidence in deepening structural reforms and more openness to foreign investment. Contrary to the best performing emerging market economies in Europe and Asia, Russia has not managed to attract sufficient strategic investment which could have stimulated a demand for improvements in the institutional environment (as a pre-condition for their implementation). This point is well elaborated by Keith Bush's paper. While the time is ripe for considerable re-thinking of policies in this area, the risk of a retrenchment of Russia away from a challenging interaction with the outside world in all areas of private and public management is also present. While it will be up to the new Russian government, who will emerge from the elections to weight the pro and cons of alternative strategies, the support of the international community will also matter. This support should increasingly focus on the medium and long term advantages of mutually favourable policy options.

Notes

- 1 The MacKinsey Global institute report published on 9 October 1999 estimates that the Russian productivity has fallen from 30 % of the US level in 1991 to 17% in 1997 mostly because the falls in demand and output were not matched by the decline in workforce.
- 2 The recent case of the porcelain Lomonosov factory, where workers organised against foreign investors is symptomatic.
- 3 An interesting article by Grosfeld and al., "Dynamism and Inertia on the Russian labour Market: a Model of Segmentation", CEPR Discussion paper Series, no.2224, argues convincingly that the Russian labour market is increasingly divided into a stagnant pool of less productive enterprises, and a dynamic segment of relatively well performing companies.
- 4 Profits are often derived from economic distortions rather than efficient production (MacKinsey Report).
- 5 The last McKinsey & Co. report argues that the most productive companies are often the least profitable.
- 6 Official sources.
- 7 Goskomstat official statistics.
- 8 PlanEcon, Monthly Report, 22 October 1999, p.12.
- 9 While the number of commercial banks has been decreasing over the years, also due to a more focussed CB policy on issuing and withdrawing of bank licences, this number is still high. The criteria for selecting banks for rehabilitation are not totally clear. The funds, 10bn roubles assigned to the agency created for this purpose, ARKO, of which almost half of it has already spent, are insignificant if compared with the fall in aggregate banking capital following the August 1998 crisis.
- 10 The theoretical underpinning of this approach is particularly weak after the strong devaluation of the rouble that should have supported export led growth. The fact that this is not taking place in Russia suggests that problems still remain on the supply side and its related structural deficiencies.

THE RUSSIAN ECONOMY IN MARCH 2000

Keith Bush

Director, Russian and Eurasian Program - Center for Strategic and International Studies, Washington, DC

Highlights

- From 1989 through 1998, the gross domestic product (GDP) of the RSFSR, then Russian Federation, declined each year apart from a 0.8 percent growth in 1997. In 1999, a growth of 3.2 percent was claimed, primarily attributable to the import substitution effect after the devaluation of August 1998, the increase in value of Russia's oil exports, and some restructuring. The 1999 GDP was about 58 percent of the 1989 level. At an official rate of exchange of 28.5 rubles to the dollar, the 1999 GDP of 4,476 billion rubles was valued at about \$158 billion: at purchasing power parity, the Russian GDP was estimated by the World Bank at around \$630 billion.
- The IMF released the first of seven \$640 million tranches of its \$4.5 billion standby loan on July 30. The second may not be released before April at the earliest because, the Fund maintains, the Russian side has not fully met the commitments it made in the July 13, 1999 joint memorandum of the Russian Government and Central Bank.
- The federal budget for the year 2000 envisages revenues of 797.2 billion rubles (\$24.9 billion, or 14.9 percent of GDP), expenditures at 855.1 billion rubles (\$26.7 billion, or 16 percent of GDP), with a primary surplus of 3.2 percent of GDP and an overall deficit of 1.1 percent of a GDP of 5,350 billion rubles (\$167.2 billion). It includes a substantial nominal increase in defense expenditure to 147 billion rubles (\$4.6 billion), although additional resources may be channeled to the military under other budget headings.
- In 1999, an inflation rate of 36.5 percent was registered. An inflation rate of 18 percent is envisaged for the year 2000, with 2.3 percent registered in January.
- The exchange rate was 28.65 rubles to the dollar on March 1. The budget for 2000 is based on an average annual rate of 32 rubles/dollar.
- Real disposable incomes in 1999 were reported to be 15.1 percent below the 1998 level. In December, 35 percent of the population received incomes below the subsistence level of 980 rubles (\$34) a month. The average wage in industry in January was 1,826 rubles (\$64) a month.

- Wage arrears by February 1 had fallen to 44.9 billion rubles, and are to be eliminated by April 15 2000, according to Acting President Putin. Pension arrears were, it is claimed, eliminated by the end of September.
- After surpluses of \$20 billion, \$28 billion, \$19.8 billion, and \$14.4 billion in 1995, 1996, 1997, and 1998 respectively, the merchandise trade balance in 1999 amounted to \$32.6 billion, excluding shuttle trade.
- The current account surplus in 1998 was \$1.6 billion, after a surplus of \$4 billion in 1997. The surplus for the first nine months of 1999 was \$14.6 billion. The IMF has projected a surplus of \$9.5 billion in 2000.
- The Central Bank's reserves on February 18 amounted to \$13.3 billion, including about \$4 billion in gold. Roughly \$1 billion held by CBR subsidiaries was excluded from the reserve total, owing to new accounting procedures.
- According to the joint Russian Government/Russian Central Bank Statement on Economic Policies of July 13, Russia's total external debt then amounted to about \$150 billion. This was expected to rise to \$166.2 billion by January 1, 2000.
- External debt service coming due in 2000 is estimated at about \$9.2 billion after rescheduling. Some \$3 billion of this is due during the first quarter.
- On February 11, the London Club agreed to write off 36.5 percent of Russia's \$32 billion Soviet-era debt. The Paris Club is expected to be less generous.
- Seventeen months after the August 1998 crash that left most banks technically insolvent, few banks have been restructured. Central Bank Chairman Viktor Gerashchenko has publicly urged restructuring, the closure of insolvent banks, and the attraction of more Western banks, but has done little.
- On December 9, 1998, the Duma passed amendments to the 1995 production-sharing agreement law that opened up 30 percent of Russia's hydrocarbon resources to development by Western corporations. Approval of individual sites by the Duma since then has been very slow.
- Fixed capital investment in 1998 was 7 percent lower than in 1997; it was less than one-fifth of the 1991 level in comparable prices. An increase of 1 percent was recorded in 1999.
- Cumulative net foreign direct investment (FDI) in Russia since 1992 has amounted to \$11.7 billion, according to Prime Minister Putin, compared with over \$350 billion in China during the same period. Net FDI in Russia in 1999 was about \$2 billion, out of a global total of \$827 billion.
- The average age of Russian manufacturing industry plant and equipment is three times higher than the OECD average. To update or replace it will take hundreds of billions of dollars. This capital is not available from domestic sources. Foreign direct investment is very low and will remain so until Russia cleans up its corporate governance act and creates a welcome environment. This suggests that Russian economic growth will remain low for the short- and medium-term.

The Long Depression

Starting in 1989, the GDP of the RSFSR, and successor Russian Federation, declined continuously with the exception of 1997, when a rise of 0.8 percent was recorded. Goskomstat estimated the cumulative drop at around 40 percent by the end of 1996. After a decrease of 4.6 percent registered in 1998, a GDP growth of 3.2 percent to 4,476 billion rubles, was claimed for 1999 - the largest increase in over a decade - with industrial output growing by 8.1 percent. This recovery is attributed to the import substitution effect after the devaluation of August 1998, the high world price of oil, and to some restructuring. The drop in output by the end of the century was about 42 percent - a far steeper fall than was registered during the Great Depression in the United States in the early 1930s. Yevgeni Yasin has projected an annual GDP of 1.5-2 percent increase over the next 2-3 years.¹

Nine Years of Transition

Annual percentage change	1992	1993	1994	1995	1996	1997	1998	1999
Gross domestic product	-14.5	-8.7	-12.7	-4.2	-3.5	0.8	-4.6	3.2
Industrial production	-18.8	-14.6	-20.6	-3.0	-3.5	1.9	-6.6	8.1
Agricultural production	-9.0	-4.0	-12.0	-8.0	-5.1	0.1	-12.3	2.4
Consumer prices	2,650.0	940.0	320.0	131.0	22.0	11.0	85.0	37.0
Real average wages	-41.0	14.0	-8.0	-13.0	5.0	2.5	-13.8	-15.1
Life expectancy at birth, years								
Men	62.0	59.0	57.0	58.0	60.0	59.0	59.0	na
Women	74.0	72.0	71.0	72.0	72.0	71.0	71.0	na
Federal budget, as % of GDP								
Revenues	16.6	14.5	14.1	13.7	12.5	12.1	11.3	13.7
Expenditures*	27.7	15.9	18.1	16.6	15.6	15.3	14.5	15.0
Balance*	-11.1	-1.4	-4.0	-2.9	-3.3	-3.2	-3.2	2.2
Balance**	na	-6.5	-11.4	-5.4	-7.9	-6.8	-7.2	-1.3

* Excludes debt service

** Includes debt service

Sources: Derived from Goskomstat and IMF reports; *Russian Economic Trends*, quarterly and monthly updates; Interfax, March 6, April 12, 1999, & February 21, 2000; *Ekonomika i zhizn*, no. 2 (1998); Bank of Finland, *Russian Economy: The Month in Review*, no. 3 (1998); and *The Russian Economy: The Week in Review*, various issues.

The most disturbing factors in respect to growth prospects are that most industrial plant, equipment, and infrastructure are obsolete or obsolescent and that investment has dropped faster than output and continues to fall. Productive capital investment in 1998 was reported to be less than 20 percent of the 1991 level in constant prices.² A drop of 6 percent was reported for 1997, a decline of 7 percent occurred in 1998,³ but, for the first time in a decade, investment

grew in 1999 by about 1 percent. The exceptionally low rate of investment throughout most of the economy is attributable to a variety of factors. They include the low rate of private saving, the budget deficit that absorbs too many investible resources, disincentives provided by the onerous and opaque tax code and legal system, capital flight, and the understandable unwillingness of banks to invest in the real economy when they have been able to earn up to 180 percent on an annualized basis from government bonds. It might be pointed out that, even if an average 5 percent growth rate of GDP could be sustained in the next century, it would take about 12 years to regain the GDP level recorded in 1989.

Much of the decline of the past years is to be welcomed because it marks the overdue restructuring of the Russian economy toward producing goods and services that meet consumers' demands rather than planners' preferences. The output of the defense industry in 1996, for instance, was reported to be only 22.9 percent of the 1991 level, with military hardware at 14.3 percent and civilian goods at 27.1 percent of the 1991 figures.⁴ Its size was to be further reduced from 2.7 million employees in 1,760 plants in 1997 to 900,000 employees in 500 plants by the year 2005, although that was before the fallout from the Kosovo crisis.⁵ Much or perhaps most of Soviet-era investment went to the military-industrial complex. Moreover, in contrast to the command economy where managers had an incentive to *overstate* their output data to overfulfill plan targets and win bonuses, executives are motivated now to *understate* production totals to evade the tax inspector and the mafia and to have surpluses for sale on the side or for use as barter. Official data are also suspect. Goskomstat was set up to monitor manufacturing output but may not fully capture the activity of the service sector and the black and grey economies. More than one-fifth of the GDP - the MinFin estimate is 22 percent, while Goskomstat stays with a figure of 25 percent - derives from the shadow economy, compared with perhaps 13 percent in Italy.⁶ A 1997 study by Larissa Pyasheva and Igor Birman argued that the unofficial economy now accounts for 50 percent of the Russian GDP,⁷ a recent estimate by the World Bank is 43 percent,⁸ while another estimate cited by *The Economist* is one of 40 percent.⁹

Inflation

After most wholesale and retail prices were freed on January 2, 1992, consumer prices increased by 2,509 percent that year. The monetary overhang disappeared overnight, as did lines and the value of people's savings.¹⁰ Tight monetary and fiscal policies brought annual inflation down from 840 percent in 1993; to 215 percent in 1994; to 131 percent in 1995; to 22 percent in 1996; and to 11 percent in 1997. With the economic meltdown of August 17, 1998, inflation rebounded that year to an annual total of 84.4 percent. Although an inflation

rate of 30 percent was projected for 1999 in the federal budget, the outturn for the year was 36.5 percent.

The Economics Ministry has projected annual inflation rates of 18 percent in 2000, 10-12 percent in 2001, and 8-10 percent in 2002.¹¹ Inflation in January 2000 rose to 2.3 percent, while the Economics Ministry sees inflation at 5.5-6 percent during the first quarter.¹²

The Federal Budget for the Year 2000

The federal budget for the year 2000 envisages revenues of 797.2 billion rubles (\$24.9 billion, or 14.9 percent of GDP), expenditures at 855.1 billion rubles (\$26.7 billion, or 16 percent of GDP), with a primary surplus of 3.2 percent of GDP and an overall deficit of 1.1 percent of a GDP of 5,350 billion rubles (\$167.2 billion). It includes a substantial nominal increase in defense expenditure to 147 billion rubles (\$4.6 billion), although additional resources may be channeled to the military under other headings.

The planned revenues of 14.9 percent of GDP were initially criticized as over-optimistic, but are now looking more realistic in light of improved tax collection due to higher profits and greater compliance. Moreover, revenues are planned on the basis of an annual average world price of \$17 a barrel, which currently looks excessively conservative. Projected expenditures are apparently predicated on severe cutbacks in the size and cost of the enormous state bureaucracy.

Earnings, Incomes, Pensions, Poverty

The average nominal monthly wage earned in January was 1,826 rubles (\$64) a month at the official rate of exchange.¹³ The average monthly pension for the 29 million old-age pensioners effective February 1 is 650 rubles a month. The minimum wage was raised to the equivalent of 83.49 rubles a month effective January 1, 1997. The figure is critical because many salaries and transfer payments are set in terms of multiples of the minimum wage. The minimum pension effective February 1 is 410 rubles a month. Supplementary benefits for pensioners range between 85 and 150 rubles a month.¹⁴ Earnings were down by 13 percent in 1995,¹⁵ recovered by 5 percent in 1996, grew by 2.5 percent in 1997¹⁶ but dropped by 13.8 percent in 1998.¹⁷ After deduction of compulsory payments and adjusted for inflation, real disposable income in October 1998 was reported by Goskomstat to be 51.7 percent of the 1991 level.¹⁸ Real wages in 1999 were reported to be 15.1 percent lower than in 1998. It should be noted that money wages and salaries account for a diminishing share of total income, down from 60.5 percent in 1993 to about 48 percent now.

Disparities in income grew until 1996. Incomes of the top 10 percent of earners in April 1997 were reported to be 12.4 times higher than those of the

lowest 10 percent, compared with a ratio of 13.5 in early 1996; 11:1 in 1993; 8:1 in 1992; and 4.5:1 in 1991.¹⁹ In December 1999, 35 percent of the population, received incomes below the then subsistence level of 980 rubles (\$35) a month.²⁰ The personal saving rate is reported to be 8.9 percent.²¹ Ruble household deposits and foreign currency deposits in October 1999 amounted to 196 billion rubles and 258 billion rubles respectively,²² in addition to an estimated \$30-50 billion in U.S. dollars, mostly under mattresses. About 85 percent of the population has no savings.²³

Unemployment and Bankruptcy

The number of citizens officially registered as unemployed on December 1, 1999, had fallen to 1.3 million or some 1.7 percent of the population of working age.²⁴ For a variety of reasons, the registered numbers are misleadingly low, and the February 1, 2000 estimate of unemployment using the International Labor Organization's definition²⁵ was 9.1 million, or 12.6 percent of the able-bodied population of 72.2 million.²⁶ When a more comprehensive measure - which included those on part-time employment, on unpaid leave, and who experienced "suppressed unemployment" - was used, the ILO earlier estimated that Russia's jobless rate stood at 17 million or 22 percent of the work force.²⁷ Enterprises keep surplus workers on their books to avoid additional taxes and redundant payments, and because labor is a relatively cheap input.²⁸ The rate is still relatively low; GDP and industrial output have fallen by about 42 percent since 1989, but the work force has declined by only about 15 percent during that period.²⁹ The average monthly unemployment benefit is set roughly at the minimum wage level (i.e., 83 rubles).

Unemployment could rise if the bankruptcy measures introduced in 1998 are implemented forcefully. The first was the bankruptcy law that came into effect in March 1998: this allows an arbitration court to declare an enterprise insolvent if it is unable to pay creditors' bills within 90 days, pay wages, or service outstanding debt.³⁰ The second was a May 22, 1998 decree, "On Measures for the More Effective Institution of Bankruptcy Proceedings and Statute on Accelerated Bankruptcy Proceedings." All creditors - including federal and local governments, UES, Gazprom, the railroads, and supplier enterprises - will be represented in arbitration court by a single creditor representative. The debtor enterprise will be offered two options as alternatives to bankruptcy: either an assessment by the Federal Service for Insolvencies and Financial Recovery (FSDN) that the plant's solvency can be restored within one year, or the introduction of external management. Failing these, bankruptcy proceedings will be immediately instituted.³¹ Before he was removed from the post of chief tax collector, Boris Fedorov announced bankruptcy proceedings against 28 major tax deadbeats.³² The joint Russian Government/Russian Central Bank memorandum of July 13, 1999

commits the government to initiate a bill to make managers responsible where applicable for pushing bankruptcy proceedings.

In 1998, more than 55 percent of all large- and medium-sized companies were unprofitable.³³ An authoritative study of Russian privatization, citing Russian national surveys of corporations in 1995 and 1996, concluded that three-quarters of corporations were in need of radical and far-reaching restructuring, and at least one-quarter of these firms should be declared bankrupt.³⁴ By September 1996, however, less than 1,000 enterprises had been declared bankrupt. Many cases were bogged down in the courts, exhausting the resources of the federal bankruptcy agency.³⁵ Threats of bankruptcy have been used increasingly to pressure enterprises into paying their tax arrears; in late January 2000, the tax authorities threatened bankruptcy procedures against 23,328 enterprises which were behind with their tax payments. Wholesale closure or restructuring has been hampered by the need to have a court order before management can be replaced, and it can take up to 18 months to push bankruptcy proceedings through the arbitration court.

More important, bankruptcy proceedings have been delayed because of the political risk of closing hundreds, perhaps thousands, of enterprises - without an adequate social safety net in place - in what are often one-factory towns.³⁶ In October 1999, there were 940 single-factory towns, with some 24 million inhabitants.³⁷ In most of these, the single factory provides not only employment, but also supplies housing, schools, clinics, stores, canteens, market gardens, and even free or heavily subsidized vacation resorts. Nearly all of these value-subtracting enterprises are located in the regions, and local authorities are understandably reluctant to press bankruptcy proceedings. For instance, Sverdlovsk governor Eduard Rossel vowed to prevent the bankruptcy or privatization of the Uralvagonzavod plant employing 25,000 workers.³⁸ Chelyabinsk governor Petr Sumin announced on April 16, 1999, that he would grant 200 of the oblast's leading firms political protection from bankruptcy. When insolvent state-owned enterprises are sold, the government channels 60 percent of the proceeds to fund the social infrastructure, which has until now been largely the responsibility of the factories themselves.

Strike action is down from 6,001,000 man-days lost in 1997 to 2,882,000 man-days lost in 1998,³⁹ and its level thus far has been relatively low by the standards of many OECD nations.⁴⁰

Foreign Direct Investment and Portfolio Investment

In 1995, worldwide foreign direct investment (FDI) is estimated to have totalled \$315 billion. Some \$36 billion of this went to China. Russia attracted just \$1.9 billion, roughly one-half of 1 percent of the world total. (Since China's population is roughly nine times that of Russia, the per capita discrepancy is not so marked.) The total for 1996 rose slightly to \$2.1 billion (although this

figure may exclude contract work.)⁴¹ Figures for 1997 show a reported \$3.9 billion in net investment out of a global total estimated at \$464 billion.⁴² A net total of \$1.8 billion was recorded for 1998 out of a world total of \$644 billion,⁴³ and the figure for 1999 is estimated at below \$2 billion, out of a global total of \$827 billion.⁴⁴ The cumulative net figure by October 1999 was put by Prime Minister Putin at \$11.7 billion.⁴⁵ Some of the principal reasons for this meager share of global FDI include political instability, the unpredictability and lack of coordination of government policies, the exclusion of foreign interests from some privatization auctions, the lack of bilateral investment treaties, the absence of contract law, capricious and exorbitant taxes, the lack of commercial infrastructure, the limits on foreign banks, constant changes in legislation affecting foreign investors, poor protection of property rights, the inability of foreigners to own land, pervasive corruption, the predations of organized crime, and appalling environmental disruption.

There have been prominent figures in the administration and the legislature who argue that Russia does not require foreign capital and can finance all needed investment out of its own resources. This is an internal debate that has yet to be resolved. Much will depend on personalities, such as Sergei Glaziev, the chairman of the Duma's Economic Committee. There can be little doubt that Russian industry needs massive reequipment: the average service life of the active portion of fixed capital is about three times longer than in OECD countries.⁴⁶ Former prime minister Chernomyrdin estimated that Russia could use and absorb up to \$50 billion of foreign investment each year. The former economics minister Yevgeni Yasin reckoned that, in the next 15 years, Russia would require some \$2.8 trillion in investment, of which one-third could come from abroad.⁴⁷ The pent-up demand for consumer services is exemplified by the telephone system. It has been calculated that it will cost at least \$40 billion and take many years for Russia to increase telephone penetration to 20 lines per 100 inhabitants (against 61 lines in the United States).⁴⁸

Meanwhile, Russia has stayed near the bottom of the investment league. Russia led the list as the riskiest business location for U.S. and UK companies during the first half of 1999, according to a survey by Merchant International Group.⁴⁹ It retained this dubious honor for the third quarter of 1999. Horror stories abound. Documents allegedly leaked from the Federal Counterespionage Agency, published in January 1995, accused some leading Western investors of attempting to "guarantee the technological backwardness of Russia."⁵⁰ Pages have been torn from shareholder registers. Western partners have been squeezed out of successful joint ventures. Komineft instituted what amounted to a 3-for-2 stock split without informing existing shareholders and diluted most holdings.⁵¹ Many enterprises, it is said, now keep three sets of books: one for themselves, one for the authorities, and one for foreign investors.⁵² The Moscow office of Johnson & Johnson was seized for alleged failure to pay some \$20 million in back taxes, and warrants were issued for two of its expatriate executives.

The invalidation, in August 1997, of Exxon's tender offer for the development of oil deposits in the Nenets region marked the first time that the Russian government had changed its mind over a highly contested and controversial foreign investment decision.⁵³ In the opinion of a member of the then-extant Gore-Chernomyrdin Commission: "It raises the question of whether a deal is a deal in Russia, because Exxon is meticulous to a fault in following the letter of the law."⁵⁴ Another major blow to Western investor confidence came with the apparent breakdown of talks over Amoco's \$28 billion, 58-year project to develop the Priobskoye oil field in Siberia in collaboration with Yukos.⁵⁵ In the dispute between Aeroflot and IMP over the joint venture Aerostar Hotel in Moscow, IMP won a \$5.8 million judgement by the Arbitration Institute of the Stockholm Chamber of Commerce. The ruling was upheld by the Russian Supreme Court, but Aeroflot still refused to pay.⁵⁶ More recently, threats to defraud Conoco and other foreign companies out of their stakes in regional mining projects provoked a protest by the U.S. embassy to the governor of Archangel.⁵⁷ On March 17, 1999, the Duma passed on first reading a bill to limit foreign voting stakes in 1,150 "strategic" companies to 25 percent of capital (i.e., one share less than a blocking stake).⁵⁸

Receptivity toward foreign direct investment varies greatly between regions. Three-quarters of FDI is concentrated in 10 out of the 89 areas, namely in the Moscow region; St. Petersburg and the Leningrad region; the Tyumen, Archangel, and Maritime regions; and the republics of Tatarstan, Komi, and Mari El.⁵⁹ The mayor of Moscow and the president of Tatarstan have welcomed, and have succeeded in attracting, foreign capital (Moscow has attracted 57 percent of all investment in Russia⁶⁰), while others are famous for their suspicion of the motivation and aims of Western business interests.⁶¹ Since May 1998, 31 of the 89 regions have defaulted on agrobonds-secured loans made by the federal government to regional agricultural firms.⁶² The State Duma has shown itself to be generally hostile to Western investment in what it considers to be strategic sectors of the Russian economy.⁶³ On July 15, 1998, when it gave a third reading to a federal draft law - "On Foreign Investment in Russia" - it passed an amendment to the grandfather clause in earlier legislation that appeared to have the effect of watering down investor protection,⁶⁴ but this was subsequently vetoed by President Yeltsin.⁶⁵ Dmitri Vasiliev, then chairman of the Federal Securities Market Commission, promised a 1998-1999 government program for the protection of investors' rights.⁶⁶ On February 12, 1999, the Duma passed in first reading a new version of a law to protect investors in the securities market.⁶⁷ In another field, legislation was passed in June 1999 that could "literally confiscate assets that U.S. and European insurance firms had already invested in the Russian economy."⁶⁸

In what may have been the single most serious setback for hopes of corporate governance in Russia to date, Dmitri Vasiliev resigned from the post of chairman of the Federal Securities Commission on October 15, 1999. He was reported

to have been frustrated over the obstruction posed by other government agencies to his efforts to instill or improve corporate governance and especially to his efforts to protect the rights of minority shareholders. Vasiliev had been defeated in his attempts to rein in Yukos, which has been widely accused of abusing minority shareholders. Perhaps the final blow was a decision by a St. Petersburg court to renationalize the Lomonosov porcelain factory: this decision annulled the 51 percent stake held by Kohlberg, Kravis, Roberts, & Co, and the US-Russia Investment Fund.⁶⁹

The first two months of the year 2000 have seen the settlement of some grievances and the reversal of some troubling actions against external partners and share-holders. Thus BP Amoco and Dart appear to have resolved their disputes with Yukos, foreign investors regained control of the Lomonosov porcelain plant, and British Alcem reinstated its management of the Vyborg paper mill. It may be coincidence or perhaps the Putin administration applied pressure to improve the investment climate?

Production-Sharing Agreement

After many months of negotiation between the Duma and the Federation Council, with much of the foot-dragging attributed to Vladimir Shumeiko, then chairman of the Federation Council,⁷⁰ a compromise version of the production-sharing agreement (*Soglashenie o razdele produktsii*) was passed by the Duma on December 6, 1995. A production-sharing agreement (PSA) is considered to be vital for attracting large scale and long-term foreign investment in the extractive industries: it establishes the share of revenue or output that is claimed by the host government and the tax regime. The heavily amended law was, however, immediately denounced by Aleksei Melnikov, a Yabloko faction member of the Duma, who had been one of the authors of the original draft; Chubais condemned the compromise version as “unworkable”⁷¹ and as an “absurdity.”⁷² It was even suggested that Sergei Glaziev—then number three on KRO’s platform and now chairman of the Duma’s Economic Committee—switched texts at the last minute.⁷³ The Federation Council passed the compromise version on December 19, and President Yeltsin signed it into law on December 30,⁷⁴ presumably in keeping with the principle that “no law is worse than a bad law.” An expert appraisal concluded:

*The current law is clearly less comfortable to foreign investors than had been hoped for by many. The lack of stable investment conditions, including clear procedures for cost and accounting calculations, difficulties with satisfying formalities for concluding production-sharing agreements, provision of customs and export exemptions, coordination with the existing tax regime, and the failure to coordinate or amend the existing law on subsoil will clearly hamper progress in attracting much needed foreign capital.*⁷⁵

The law further required that the Duma approve every oil deal in strategic areas, and it also gave to the Russian side a unilateral renegotiation clause to walk away from contracts should world oil prices change. The former minister of fuel and energy, Petr Rodionov, told Western investors and corporations in October 1996 that mandatory orders for competitive Russian-made equipment would be written into all contracts with foreign investors.⁷⁶ In October 1996, the Duma's audit chamber called for the government to withdraw the list of oil deposits subject to production sharing until it could provide a comprehensive justification for each site.⁷⁷

As late as July 1999, only three production-sharing agreements were actually in force - the grandfathered Sakhalin-1 and Sakhalin-2 projects, and the Kharyaga project signed with Total in 1995.⁷⁸ The Piltun-Astokhskoye field in Sakhalin-2 began commercial output of crude in mid-July. On July 22, 1997, the president signed a law authorizing five oil and gas fields, a gold mine, and an iron ore deposit for development under PSA. Only two of the sites - the gold mine and an oil deposit in the Barents Sea - were open to foreign investors: they could attract about \$1 billion in FDI. A second batch of nine sites was making its slow way through the Duma. Much enabling legislation remains to be passed. On November 26, 1997, it was announced that three further commissions had been set up to prepare several projects near Sakhalin, on the Barents Sea shelf, in Khanty Mansi, and in Tatarstan.⁷⁹ But on July 15, 1998, the Duma adopted a bill amending the PSA law. This amendment stipulated that no more than 20 percent of the country's proven natural resources and 10 percent of "strategic natural resources" could be given away to foreign investors under production-sharing agreements.⁸⁰ A special federal law would be required to approve PSAs concerning the most important natural resources - hardly encouraging for potential investors.⁸¹ An AMOCO executive complained that the amendment could stop his company's bid to develop the multibillion-dollar Priobskoye field, since the agreements already in place were close to the 20 percent mark. Furthermore, new legislation on the protection of foreign investment, passed in July 1998, fixed a new five-year limit on tax relief, royalty provisions, and other terms that could seriously reduce the viability of the PSAs.⁸²

After nearly three years when little progress was recorded in amending the PSA legislation, exhortation to move forward on PSA was included in Primakov's economic stabilization plan published on November 15, 1998. The former prime minister repeatedly urged the Duma to "support him in passing laws that are necessary for the country's normal development. First of all, these are amendments to the laws on production-sharing agreements and on foreign investments, and on the adoption of a law on concessions."⁸³ On December 3, 1998, a committee of the Duma and the Federation Council approved the groups of fields that can be developed under PSAs without having each site also approved by parliament: these include oil fields with up to 25 million tons of reserves, gas fields with up to 250 billion cubic meters of gas, and fields with up to 50 tons of gold.

(On April 13, 1999, the Duma PSA committee agreed to authorize PSA status for the Priobskoye project, even though it is said to hold 700 million tons in recoverable reserves.⁸⁴) The new legislation requires PSA participants to purchase 70 percent of their equipment and hire 80 percent of their work force in Russia. The Duma passed the PSA amendments on December 9 and the Federation Council approved them on January 27, 1999. In mid-February, the Duma approved at first reading a list of nine more fields that may be developed under PSA. The fields contain about 10 percent of known oil reserves in Russia.⁸⁵ On April 21, the Duma passed further PSA legislation to cover foreign participation in the development of 37 oil and gas fields, while on April 24, the Federation Council approved unanimously a law on developing the Kirinsky block of the Sakhalin-3 PSA. In early June, President Yeltsin signed into law PSA legislation covering eight more fields, but on June 11 the Duma postponed indefinitely debating bills applying the PSA to the Priobskoye and Northern Territories blocks.⁸⁶ The delay in getting Duma approval of the site has caused Atlantic Richfield Company (ARCO) to withdraw from its Sakhalin-4 gas project.⁸⁷ What are also needed are laws that would integrate PSAs into the existing tax regime.

Foreign Trade

Foreign trade recovered quickly after the abrupt severing of ties with the other former Soviet republics and with Comecon, growing for several years in double-digit percentage figures while GDP declined. Merchandise trade surpluses (excluding shuttle trade) of \$20 billion, \$28 billion, \$19.8 billion, \$14.4 billion, and \$32.6 billion respectively were recorded in 1995, 1996, 1997, 1998, and 1999.

Capital flight continues, although estimates of its scale vary greatly. The IMF was quoted as giving tentative totals of \$13 billion for 1992 and \$8 billion for 1993.⁸⁸ The head of the Central Bank's Currency Regulation Directorate gave a cumulative figure of \$60-80 billion since 1991.⁸⁹ The Ministry of Internal Affairs estimated the cumulative total of capital flight by the end of April 1996 to be \$40 billion.⁹⁰ Yevgeni Primakov, then head of the Foreign Intelligence Service, put the annual level of capital flight at \$15-20 billion.⁹¹ During a conference on money laundering, held in Prague in February 1997, it was suggested that about \$60 billion in capital had fled Russia during the preceding five years.⁹² Then Interior Minister Sergei Stepashin put the outflow during the past seven years at nearly \$76 billion.⁹³ A joint Canadian-Russian study published in 1998 estimated the accumulated capital flight since 1990 at around \$120 billion,⁹⁴ a figure considerably higher than the total of loans, credits, and other assistance from the IMF, World Bank, other institutions, and Western governments. The reasons for the massive scale of capital flight include political instability, the loss of confidence in the ruble as a store of value after the high inflation

of 1992, the desire to avoid excessive and arbitrary taxes, and the continuing poor protection of property rights.

Russia's current account registered surpluses of \$12 billion, \$3.5 billion, and \$2.5 billion in 1996, 1997, and 1998 respectively, and \$14.6 billion for the first nine months of 1999. The IMF projects a surplus of \$9.5 billion in 2000. On February 18, the reserves of the Central Bank amounted to \$13.3 billion, including about \$4 billion in gold.

The Merchandise Trade of Russia, 1992-1999
(\$ billion in current prices, excluding shuttle trade)

	1992	1993	1994	1995	1996	1997	1998	1999
Exports	53.6	59.7	68.1	81.1	87.7	86.7	73.9	69.9
To CIS	11.2	15.4	14.9	15.6	16.7	17.8	14.9	10.5
To other countries	42.4	44.3	53.2	66.0	71.0	68.9	59.0	59.4
Imports	43.0	44.3	50.5	60.9	59.7	66.9	59.5	29.8
To CIS	6.0	11.5	13.5	16.7	17.5	17.5	13.7	na
To other countries	37.0	32.8	36.9	44.1	42.2	49.4	45.8	na
Trade Balance	10.6	15.4	17.6	20.2	28.0	19.8	14.4	40.1

Sources: WEFA, *Eurasia Economic Outlook*, November 1997; Interfax, February 19, 1999, and January 25, 2000; *Russian Economic Trends*, March 1999.

Oil and petroleum products are Russia's principal export commodities, and the price and disposition of its exports of crude oil and petroleum products are politically and economically sensitive. Although output fell steadily - from 340 million tons in 1993, to 302 million tons in 1994, and to 296 million tons in 1995 - exports rose from 81 million tons in 1993, to 115.8 million tons of in 1996, and to 127 million tons in 1997. The Near Abroad received an estimated 25.5 million tons of oil in 1995 for an average price of \$73.90 a ton, compared with \$107.50 a ton for Russian crude supplied to the Far Abroad.⁹⁵ Of the 127 million tons exported in 1997, only 17.1 million tons went to the CIS and the rest to the Far Abroad.⁹⁶ Earnings from oil sales in 1997 accounted for \$14.8 billion, or 17 percent of total export revenues. In addition, 61 million tons of products earned a further \$7.2 billion. It has been calculated that a change of \$1 in the price of a barrel of crude oil changes export revenues by \$1.2 billion. The 1998 budget was reportedly predicated on an average annual world price of \$15.50 a barrel, and revenues were seriously affected by the drop in world oil prices.⁹⁷ The recovery in world oil prices in 1999 meant that Russia earned much more from a smaller volume of oil. Whereas Russia exported 126.9 million tons of crude for \$9.5 billion in 1998, it exported 123.9 million tons in 1999 but earned \$13.3 billion. Of the 1999 total, 8.8 million tons went to

CIS countries for \$585 million, and 115.1 million tons were sold to the Far Abroad for \$12.7 billion.⁹⁸

Arms sales have accounted for a substantial share of Russia's exports: their value in 1995, 1996, 1997, and 1998 is estimated at about \$3.0 billion, \$3.4 billion, \$2.6 billion,⁹⁹ and \$2 billion¹⁰⁰ respectively. Revenues from the export of nuclear materials and technology have also been high, earning \$2.05 billion, \$2.2 billion, and \$2.5 billion in 1995, 1996, and 1997 respectively.

WTO Membership

Russia first applied to join the GATT (the WTO's predecessor) in June 1993, and a Working Party was set up by the GATT General Council to consider the accession application.

The first hurdle was the preparation and circulation of a Memorandum on the Foreign Trade Regime. This explains the applicant's policies and institutions regarding trade in goods and services, and encompasses the financial, insurance, and telecommunications sectors. The issues to be covered include various aspects of macroeconomic policy, especially related to foreign exchange management and controls, investment and competition policy, protection of intellectual and other property rights, as well as enterprise privatization. The memorandum for Russia was circulated to members of the GATT in March 1994.

The second stage consisted of initial questions and requests for clarification posed by members based on the memorandum and the circulation of the answers filed by the applicant. In the case of Russia, this took more than a year (June 1995). The follow-up questions and clarifications are in process.

Some common themes emerge when a transition economy, and especially a former Soviet republic, applies for accession. The first is the concern that the laws and regulations of the acceding country are in conformity with WTO provisions. These include the Law on Customs, the tariff schedule, regulations on imports and exports, laws on joint stock companies, the central bank and credit institutions, licensing of economic activity, and domestic taxation. Second is the degree of privatization and the transparency of the government rules and criteria. The third set of issues relates to the jurisdiction and capacity of national agencies to implement policies on which commitments are made. Other issues of concern in regard to former Soviet republics are the arrangements for the value-added tax (VAT), and the free trade arrangements and customs union agreements signed by several of the CIS countries.¹⁰¹

In February 1998, the Russian government submitted to the WTO a list of nearly 10,000 imported goods on which it was prepared to cut import duties. It also sent a list of 500 items to be excluded, including oil, gas, and ferrous and nonferrous metals. In May 1998, Russia submitted a detailed market access offer. This proposed the maximum duty levels that the Russian government would accept if its application to join the WTO were approved. They were

generally viewed as excessively high. Prospects for early WTO membership have been further clouded by an increasingly vociferous “buy-Russian” campaign, articulated by, *inter alia*, President Yeltsin, and the widespread resistance to foreign direct investment. In July 1998, a presidential decree hiked import tariffs from a prior average of 14 percent, by 3 percent across the board effective August 15.¹⁰² The eighth session of the working party looking at Russia’s accession ended in Geneva on July 30. Satisfaction was noted with progress on some fronts, although there was concern voiced about the pending 3 percent increase in tariffs. A new policy linking import duties to the purchase or lease of domestic goods has been condemned as a possible deviation from the WTO accord on trade-related investment measures or TRIMS.¹⁰³

An early draft of the Primakov administration’s stabilization plan called for increases of up to 100 percent on duties on “imports damaging local producers.”¹⁰⁴ The final version of the plan, published on November 15, softened this considerably, albeit ambiguously, stipulating: “Russia’s accession to the WTO should promote the creation of an environment conducive to expanded access to foreign markets for Russian goods and services and promote protection for Russian products while maintaining the competitive environment essential for state supply for agriculture and protection of the market for agricultural and food products.”

The second draft federal budget for 2000 provides for levying value-added taxes on CIS countries’ goods according to the country of origin, rather than the country of destination. This contravenes the WTO’s country-of-destination rule, and amounts to double taxation of goods from CIS countries in view of the fact that most of these follow the WTO rule. Russian spokesmen, as well as the Russian media, have been very critical of Kyrgyzstan and Georgia, the first two CIS countries to accede to the WTO, as well as of Moldova and Armenia, which are close to joining.¹⁰⁵

Exchange Rate

Since the devaluation of August 17, 1998, the exchange rate has fluctuated between 6.30 and 30.15 rubles to the dollar. After remaining relatively steady around 23 rubles to the dollar throughout February and the first half of March, the rate fell steadily to 26.84 rubles to the dollar by December 7, but has remained fairly stable at around 28.6 rubles to the dollar for the first two months of 2000. Effective January 1999, exporters have been obliged to sell 75 percent of their export revenues on the market. On at least two occasions, former first deputy prime minister Yuri Maslyukov suggested some kind of currency board for the ruble, tying the currency to a basket of currencies including the Euro,¹⁰⁶ a concept rigorously rejected by his colleague, Viktor Gerashchenko. The budget for 2000 is based on an average annual exchange rate of 32 rubles to the dollar.¹⁰⁷

External Debts and Credits

By January 1, 1999, Russia's sovereign debt amounted to \$143.9 billion, according to former finance minister Mikhail Zadornov. To this should be added an estimated \$14.9 billion in dollar-denominated domestic debt.¹⁰⁸ About \$103 billion of the debt was inherited from the former Soviet Union. Owing to the structure of these assumed Soviet obligations, more than half of this debt was originally due for repayment in 1993-1996. The ratio of Russia's external debt to exports is nearly 200 percent and its ratio of debt to GDP is about 100 percent, with both ratios comfortable in comparison to those being shouldered by many emerging economies. The July 13 joint Russian Government/Russian Central Bank statement put Russia's total external debt at that date at around \$150 billion, and projected the debt to rise to \$166.2 billion by January 1, 2000.

After a series of rollover agreements, Russia finalized the rescheduling of its commercial debt to the value then of \$32.5 billion with the London Club: after a 7-year grace period, repayment was to be spread over 25 years. A similar agreement on rescheduling sovereign debt of \$40 billion owed to the Paris Club was finalized in October 1997: the agreement provided for a grace period through the year 2002, during which Russia was to pay only interest, and then repayment of the principal over 19 years. After the crash of August 17, 1998, the repayment schedule went back to the drawing board. In August 1999, the Russian government and the Paris Club rescheduled about \$8.1 billion in Soviet-era debts that were due in 1999 and 2000. Russia agreed to pay \$600 million in 1999 and 2000, and deferred overall restructuring of the \$38 billion owed to the 18 lender governments of the Paris Club until after the presidential elections set for 2000. On February 11, the London Club agreed to write off 36.5 percent of Russia's \$32-billion Soviet-era debt. The balance will be restructured into 30-year eurobonds, with a seven-year grace period.¹⁰⁹ It appears that the Paris Club will be less generous as Germany, which is owed half of the outstanding debt, has publicly rejected such a write-off.

The Russian government has been differentiating between the Soviet-era "odious" debt and the Russian debt incurred since January 1992, claiming that it is still servicing its own Russian debt, while not able to meet its Soviet-era commitments.¹¹⁰ In November 1998, a deputy finance minister admitted that Russia had formally sought to reschedule its Soviet-era debts for the second time. He conceded that Russia could not pay more than \$10 billion out of the estimated \$17.5 billion that fell due in 1999.¹¹¹ By mid-February 1999, according to the Ministry of Finance, Russia had missed \$1.5 billion in foreign debt service since August 17.¹¹² Economics Minister Andrei Shapovalyants raised the possibility of writing off sovereign debt, citing the cases of Poland and Bulgaria. A deputy finance minister spoke of the "Polish model," whereby half of the old debt is written off and the other half rescheduled.¹¹³ At a press

conference in March 1999, then first deputy prime minister Yuri Maslyukov said that the government was seeking to have 75 percent of the Soviet-era debt written off by the London and Paris Clubs. This faced vigorous opposition from Germany, however, which holds about one-half of Russia's sovereign debt. On May 20, former Finance Minister Zadornov stated that Russia was hoping for a rescheduling of \$16 billion out of the total of \$17.5 billion due in debt service in 1999.¹¹⁴ On May 24, Russia asked its London Club creditors to roll over its June 2 Soviet-era debt service by six months: about \$22 billion in principal notes (PRINS) and \$6 billion in interest arrears notes (IANS) were outstanding.¹¹⁵ In the year 2000, some \$10 billion in Russian Federation debt and about \$6 billion in Soviet-era debt would have come due in the absence of restructuring.¹¹⁶ During the next 12 years, Russia must find between \$14 billion and \$19 billion annually to service its foreign debt.¹¹⁷

The London talks on resolving the frozen domestic (GKO) debt seem to have petered out, with most foreign investors accepting the Russian government's terms that yield less than 5 percent of the face value of the bonds. Whereas in December 1998, the Russian government offered \$550-800 million at 11 monthly auctions, on March 22, 1999, this offer was reduced to \$200 million at four monthly auctions.¹¹⁸

At the beginning of 1998, Russia's indebtedness was offset-on paper at least-by the estimated \$120.2 billion owed (half of it for military hardware) to the former Soviet Union, and hence to Russia, by former client states such as Cuba, Mongolia, Vietnam, Iraq, Afghanistan, Angola, North Korea, Mozambique, and Ethiopia, and by other states like India, Algeria, Libya, Syria, Yemen, and 43 other nations.¹¹⁹

This figure and earlier estimates of up to \$149 billion appear to derive from an original aggregate of 96.4 billion transfer rubles converted at \$1=0.63 rubles, and thus are subject to some dispute. Most of these debtor nations are, in any case, either insolvent or unwilling to repay. Now that Moscow has joined the Paris Club as a creditor nation, those countries still owing money to Russia should not, in principle, be able to borrow new money from other members of the club. This excludes some of Russia's biggest debtors, like Cuba, Vietnam, Libya, and Iraq. The original draft budget for 1998 counted on the receipt of \$1.25 billion that year from debtor countries.¹²⁰ It appeared that Moscow would be obliged to accept the so-called Naples conditions, whereby two-thirds of the debt is written off and payment of the balance is extended over 23 years, with a six year grace period.¹²¹ Assets abroad of the former USSR, now accruing to Russia, are valued variously from between \$2 billion and \$600 billion, although these too may be hard to realize.¹²² In November 1999, the State Property Ministry declared that it owned 2,773,000 square meters of property abroad, with a total value of \$3.2 billion.¹²³ A further \$6.8 billion - stemming mainly from technical credits issued in 1992-1993 - was owed to Russia by other former Soviet republics,¹²⁴ plus over \$4.4 billion for fuel and energy deliveries.

Tax Code

Taxes have proliferated during the past eight years and present a major disincentive to full payment of taxes and to domestic and foreign investment. One authoritative U.S. study reckoned that whereas in 1991, joint oil ventures were paying four primarily profit-based taxes, by 1996 they were paying 23 taxes that were mostly based on gross revenues.¹²⁵ The former minister of fuel and power engineering, Petr Rodionov, went further in September 1996 to assert that "oil companies currently pay 42 different taxes, which account for 58.5 percent of the price."¹²⁶ Although he was presumably including local taxes, it does not reduce the total burden. The government submitted a new version of the tax code - said to be the seventh variant - to the Duma in February 1998. It reduced the number of taxes from 50 (perhaps as many as 150 if local taxes are included) down to 28, cut the corporate tax from 35 to 30 percent, liberalized and simplified depreciation rules, canceled the sales tax, kept the VAT at 20 percent, switched more of the tax burden from enterprises to individuals, and eliminated most tax privileges.¹²⁷

On December 18, 1998, the Duma passed at first reading a set of 19 proposed changes to the tax system. The principal amendments included a reduction in VAT from 20 to 15 percent; a reduction in the profits tax from 35 to 30 percent; an adjustment of personal income tax to reflect inflation; raises in some excise duties, including those for alcohol and gasoline; and the introduction of an imputed tax.¹²⁸ At the urging of the IMF, the reduction of the VAT will be postponed until the year 2000. In August 1999, Prime Minister Putin complained that Russia is the only developed country where 85 percent of taxes are collected from enterprises and only 15 percent from the population.

The Banking Sector

Until quite recently, many felt that it was a question not so much of if, but when, a major banking shakeout would occur. The Russian financial sector survey, commissioned by the European Union, predicted in early 1996 that 1,500-1,600 of the remaining 2,285 commercial banks then active in Russia, were likely to fold within a few years.¹²⁹ Many or most of the existing banks had simply grown too fast and had never been completely capitalized. A high proportion of the banks' assets were nonperforming - perhaps 60 percent compared with less than 18 percent in the United States. Having grown fat from cross-currency arbitrage and high-yield, short-term investments, many were suffering from savings and loan disease: they had long-term assets and short-term liabilities. Thus, Black Tuesday of August 1995 may have been just a warning signal. Sergei Dubinin, then chairman of the Central Bank, told a New York audience in October 1996 that 10-15 percent of Russian banks were in a very difficult position. During 1996, licenses of 289 banks were revoked, and by year-end,

some 300 medium- and small-sized banks of the total 2,008 banks were under review. In 1997, the central bank withdrew a further 330 licenses. The sector is still small in relation to the economy: it has been estimated that total banking assets in 1997 equaled only 19 percent of GDP.¹³⁰ The placing of Tokobank, one of the top 20 banks, into administration in May 1998, when it was unable to make payments to its foreign creditors, was seen as the first casualty from a widespread practice of borrowing too heavily in the syndicated loan and Eurobond markets. The failure of the rescue attempt for Tokobank was followed by the takeover by Oneksimbank of Unikombank, the thirty-fourth largest bank in the country. By October 1, 1999, the number of banks had declined to 1,351.¹³¹ Effective January 1, 1998, new banks starting up were required to have charter capital of at least 4 million ECU. Some 43 percent of the banks operating in 1997 had charter capital of less than 1 million ECU. Earlier, this amount was going to be the minimum capital requirement for commercial banks effective January 1, 1999,¹³² and would have halved the number of banks. The Russian Central Bank is reported to have reduced the interest rate on its loans to commercial banks taking part in intrabank transactions, thereby injecting liquidity into the banking system.¹³³ The Russian government and the central bank established the Agency for Restructuring of Credit Organizations (ARKO) which was registered in January 1999. The CBR owns 49 percent and the government 51 percent of ARKO's patently inadequate share capital of 10 billion rubles. ARKO's functions were meant to include helping with the bankruptcy of insolvent banks, injecting liquidity into salvageable banks, assisting banks in restructuring their debts, and attracting new investment. Little evidence of ARKO's activity had appeared by October.

At the beginning of 1999, five out of the nation's 10 largest banks (Inkombank, SBS-Agro, Oneksimbank, Rossiisky Kredit, and Menatep) were deemed to be effectively insolvent, but as late as October, it is not clear how many and which banks have been bailed out by the Central Bank. Earlier this year, the World Bank found that 15 out of 18 large Russian banks had "negative equity" and should be liquidated or restructured.¹³⁴ On April 1, Viktor Gerashchenko announced that the CBR would decide "in the next few weeks" which of the troubled big banks would survive. He confirmed that 18 of the country's most important banks, which control 80 percent of the banking system and hold 45 percent of private deposits, had been having problems.¹³⁵ To restructure the entire commercial banking system could take three to five years and could cost anywhere between 100 billion rubles¹³⁶ and \$20 billion.¹³⁷ In mid-May, the Central Bank announced that it would revoke the licenses of 12 major banks, including Menatep and Unikombank. This was widely viewed as not only tantamount to closing down the burnt-out shells of once important banks, but also as clamping down on a widespread tax evasion scheme.¹³⁸ But by the end of June, the Central Bank had withdrawn the licenses of only four large banks - Oneksimbank, Mosbiznesbank,

Promstroibank, and Mezhkombank - and that only “under unprecedented pressure from the IMF and World Bank.”¹³⁹

Some leading figures - including Geraschenko, Volsky, and Zhukov - have publicly urged foreign banks to acquire shares in Russian banks, thereby increasing their share in the Russian banking system from the 12.6 percent registered on September 1. In April 1999, Gerashchenko announced that the Central Bank would ask the Duma to adopt a law raising the share of foreign capital in the Russian banking system from 12 to 25 percent.¹⁴⁰ At the end of 1999, there were 1,349 banks still operating.

IMF

As of January 31, Russia owed the IMF \$14.565 billion, making it the Fund’s biggest debtor, followed by Mexico at around \$9 billion.¹⁴¹ A total \$4.6 billion was due to be repaid in 1999 and 2000.

On April 28, 1999, the IMF agreed in principle to release a total of \$4.5 billion in new loans over the next 18 months, with \$3 billion being made available in 1999. The credit would reportedly be disbursed in six or seven quarterly tranches, with performance being monitored on a monthly basis. The money would, in essence, be rolled over by transferring the amount from one IMF account to another, thus eluding “sticky fingers” in Moscow. Reported conditions required by the Fund included: the passage of new banking legislation, with the possible restructuring or closing of up to 18 of the largest banks; the improvement of an existing law on bank insolvencies; the enactment of new revenue measures amounting to the equivalent of an estimated 3.5 percent of GDP, including the raising of the excise taxes on alcohol and gasoline and rescinding the reduction of the VAT from 20 to 15 percent; the relaxation of restrictions on foreign exchange; and the pressuring of natural monopolies to increase cash tax collection.¹⁴² The Fund’s blessing was expected to clear the way for some \$2 billion from the World Bank, about \$1 billion from the Japanese government, and for negotiations to continue with the Paris and London Clubs for re-scheduling of Russia’s Soviet-era debts.

In March 2000, the IMF was still withholding disbursement of the second tranche. In addition to the conditions stipulated above, the Fund, the World Bank, and the G-7 have expressed concern over proposed increases in defense expenditure arising from the second Chechen war, with the concomitant charges that IMF moneys were being used for this purpose. There were renewed demands for the Russian Central Bank to clean up its act; with requests for quarterly audits of its reserves and for transparency over the activities of its subsidiaries; for the government to submit an anti-money-laundering bill to the Duma; for the release of a third audit on how Russia has used IMF funds in the past; for a schedule for switching the Central Bank and commercial banks to international accounting standards; for a wide-ranging audit into the operation of Sberbank;

for the passage of legislation on bankruptcy; and for the railways, Gazprom, UES, and Transneft to report their financial statements in accordance with International Accounting Standards (IAS). Disbursement of the second tranche is now expected not until after the presidential election on March 26.

World Bank

Since 1992, the World Bank has approved spending of \$11 billion on 42 projects in Russia and disbursed some \$6.5 billion of that sum. Over \$4 billion has gone to budget-substituting loans for restructuring the Russian economy, and \$2 billion has been allocated for various investment loans.¹⁴³ In April 1999, World Bank president James Wolfensohn said that he would recommend \$2.3 billion in new loans to Russia over the next two years and help arrange another credit from the Japanese government for \$1 billion. As much as one-third of the new money could go to paying off interest on previous World Bank loans.¹⁴⁴

The Duma Election of December 19, 1999

The voter turnout on December 19 was 61.8 percent, far higher than equivalent counts in the US or in most West European countries. As of January 21, the CPRF was the largest faction in the new Duma with 90 seats, followed by Unity with 82, FAR with 45, the Union of Right-Wing Forces with 32; People's Deputies 57; Russia's Regions 41; Agro-Industrial Group 39; Yabloko 21; and the Zhirinovskiy Bloc with 17. New elections must be called in March in nine districts.

After the controversial deal between the CPRF and the Unity bloc on January 18, an incomplete listing of the speaker, deputy speakers, and chairmanships of Duma committees follows¹⁴⁵:

- **CPRF**

Speaker	Gennadi Seleznev
Economic Policy and Entrepreneurship	Sergei Glaziev
State-Building	Anatoli Lukyanov
Industry, Construction, and High Technology	Yuri Maslyukov
Labor, Social Policy, and Veterans' Affairs	Valery Saikin
Federation Affairs and Regional Policies	Leonid Ivanchenko
Education and Science	Ivan Melnikov
Women, Family, and Youth Affairs	Svetlana Goryacheva
Non-Governmental and Religious Organizations Affairs	Viktor Zorkaltsev
Culture and Tourism	Nikolai Gubenko

- **Unity**

Property	Vladimir Pekhtin
Energy, Transportation, and Communications	Vladimir Katrenko

Security	Aleksandr Gurov
Natural Resources and Their Use	Aleksandr Belyakov
Environment	Vladimir Grachev
Local Self-Government	Vladimir Mokryi
Reglementation and Organization of Duma Work	Nikolai Loktionov
• People's Deputy Group	
Credit Organizations and Financial Markets	Aleksandr Shokhin
Defense	Andrei Nikolaev
Foreign Affairs	Dmitri Rogozin
Health and Sports	Nikolai Gerasimenko
Problems of North and Far East	Valentina Pivnenko
• Fatherland-All Russia (OVR)	
Deputy Speaker	Georgi Boos
CIS Affairs	Boris Pastukhov
• Union of Rightist Forces (SPS)	
Deputy Speaker	Boris Nemtsov
Legislation	Pavel Krasheninnikov
• Russian Regions	
Budget and Taxes	Alexander Zhukov
• LDPR	
Deputy Speaker	Vladimir Zhirinovskiy
Information Policy	Konstantin Vetrov
• Agrarian-Industrial Deputies' Group	
Agrarian Issues	Vladimir Plotnikov
Nationalities	Alexander Tkachev
• Yabloko	
Deputy Speaker	Vladimir Lukin

Prospects for Economic Growth

The Russian GDP in 2000 is projected to rise to 5,350 billion rubles. At the forecast official annual average rate of exchange of 32 rubles to the dollar, this is equivalent to \$158 billion, or less than 2 percent of the US GDP that amounted to \$9.5 trillion in 1999. At purchasing power parity, according to the World Bank, Russia's GDP will be equivalent to about \$650 billion.

Now it is evident to any visitor to Moscow or any other Russian city that a great deal of economic activity goes unrecorded (and untaxed). The official Russian statistical authority, *Goskomstat*, is aware of this gray, black, or shadow economy, and factors in an additional 25 percent of the value of the formal economy to cover its activity. Other estimates go as high as 50 percent. Yet countering this *understatement* of the size of the economy is the fact that up to 70 percent of transactions within it are, it is reported, conducted in the form

of barter, the value of which is notoriously *overstated*. So we are looking at an economy in roughly the same ballpark as Spain.

The Russian manufacturing industry now constitutes a gigantic rust belt. The average age of plant and equipment is roughly three times higher than the OECD average. The only Russian manufactured products that are, generally speaking, competitive on the world market are military hardware, nuclear power plants, and space engineering. The domestic demand for these products is severely restricted by budgetary constraints, and the overseas market is limited. After decades of neglect, the infrastructure—roads, railways, pipelines, power lines, water supply, sewage—must also be renewed.

To update or replace this aged plant and equipment, and to renew the infrastructure, will require hundreds of billions of dollars. Yevgeni Yasin has estimated that Russia will need some \$2.5 trillion in investment during the next 20-25 years, of which about one-quarter will have to come from abroad.¹⁴⁶ But the domestic money supply M2 (currency in circulation, demand deposits, and time deposits) in November 1999 was reported to be only 646.6 billion rubles (\$22.7 billion)¹⁴⁷ while the estimated \$30-50 billion in hard currency (now stored largely under mattresses) is unlikely to be entrusted to domestic banks until or unless Western banks are given guaranteed and secure access to the Russian retail banking system and provided with sufficient incentive to do so. Russia registered a current account surplus of about \$20 billion in 1999, which was roughly equal to the amount of capital flight. Very little of the estimated \$150 billion of flight capital since 1991 is expected to be returned to Russia in the short- or medium-term. The bulk of investment capital must therefore come from abroad in the form of foreign direct investment (FDI).

Russia is currently attracting less than one percent of the world's FDI. In 1999, net FDI in Russia amounted to about \$2 billion, out of a global total of \$827 billion¹⁴⁸ (China drew nearly \$40 billion). The reasons are well known: they include political instability; virtual absence of corporate governance; capricious and exorbitant taxes; the lack of commercial infrastructure; poor protection of property rights; pervasive corruption; and the depredations of organized crime. This hostile environment will take many years to correct, and thus FDI in Russian manufacturing capacity is unlikely to grow substantially in the near future. (More attractive prospects prevail for the extractive sectors, after recent progress in advancing production-sharing agreements (PSAs) and enabling legislation).

With domestic and foreign capital wholly inadequate to finance the necessary reconstruction and re-equipment of the manufacturing sector, former first deputy prime minister Yuri Maslyukov promised, until he was fired in May 1999, that state funding would suffice. But the federal budget for the year 2000 provides for total revenues of only \$24.9 billion and total expenditures of \$26.7 billion. After the anticipated boosting of defense expenditure, all additional government funding for the foreseeable future will have increasingly to be devoted to

countering the acute deterioration of the nation's health, to combating environmental disruption, and to restoring an educational system that was perhaps the most positive legacy of the Soviet era.

The scale of capital required for the massive re-equipping and replacement of Russia's manufacturing industry and the infrastructure is not in sight. With its vast natural resources and its highly educated workforce, Russia's economy may well experience the boom or chudo (miracle) predicted for it by some informed observers. But this will not happen anytime soon.

Notes

- 1 Interfax, February 23, 2000.
- 2 *Rossiiskaya gazeta*, September 25, 1997; cf. *Russian Economic Trends*, November 14, 1995; and *Segodnya*, June 9, 1995.
- 3 *Rossiiskaya gazeta*, March 2, 1999.
- 4 *Krasnaya zvezda*, August 3, 1996.
- 5 Interfax, January 21, 1998, citing Urinson; cf. Interfax, December 25, 1997.
- 6 Reuters, March 17, 1997; cf. *Russian Economic Trends*, October 22, 1996.
- 7 *Financial Times*, January 16, 1998.
- 8 NTV, April 23, 1999.
- 9 *The Economist*, August 28, 1999.
- 10 Reuters, March 31, 1998.
- 11 Interfax, June 15, 1999.
- 12 Interfax, February 29, 2000.
- 13 Interfax, July 20, 1999.
- 14 ITAR-TASS, January 15, 1997; cf. *Rossiiskaya gazeta*, April 24, 1996.
- 15 Interfax, January 22, 1996.
- 16 *Rossiiskaya gazeta*, January 9, 1998; cf. *Russian Economic Trends*, December 1997.
- 17 *Russian Economic Trends*, February 1999.
- 18 Interfax, November 28, 1998.
- 19 Interfax, February 17, 1997; cf. Interfax, November 15, 1996; ITAR-TASS, October 15, 1996; *Komsomolskaya pravda*, July 17, 1996; *Rossiiskaya gazeta*, August 5, 1995. *Ekonomika i zhizn*, no. 1 (1995) put the multiple in 1994 at 21, but this is thought to have taken into account income that is concealed from taxation.
- 20 *Rossiiskaya gazeta*, January 18, 2000.
- 21 *Delovoi mir*, December 19-25, 1994.
- 22 *Russian Economic Trends*, January 2000.
- 23 Interfax, July 30, 1998; cf. *Delovoi mir*, June 4, 1997.
- 24 *Rossiiskaya gazeta*, January 26, 2000.
- 25 A person is deemed unemployed if he or she has no job in the preceding week and is available and looking for work.
- 26 Interfax, February 21, 2000.
- 27 *Transition*, April 1997, p. 27.
- 28 *Financial Times*, February 6, 1997.
- 29 IMF Staff Country Report no. 87/63, p. 10; cf. *Rossiiskie vesti*, January 24, 1997.
- 30 Radio Rossii, March 1, 1998.
- 31 *Rossiiskaya gazeta*, May 28, 1998; cf. *Moscow News*, May 14-20, 1998.
- 32 *Wall Street Journal*, September 29, 1998.
- 33 ITAR-TASS, March 1, 1999.
- 34 Joseph R. Blasi, Maya Kroumova, and Douglas Kruse, *Kremlin Capitalism: The Privatization of the Russian Economy* (1996), cited in the *Financial Times*, June 19, 1997.
- 35 *Financial Times*, October 16, 1996.
- 36 *Financial Times*, February 24, 1995.

- 37 Vremya MN, October 22, 1999.
- 38 ITAR-TASS, June 16, 1998.
- 39 *Russian Economic Trends*, May 14, 1999.
- 40 *Russian Economic Trends*, March 1998; cf. Vek, no. 45, 1997.
- 41 ITAR-TASS, February 21, 1997.
- 42 *Economist*, July 18, 1998.
- 43 Interfax, May 22, 1998.
- 44 Reuters, February 10, 2000.
- 45 Interfax, October 4, 1999.
- 46 Interfax-FIA, October 27, 1998.
- 47 Interfax, May 16, 1997; cf. *Rossiiskaya gazeta*, September 14, 1996.
- 48 *Journal of Commerce*, November 21, 1996.
- 49 Reuters, June 30, 1999.
- 50 *Rabochaya tribuna*, January 24, 1995.
- 51 *Wall Street Journal*, February 15, 1995.
- 52 *Rossiiskie vesti*, October 3, 1996.
- 53 *Journal of Commerce*, August 21, 1997.
- 54 *Wall Street Journal*, August 28, 1997.
- 55 *Wall Street Journal*, September 11, 1997.
- 56 *Financial Times*, April 3, 1998.
- 57 *Journal of Commerce*, August 3, 1998.
- 58 Reuters, March 17, 1999.
- 59 Radio Rossiya, December 29, 1997.
- 60 Interfax, November 14, 1997.
- 61 *Komsomolskaya pravda*, August 13, 1996.
- 62 *Wall Street Journal*, August 6, 1998, and *Financial Times*, August 7, 1998.
- 63 ITAR-TASS, December 18, 1996.
- 64 *Kommersant-Daily*, July 16, 1998.
- 65 ITAR-TASS, August 1, 1998.
- 66 *Izvestia*, July 30, 1998.
- 67 Interfax, February 12, 1999.
- 68 AP, June 28, 1999.
- 69 *New York Times*, October 16, 1999.
- 70 ITAR-TASS, November 10, 1995.
- 71 Interfax, December 6, 1995.
- 72 *Ekho Moskvy*, December 6, 1995.
- 73 *Segodnya*, December 12, 1995.
- 74 Interfax, January 6, 1996.
- 75 *CIS LawNotes*, February 1996.
- 76 *Rossiiskaya gazeta*, October 5, 1996.
- 77 Interfax, October 31, 1996.
- 78 Interfax-PIA, July 8, 1997.
- 79 Interfax-PIA, November 26, 1997.
- 80 Interfax-FIA, July 15, 1998.
- 81 *Kommersant-Daily*, June 27, 1998.
- 82 *Journal of Commerce*, July 23, 1998.
- 83 See RIA/Novosti, December 11, 1998, for the last restatement.
- 84 Interfax-PIA, April 14, 1999.
- 85 *Russia Portfolio*, March 1, 1999.
- 86 Reuters, June 11, 1999.
- 87 *Kommersant-Daily*, February 9, 2000.
- 88 *Financial Times*, April 25, 1994.
- 89 *Ekho Moskvy*, October 29, 1996.
- 90 Interfax, April 28, 1996.
- 91 Interfax, December 20, 1995.
- 92 *Financial Times*, February 14, 1997.
- 93 Interfax, February 11, 1999.

- 94 *Trud*, January 20, 1998, citing then CBR chairman Sergei Dubinin; cf. *Segodnya*, July 29, 1995.
- 95 Interfax, January 17, 1996.
- 96 Interfax-PIA, March 11, 1998.
- 97 Interfax-FIA, March 18, 1998.
- 98 Interfax, February 14, 2000.
- 99 Reuters, November 18, 1997; cf. Interfax, January 28, 1997; *New York Times*, August 20, 1996.
- 100 *Novoye vremya*, June 1, 1999.
- 101 Drawn from Constantine Michalopoulos, "WTO Accession for Countries in Transition," *Post-Soviet Prospects*, June 1998.
- 102 *Kommersant-Daily*, July 21, 1998.
- 103 *Journal of Commerce*, August 3, 1998.
- 104 Reuters, October 27, 1998.
- 105 See Jamestown Foundation's *Fortnight in Review*, October 8, 1999.
- 106 ITAR-TASS, October 1, 1998, and Interfax-FIA, October 28, 1998.
- 107 Interfax, June 10, 1999.
- 108 Interfax, December 7, 1998.
- 109 *Financial Times*, February 14, 2000.
- 110 For instance, NTV, September 21, 1998.
- 111 *Financial Times*, November 21-22, 1998.
- 112 Bloomberg, February 19, 1999.
- 113 Interfax, February 11, 1999.
- 114 Interfax, May 20, 1999.
- 115 Reuters, May 27, 1999.
- 116 *Moscow News*, June 30-July 6, 1999.
- 117 *Moscow News*, June 30-July 6, 1999.
- 118 *Wall Street Journal*, April 13, 1999.
- 119 ITAR-TASS, May 25, 1998.
- 120 *Rossiiskaya gazeta*, October 14, 1997.
- 121 Interfax, August 5, 1996.
- 122 *Rossiiskaya gazeta*, May 28, 1998; cf. Interfax, July 3, 1995; *Trud*, January 22, 1998.
- 123 ITAR-TASS, November 23, 1999.
- 124 ITAR-TASS, June 18, 1998; cf. *Segodnya*, October 19, 1995.
- 125 U.S.-Russia Business Council, "Russia After the Election," July 26, 1996.
- 126 Interfax, September 2, 1996.
- 127 ITAR-TASS, February 2, 1998; cf. *Russian Economic Trends*, December 1997; Interfax, June 19, 1997.
- 128 Interfax, December 13, 1998.
- 129 *Financial Times*, March 13, 1996.
- 130 *Financial Times*, January 7, 1998.
- 131 Reuters, October 25, 1999.
- 132 ITAR-TASS, January 13, 1998.
- 133 *Moscow Times*, October 8, 1998.
- 134 *Moscow Times*, April 29, 1999.
- 135 ITAR-TASS, April 15, 1999.
- 136 Interfax-FIA, March 13, 1999.
- 137 Reuters, April 14, 1999, citing an EBRD official.
- 138 *Economist*, May 22, 1999.
- 139 Interfax-Vremya, June 27, 1999.
- 140 Interfax, April 15, 1999.
- 141 Interfax, February 17, 2000.
- 142 *Financial Times*, April 30, 1999.
- 143 Interfax, November 6, 1998.
- 144 *Wall Street Journal*, April 16, 1999.
- 145 *Nezavisimaya gazeta*, January 21, 2000.
- 146 ITAR-TASS, February 23, 2000.
- 147 *Russian Economic Trends*, January 2000.
- 148 Reuters, February 10, 2000.

PROSPECTS FOR ECONOMIC SECURITY AND GROWTH IN UKRAINE

David Snelbecker

*Policy Advisor, Harvard University,
Ukraine Macroeconomic Reform Project, Kyiv*

Abstract

The current economic situation in Ukraine is difficult and deteriorating. Real wages and pensions are low, often below the poverty level. GDP is falling. Barter, arrears, and the informal sector are growing. The superficial appearance of price and exchange stability masks deep fiscal disbalance. Rather than becoming an emerging market economy, Ukraine has transitioned from centrally planned socialism into an economy that is still mostly socialistic in many of its characteristics. Comprehensive reforms are necessary in order to put Ukraine onto the path of true economic development. “New,” market-oriented enterprises should be supported by a substantial reduction in the tax burden, in particular in taxation of value- and job-creating enterprises, and by extensive deregulation. “Old,” state-owned, socialist enterprises should be reformed by changing the environment in which they operate, mostly with measures aimed at hardening budget constraints. Policies should be adopted to open the economy internationally as much as possible to a freer flow of goods, services, currency, and people. The budget-sphere must be radically restructured and downsized. The two greatest threats to Ukraine’s economic security over the next two years are:

- that Ukraine may fail to fundamentally change the ruinous economic policy that has been in place since independence;
- that Europe may close its borders to Ukraine as Central European countries become more integrated into European institutions.

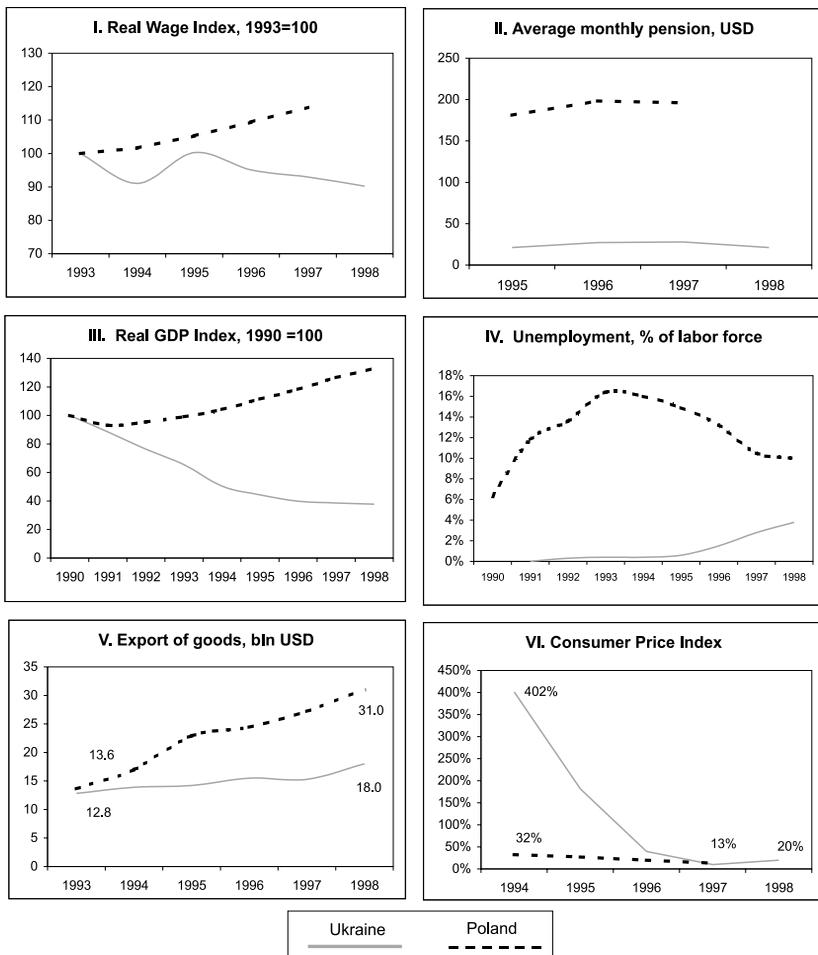
If Ukraine and Europe are successful in addressing these potential threats to economic security, then the next two years may in fact turn out to be a period during which Ukraine builds economic security, solidifies its political independence, and makes great progress in the process of integration into the community of European nations.

Current Economic Situation

The current economic situation in Ukraine is difficult and deteriorating. The following charts compare recent economic trends in Ukraine and in Ukraine’s neighbour, Poland. It is useful to compare trends in Ukraine with those in

Poland because Poland is an example of a successful transitional economy and therefore shows how trends should be going.

Charts I-VI : Comparisons of Ukraine and Poland¹



In Poland, once freed from the shackles of socialism and after a brief adjustment period, the economy quickly grew with substantial increases in real GDP, wages, and pensions. In Ukraine, however, GDP, wages, and pensions have fallen quite substantially. Current GDP per capita in Ukraine is approximately US\$820, average wages are US\$52, and average pensions are US\$18.

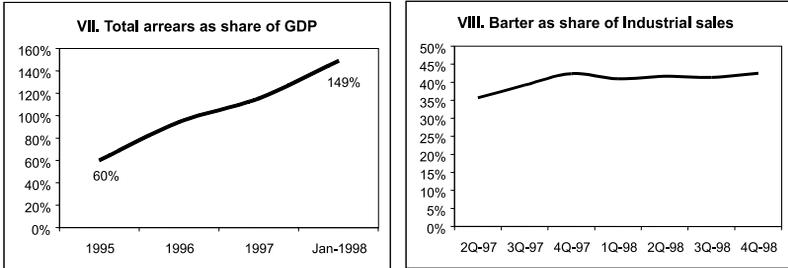
Socialist economies were over-industrialised, while their service and financial sectors were underdeveloped. Part of the transition process therefore requires sectoral restructuring, with a decrease in the relative size of some sectors and an increase in others. This restructuring in the short run can cause much higher unemployment, but in the medium-term most laid off workers eventually find new jobs in a booming reformed economy. In Poland, unemployment at first rose sharply but then fell again. In Ukraine, however, unemployment has hardly moved up. These trends suggest a lack of substantial economic restructuring in the economy.

Despite hyperinflation in the early 1990s, inflation rates in recent years have been quite low and the exchange rate has been even more stable. In many countries, low inflation and a stable exchange rate signify government fiscal discipline and a low budget deficit that does not require any printing of money in order to finance. In Ukraine, however, the experience of low inflation and a stable exchange rate signify no such success with fiscal reform. On the contrary, government expenditure commitments have been quite high, far in excess of revenues. Instead of financing the deficit through printing money (as had been the case in 1992-1994, causing hyperinflation), the government simply runs up high arrears, for instance by not paying budget-sector workers or utility bills. Therefore, the apparent macroeconomic stability is illusory, covering up deep fiscal imbalance. Moreover, price and exchange stability have been maintained for several years largely by spending down national-bank foreign reserves and implementing administrative controls on currency exchange and foreign trade that have had a sharply negative impact on the financial and trading sectors. In sum, stabilisation policy, despite the numbers, cannot be considered to have been a success.

Two problems almost unique to Ukraine and other post-Soviet economies are barter and arrears. Increasingly, rather than paying with money, enterprises pay in-kind, offering goods to workers in lieu of wages, to government in lieu of taxes, and to other enterprises in lieu of payment for inputs. The prevalence of barter to such a degree as one finds in Ukraine suggests deep economic distortions. For some reason, managers prefer to pay in-kind rather than paying in money despite the high transaction costs usually associated with barter trade. Perhaps they are evading high tax rates by circumventing the banking system; or they are hiding profits from weak corporate owners in non-transparent in-kind deals; or they merely are struggling to continue unprofitable production that is allowed by an absence of a functioning bankruptcy law.

Arrears of all kinds continue to mount. Enterprises have more and more past-due debts that they owe to workers in wages, to government in taxes, and to each other for inputs. The total outstanding size of arrears in the economy now it is far greater than GDP.

Charts VII-VIII²



Increasingly, enterprises and individuals hide their income in the informal sector, evading taxes and regulations. From a totalitarian society under Soviet times where little informal economic activity was possible, Ukraine's informal sector has grown to such an extent that many guess it represents around 50% of total output. Net investment (foreign and domestic) is extremely low, perhaps even negative when one takes into account depreciation of existing assets. As a consequence, both GDP and real living standards decline.

In sum, all the economic trends that should be going up are instead going down, and all the trends that should be going down are instead going up. Rather than increasing in size every year through value-adding production, the economy of Ukraine is slowly self-destructing, consuming its own capital stock in order to survive for the short-term. Along its current path, without a radical change in course, the formal economy eventually will just wither away.

The implications of current economic trends for Ukraine's security and stability are clear. A country with an economy that is slowly spiralling downward risks eventual political instability as well, which can then destabilise the region and create immigration pressure in neighbouring countries.

In spite of the current gloomy outlook, however, prospects for Ukraine are not hopeless. Ukraine's potential for development is quite good. Given its highly educated workforce, its internal ethnic harmony, and its proximity to European markets, Ukraine actually has the potential for dramatic, sustained economic growth, perhaps as high as 10% per year for an extended period of time. What has prevented Ukraine from realising its potential over the last eight years has been ruinous economic policy. If Ukraine could be successful in fundamentally changing its economic policy, its economic prospects also will change as fundamentally. Before addressing the question of what economic policies are needed, I turn first to a discussion of the root causes of Ukraine's current problems.

Root Causes of Current Economic Problems

Ukraine, arguably, is no longer a transitional economy, but rather has reached a new equilibrium path. Like Russia, Ukraine since the break-up of the Soviet Union has evolved from centrally planned socialism into a new type of socialistic economy. This type of economy we might call “oligarchic socialism” to contrast it with centrally planned socialism. Oligarchic socialism - or what others have called a virtual economy³ - is quite unlike a true market economy, even unlike the emerging market economies of Central Europe. Rather, it is perhaps most similar to Central European economies 25 years ago under what was called reform socialism or goulash socialism - socialism with a few market elements mixed in. The oligarchic socialism that has developed in Ukraine, and also in Russia, with its peculiar characteristics of arrears, barter, and shadow economy, seems quite stable and potentially long lasting. Without a radical change in course, despite prior hopes and expectations, current economic conditions may not be merely a transitional phase in the development of a true market economy but rather a quite permanent state.

The **economic** characteristics of oligarchic socialism are similar to the characteristics of centrally planned socialism, with some important exceptions, as shown in Table 1.

Oligarchic socialism differs from centrally planned socialism most fundamentally in that decision making is not concentrated at the centre. Rather, decisions regarding allocation of resources are decentralised, made by enterprise managers or sectoral and local-government bureaucrats. The breakdown in centralised control, which is related to the end of iron-fist totalitarianism, also has allowed the development of a shadow economy where none would have been tolerated under the past system.

Oligarchic socialism is similar to centrally planned socialism in that: budget constraints are soft; prices are distorted and do not signal relative scarcity; enterprises maximise production and employment rather than profits; and goods and services are “sold” without using money as the means of exchange. These characteristics apply to most enterprises and the budget sphere, but not to some “new” enterprises, often operating in the shadow economy, which are more market-oriented.

In seeking to explain why central European countries have developed into emerging market economies while Ukraine, Russia, and the other large post-Soviet countries have transformed into oligarchic socialism, I suggest the following hypothesis.

In the central European countries, “new,” market-oriented enterprises (mostly small businesses or other enterprises with effective private ownership) became particularly widespread and strong at the early stages of reform, and the economies were open to international trade and contact with the rest of the world. The new enterprises and foreign companies dominated over “old” socialist enterprises

Table I - Systemic Economic Characteristics

Soviet period (Centrally planned socialism)	Contemporary Ukraine (Oligarchic Socialism)	Market
Soft budget constraints in budget and enterprise sectors	Soft budget constraints in budget and enterprise sectors	Hard budget constraints in budget and enterprise sectors
Promised state programs exceed available resources	Promised state programs exceed available resources	Promised state programs within available resources
Distorted prices, set arbitrarily by the centre, do not signal relative scarcity	Distorted prices, set arbitrarily by enterprise managers or bureaucrats, do not signal relative scarcity	Prices, set freely by market mechanism, signal relative scarcity
Enterprises, with weak ownership by the state, maximise production and employment	Enterprises, with weak ownership by the state or dispersed private owners, maximise production and employment	Enterprises, with strong private ownership, maximise profits
Allocation of resources is centralised, directed by the government based on political objectives, unconnected to flows of money	Allocation of resources is decentralised, directed by enterprise managers or bureaucrats based on political or rent-seeking objectives, unconnected to flows of money (payment in barter for goods and services; and arrears)	Allocation of resources is decentralised, directed by enterprise managers, based on profit-maximising objectives, connected to flows of money (payment in money for goods and services)
Price distortions and soft budget constraints manifest themselves in shortages	Price distortions and soft budget constraints manifest themselves in hyperinflation when monetary policy is loose and in arrears and barter when monetary policy is tight	No price distortions; hard budget constraints
Totalitarianism does not allow much economic activity outside the state sector	Liberalised political climate allows shadow economy - small enterprises and evasion at large enterprises	General economic liberty

in setting the overall economic environment. That is, because of the relative strength and prevalence of “new” enterprises and openness to the outside world, a market environment prevailed: enterprises maximise profits subject to hard budget constraints and pressure from competition and owners; prices give accurate signals of relative scarcity; and money is used as the medium of exchange. Even “old” socialist enterprises were subjected to this market environment and slowly reformed to conform to new conditions. The prevalence of new enterprises and openness of the economies were due both to initial starting conditions and to positive economic policies that were adopted by reformist governments (eg, deregulation, adoption of market-oriented commercial codes, and general openness).

However, in the large post-Soviet countries, there were far fewer “new” enterprises and far less openness to the West. “Old” socialist enterprises dominated, perpetuating the socialist environment of loose budget constraints, poor corporate governance, distorted prices, limited competition, and barter. A market environment was not created, but even potentially healthy enterprises are corrupted and held back by the prevailing socialist environment. Even potentially profitable enterprises cannot find customers with money and have trouble allocating resources efficiently in the face of distorted prices. Because of tougher starting conditions (fewer “new” enterprises and less openness to the outside world) and failure to adopt reform policies, these countries have remained stuck in a low-level equilibrium of oligarchic socialism.

Similarly, along a **political** dimension, large post-Soviet countries are caught in a Catch-22. In order for economic reforms to succeed politically, there must be interest groups that support them. However, it is hard to imagine how such interest groups for reform (small-business associations, corporate shareholders, etc.) will emerge until after economic reforms are implemented. In contrast, not only did Central European countries at the outset of the reform process have sufficient “new” enterprises to create a predominantly market economic environment, they also had sufficient pro-market interest groups to create a predominantly pro-market political environment.

In Ukraine and other large post-Soviet countries, there are few small businesses, few true private shareholders, few large value-adding enterprises other than those based on natural resources, and few influential academics educated in market economics. That is, there are few clear political allies to fight for reforms. Lined up against reforms, however, are a number of influential groups, including managers and murky figures drawing illicit rents from value-subtracting state-owned enterprises. In addition to those in the enterprises, there are bureaucrats at all levels of government who have a rent-seeking interest in maintaining the current regime of excessive regulation and taxation. These enterprise managers, bureaucrats, and other rent-seekers - all of whom might be called the oligarchs of the economy - use their considerable political power to block reforms. The relative political power of the oligarchs in the large post-Soviet countries compared to in central Europe (or, conversely, the relative absence of political power of pro-reform constituencies) has been a key factor in the slow pace of reforms in these countries.

Needed Economic Reforms

A prescription of policy measures should rest on four pillars:

- support to “new” enterprises (through tax relief for value-added, job-creating enterprises, and through deregulation);

- pressure to reform on “old” enterprises (through strengthening of private ownership in the long run and punishment of value-subtracting activities by the tax system in the short run);
- comprehensive opening of the economy to the outside world in order to “import” market environment (including monetary and exchange policy compatible with growth and integration into the world economy);
- restructuring the budget sector to greatly reduce expenditure commitments.

In order to succeed in getting the economy to jump from a low-level socialist equilibrium to a higher-level market equilibrium, reforms must be comprehensive and far-reaching. The following four sections provide specific proposals that could comprise a comprehensive reform program. They are meant give preliminary ideas in order to orient discussion. Much additional analysis would be needed to construct a program that actually could be implemented.

Supporting “New” Enterprises

“New” enterprises should be supported by a substantial reduction in the tax burden, in particular in taxation of value- and job-creating enterprises, and extensive deregulation. The value added tax rate should be reduced, perhaps to 15%. All payroll taxes other than contributions to the pension fund should be eliminated. Pension reform should be undertaken to introduce capitalised individual retirement accounts in order to draw a tight link between contributions and benefits and to maximise the return on contributions. A ceiling on the tax base used for payroll contributions should be set at roughly two times the average monthly income. For the personal income tax, the non-taxable minimum income should be set at the same level of roughly two times the average monthly income, above which a flat rate of, say, 30% should be applied. Other targeted taxes, for instance to the innovation, roads, and other sectoral funds, should be eliminated.

Deregulation should focus on eliminating the incentives bureaucrats have for harassing businesses by eliminating their potential financial gains. All penalties, fees for licenses, and other payments to government control organs should be paid to central and local government budgets, not to the budgets of the control organs. In cases where control organs assess penalties for violation of law or regulation, all payments should be made through the banking system (as phone and communal services now are paid). No control organ official should have the right to accept any payment in cash. Accepting payment in cash should be grounds for immediate dismissal of any control organ official. These regulations should apply widely, for instance to all inspections of enterprises and even to visa issuance by embassies and to traffic police. Other deregulation, such as elimination of restrictions on domestic trade, also should be implemented.

Reforming “Old” Enterprises

Old, state-owned, socialist enterprises should be reformed by changing the environment in which they operate, mostly with measures aimed at hardening budget constraints. The standard array of policies are needed:

- improvement of bankruptcy procedures and institutions;
- determination of a small number of specific enterprises for first bankruptcy actions;
- continued privatisation;
- strengthening of corporate governance mechanisms;
- improvement and enactment of contract and other commercial law.

These measures, which one might call first-best solutions, seem to have been difficult to implement quickly. Therefore, another set of measures is recommended, which one might call second-best solutions, which can be implemented quickly if there is political will and that would put substantial pressure on old enterprises to reform. The goal of such measures should be to harden budget constraints and to discourage barter, value subtracting production, and other socialistic economic activity. The value-added tax should be applied on an accrual basis with special provisions to prevent excessively high credits when inputs are paid for in barter or when inputs in value subtracting enterprises cost more than finished goods. Most zero ratings should be eliminated from the value-added tax, especially on energy and especially for budget-sphere organisations, to bring more of the economy into the tax web. Absolutely no tax revenues should be permitted in-kind. Only monetary payments should be tolerated. No in-kind payment should be counted toward revenue targets agreed with IFIs. Payment for all energy also should be permitted only in cash, not in-kind or with promissory notes. While in most cases government financial assistance for enterprise restructuring only makes things worse, the government (with foreign assistance) can play an important role in facilitating restructuring of old enterprises by allocating sufficient funds for severance pay of laid off workers.

Promoting an Open Economy

In order to “import” a market environment, policies should be adopted to open the economy as much as possible to a freer flow of goods, services, currency, and people. Administrative non-tariff barriers on trade and all tariffs on exports should be eliminated. A low, uniform, transparent import tariff level should be set. Consideration should be given to contracting out pre-inspection for imports to internationally recognised companies. This would eliminate excessive bureaucracy and corruption in the current customs system. Administrative restrictions on currency trade should be eliminated, and a free, floating exchange-rate should be set, perhaps within a wide, crawling, indicative band. Requirements for visas for citizens of European Union and North American countries should

be eliminated. Foreign banks interested in lending to Ukrainian business activities should be encouraged to open local branches with as little bureaucratic regulation as possible. Certification standards for all products from European Union countries, Poland, Hungary, and the Czech Republic should be excepted automatically without requiring re-certification in Ukraine.

Radically Restructuring the Budget Sphere

A legacy of socialism is that the government promises expenditures on programs far in excess of what available resources will allow, contributing to a high tax burden that stifles enterprises. The budget sphere has swollen so far beyond its means that it is essentially bankrupt. Comprehensive restructuring is essential. The substantial tax cuts recommended earlier would require commensurately deep cuts in expenditures. An overall expenditure level that is reasonable should be determined at the outset of the budget process, spending limits should be set for each broad area, and commitments for hiring staff and other expenditures should be made within these limits. Those who are laid off must be allocated severance pay. In parallel, regulations and rules must be developed for strengthening the budget process and assigning personal responsibility to managers for ensuring that expenditure commitments do not exceed allowable levels.

Economic Security

Military security and economic security are fundamentally different. Military security is defensive - keeping one's enemies out. Economic security is constructive - building a strong economy within. Military security means closing one's borders to prevent one's neighbours from crossing when bearing arms. Economic security means opening one's borders to allow one's neighbours to cross when bearing goods to trade or money to invest in companies and to spend on goods. Military security requires closed borders, but, in a globalise economy, economic security requires open borders.

For Ukraine in particular, open borders will be critical for successful economic development. Ukrainian companies and Ukrainian consumers need access to Western companies, which can pay in cash rather than in-kind and which have capital to invest, high-quality goods to sell, and technology to transfer. Also, competition from Western companies will be an important force for restructuring Ukrainian enterprises.

By way of conclusion, I would suggest that Ukraine faces two significant threats to its economic security over the next two years. The first, and greatest, threat to economic security is that Ukraine may fail to fundamentally change the ruinous economic policy that has been in place since independence. Although little change is possible before fall presidential elections, immediately thereafter

the new administration (even if the same president stays in power) will have an important opportunity to change economic course and implement a comprehensive economic reform program. Failure to take advantage of this opportunity may lead the country into deeper economic malaise and eventually political destabilisation. Successful implementation of comprehensive reforms, however, could put Ukraine onto the same path of rapid economic development that its Central European neighbours have followed over the last eight years.

The second threat to its economic security that Ukraine faces is the possibility that Europe may close its borders to Ukraine, either because of protectionist lobbying from domestic interests in various European countries, or as a by-product of accession of Central European countries into the European Union. (That is, visa regimes and trade policies adopted by Central European countries as they prepare for EU membership may reduce access for Ukraine to these countries.) Given that European countries are Ukraine's most important market-oriented trade partners and most common destinations for Ukrainian tourists, such a closure of Europe's borders would have a significant negative impact on Ukraine's prospects for near-term economic security and development.

If Ukraine and Europe are successful in addressing these potential threats to economic security - that is, if Ukraine is successful in implementing a comprehensive economic reform program after the presidential elections, and if Europe is successful in maintaining open borders with Ukraine - then the next two years may in fact turn out to be a period during which Ukraine builds economic security, solidifies its political independence, and makes great progress with integration into the community of European nations.

Notes

- 1 Based partially on ongoing research comparing Ukraine with Central European countries, by Janusz Szyrmer and Dimitar Mishev, HIID. Data sources include official government statistics organs of Ukraine and Poland, and from Ukrainian Economic Trends (Kyiv: Ukrainian-European Policy and Legal Advice Center). All charts and many calculations in this paper were prepared by Aleksei Sluchinsky, HIID.
- 2 *Ibid.*
- 3 The "virtual economy" is described in Clifford G. Gaddy and Barry W. Ickes, "Russia's Virtual Economy," *Foreign Affairs*, July/August 1998, Vol. 77, No. 5, pp. 53-67. In this paper, I seek to extend their analysis, describing economic characteristics more in detail, in the context of an economy that has transitioned from centrally-planned socialism to a new form of socialisms.

THE IMPACT OF THE SOVIET LEGACY ON REFORMS IN UKRAINE

Vira Nanivska

Director of the International Centre for Policy Studies, Kyiv

Ten years ago, businesses all over the world looked with enthusiasm towards the opening up of the Soviet Union, envisaging unprecedented market opportunities. Today there is a general sense of frustration that these expectations have not been fulfilled. What should we think about this? Are the FSU countries doomed to failure, or have reforms been ill advised?

Economic Decline in Ukraine

Ukraine is a country of great potential. It is blessed with well-educated people, abundant natural resources, and a predominance of industry and agriculture in the national economy. Its geographical location in the heart of Europe leaves Ukraine in a favourable position to benefit from world trade.

At the time of gaining independence in December 1991, Ukraine was widely considered to have excellent prospects. Instead, it has endured one of the world's worst depressions in modern history, lasting for nearly nine years, with GDP reduced by over 60%. Even among the countries of the former Soviet Union, Ukraine stands out as having one of the longest and deepest periods of economic decline.

The impact of the decline on the people of Ukraine has been acute. They must now live on less than half the income they had only a few years ago. At least 30%, and perhaps up to 75%, of families now live below the poverty line. Sickness from preventable causes is rising, death rates are climbing, life expectancy is falling, and the population is shrinking.

Why has Ukraine not been able to take advantage of its great potential?

Government Grappling with a New Role

Economic stagnation in Ukraine is exacerbated by poor policy decisions and the lack of a farsseeing economic strategy. Ukraine has not developed overall objectives and is bogged down in "fire-fighting". While the President and government have articulated a clear medium-term economic policy direction,

policy implementation bears little resemblance to that vision. As a result, Ukraine has stumbled from one crisis to another.

In Ukraine, as in all transition countries, the transformation process is dependent not only on the capacity of the internal forces of government and society but also on the power of technical assistance. One of the singular benefits of technical assistance in Ukraine is that it has provided invaluable opportunities to develop concepts, mechanisms, and solutions regarding reform.

After long years of intellectual isolation, Ukrainians were eagerly looking for Western experience. For their part, donors believed that:

- the post-Soviet Ukrainian government had both the mandate and the capacity to make reform decisions - upon being given the right recommendations;
- civil society in Ukraine would automatically become active and independent when total state control was removed;
- Ukrainian business would work with foreign investors according to generally accepted business rules.

Given these assumptions, donors saw their role as advising the government of Ukraine on reforms whilst financially supporting the transition. By providing technical assistance to the government, donors believed that it would take the lead in reforming economic and social institutions.

The international community tends to see the cause of inadequate reforms and economic strategy in Ukraine as exclusively due to a lack of political will by the President and government of Ukraine. We argue that reforms in Ukraine have also not worked because of gaps between the design of technical assistance programmes and institutional reality in the former Soviet Union.

The Ukrainian government lacks the skills needed to fulfil its new role in a market economy. Up to eight years ago, the Ukrainian government had an absolutely different objective, role and function. It did not have any real governing responsibilities as one of the Soviet Socialist Republics, rather it was fully engaged in the distribution of resources and direct management of a huge, country-sized production line. No policy formulation was involved, as all policy decisions were made by the Central Committee of the Communist Party. The government was there just to execute orders.

Old Government Machinery is Incompatible with New Challenges

After the collapse of the totalitarian regime, the Soviet-style government machine proved unable to cope with the new challenges of transformation, both substantively (what to do?) and managerially (how to make it happen?). In terms of the economic substance of reform, the government was at least receiving abundant recommendations, whereas in getting the reforms implemented, it has been left alone with its incompetency.

Moreover, reform measures entail both government and parliamentary decisions, which inevitably change the status quo of society. These changes are bound to affect the interests of some societal groups and to provoke the active opposition of others. Well-organised opposition groups usually attract financial resources rather quickly, and in an effort to retain social support they use familiar communist slogans which have been long instilled in people's minds.

Reformists, however, do not have the necessary skills, experience, or resources to defend their course. In addition, they have had to deal with the challenges of early democratisation, including a recalcitrant parliament, political parties in their infancy, and shaky support for freedom of speech.

In order to function properly in the new democratic arena, it is extremely important for the government to institute the development and implementation of state policy, and to do it despite the opposition. It is no longer possible just to make decisions, knowing that they will be fulfilled without question. It is necessary to justify these decisions, prove why they are better than the alternatives, and show what consequences they will have compared to other decisions. Moreover, analytical and political justifications must be presented in order to win the support of the public.

The Soviet government did not, and could not by its very nature, have procedures or institutional knowledge for these tasks. Soviet analytical departments were never assigned the tasks of justifying alternative decisions, measuring public costs, and weighing possible consequences; and state leaders never worried about justifying their decisions to the public. Suddenly, reforms were requiring the government to give up its ownership of and control over the economy, including the need to curb its previously unrestricted and non-transparent spending habits.

Liberalisation failed to create markets in place of state control, and instead strengthened the hold over Soviet shadow economy. Privatisation programmes did not affect the existing shadow economy and macroeconomic stabilisation failed to reduce the overall role of government in society.

Unfortunately, even during the present reform process, new capacities to fulfil policy analysis tasks have not been developed. Ideally, the institutional capacity of the Ukrainian government's mechanisms to carry out reforms should include:

- employing qualified experts for professional policy analysis, namely: research on the possible short- and long-term consequences of suggested decisions; evaluation of the public costs of not making those decisions and (especially in Ukraine) the costs of reinforcing them; and comparison of these decisions with defined goals;
- an institutional ability to manage change, including a department of reform management able to formulate reform strategy; differentiating process from substance; identifying driving forces and opponents of reform; developing action plans; and building political support throughout the country;

- putting organisational procedures in place to provide extensive support for government reform policies, including an officially structured system of communication with the Parliament, as well as procedures and documents that fulfil the principle of government transparency for the public.

Unfortunately, technical assistance to date has not really helped to develop Ukraine's analytical competence within and outside the government. Groups of foreign experts that conduct their own research and offer recommendations to the government are an extremely interesting source of information, but they cannot be used directly to any great or lasting effect in the Ukrainian policy-making process.

Reforms have still not touched government institutions, and the Soviet-style government machine remains intact. It is engaged in a dual-track system of work, with new tasks being added to the unchanged old patterns. That is why policy **advice** provided through technical assistance programmes is not being implemented in Ukraine, because policy **analysis** - a requisite standard for any Western government - has not, in fact, been instituted.

Assuming even that the will is present, the government also lacks the skills to effectively communicate reform measures to the people of Ukraine. The simple basics of a market economy and the rationale for reforms have not been explained to the people, nor has future prosperity been linked to the success or failure of reforms in the people's eyes.

For example, voucher privatisation was promoted as a purely liberal-socialist equity measure aiming at "fair redistribution of state property", but at a fundamental level those who were not involved in private business (including public servants, teachers, doctors, pensioners, and soldiers) did not see how they could benefit from shops or factories changing ownership. Their lack of understanding prevented them from becoming allies of reforms and, in this case, pushing for transparent bankruptcy procedures.

Why was the Situation Different in Central European Countries?

In fact, there have been two different approaches to technical assistance - one applying to countries of Central Europe and another to those of the former Soviet Union:

- In Central Europe the focus has been on European integration. Institutions were developed to allow integration into the EU. Government officials of Central European countries worked to adjust their institutions to EU standards, including in the framework of technical assistance projects with their counterparts in Western European governments.
- In the former Soviet Union, technical assistance has been aimed at consulting, advice, and information sharing, with no institution building. The first project

on public administration reform in Ukraine started in late 1997, compared to 1991 in Poland.

The Changing Role of Technical Assistance

Considering the overall high level of education in Ukraine, the Ukrainian government actually has remarkably few specialists with the knowledge and expertise necessary for government work in a democratic, open, and transparent society. Public servants lack the skills needed to give quality strategic advice to the government.

In this context, it is unfortunate that technical assistance in Ukraine has been focused on **giving advice** rather than on **teaching Ukrainians to develop and formulate policy advice**. As a result, the government of Ukraine has been unable to evaluate foreign advice or implement it.

Furthermore, it is necessary to distinguish between technical aid to the government and independent policy research by international experts. The latter is very interesting and valuable, both for Ukrainians and donor countries, but there is no way it can replace technical assistance for the government to do similar research. Technical aid has to be aimed at helping Ukrainian institutions to ask the proper questions, find the answers, and thus support the decision-making process.

In fact, it often happens that foreign consultants do not promote the transfer of knowledge at all, because they are expected to produce their **own** work in the form of advice, as opposed to guiding, consulting, and supervising Ukrainians doing that work. Ultimately, all parties are frustrated - the international side because Ukrainians do not follow their advice and the Ukrainian side because they were not helped to deal with their problems. It is no wonder, really. People are not ready to pick up advice until they themselves have gone through, or have at least started, a comparable intellectual process of policy-oriented thinking. What is more, existing Ukrainian institutional mandates, organisational structures, job descriptions, and much of the normative and legal foundation conspire to foil the work of the modern democratic policy process. Meanwhile, donors expect government recipients to set things right overnight.

Actually, nowhere in the world do public servants go to their workplace and start a revolution every day. As a rule, they merely join an existing system in order to fulfil assigned functions and tasks. However, the Ukrainian government, like Baron Munchausen, is expected to drag itself by its own hair into a new role. Ukraine, unlike the Baltic and CEE states, does not have specially designed TA-supported programmes to establish a new institutional capacity for future democratic government. Quite the opposite, resources are often spent on quasi-government formations which cannot change or replace unreformed government institutions and do not build foundations for the required future government structure.

In order to help establish a new government institutional capacity, which is imperative for leading the reform process, existing government institutional capacity has to be engaged in developing and implementing special retraining programmes which focus on policy skills. Then, all those who participate in the programmes - both at the individual and the departmental level - will change. Technical aid must be targeted not at temporary or “transitional” agencies, but at those government departments which are an indispensable part of the future government - and they must not delay restructuring any further.

The work of implementing reforms can only be done by government institutions that are fundamentally different from the Soviet type. In order to restructure government institutions, however, it is essential to develop targeted technical aid projects, because **the government will not be able to restructure itself** without these programmes.

Technical assistance programmes can play a key role in reforms, and if we want to facilitate the reform process, we have to revise the mechanism and procedures for TA programmes. In addition to designing projects which facilitate the development of new government functions and support its new role, we must also completely restructure the training programmes which do little more for Ukrainian participants than provide sightseeing tours overseas; they need substantive training, including continuing study programmes upon return.

At ICPS, two such programmes have been geared specifically toward revising mechanisms and procedures - the World Bank’s Country Economic Memorandum (CEM) and USAID’s Centres of Policy Excellence (CoPE). The CEM was designed as a way to transfer analytical methods used in the World Bank to the Ukrainian executive branch of government, including commenting, reviewing, and discussion methods. Much writing was done by the Ukrainian side during their training, organised as carefully designed home assignments in policy analysis, while the international consultants were free to enjoy their proper and unquestionably appreciated role of commenting, consulting, advising, and guiding. The resulting economic reports covering eight sectors of the economy have been published by the World Bank.

The primary component of the CoPE programmes on budget and regulatory reform policy is the fellowship programmes. A working group of government officials, assigned by their respective ministries, is completing a set of capacity-building exercises that are designed to improve their ability to support the budget policy process in Ukraine. Proposed and vetted by the Ministries of Finance, Economy, and the National Bank of Ukraine, the fellows attend weekly seminars, undertake individual projects designed to address issues of direct importance to their professional responsibilities, and participate in a regular review of their progress and performance within the programmes.

Besides the Country Economic Memorandum (CEM) and the Centres of Policy Excellence (COPE), there appear to be no economic policy projects in Ukraine that require the systematic, coherent, and carefully planned involvement

of government officials, whose project work is included in the objectives of the institution where these public servants are employed.

Conclusions

Ukraine cannot be said to have failed in making the transition from a totalitarian regime to a democratic market society. On the contrary, market forces, naturally embedded in people's vested interests, are thriving in Ukraine. Private initiative is far ahead of the regulatory framework, with 60% of the economy working in the grey market. Moreover, Ukrainians are highly educated people, with 100% literacy and more universities and PhDs per capita than in any developed country, giving them a great capacity to learn.

We believe that at the moment of independence there was full political will in Ukraine to go the Western way. However, this will did not manifest itself in concrete policy decisions because there was no institutional capacity in the government to deal with the challenge of making radical political choices in a fledgling democratic environment. Ukraine has paid a high price for early democratisation, which was not matched in the government by an institutional capacity to make difficult reform decisions in the face of old-guard opposition - and of freedom of speech. Ukraine still has to learn to build on existing societal forces instead of fighting them.

The progress of reform in Ukraine has been grossly hampered by the lack of government capacity for policy-making. The reform design did not take into account the Soviet institutional legacy and the market behaviour of people who have the instinctive drive to make money wherever possible and who are not willing to wait until the proper legislation or procedures are in place. The onus and responsibility for the failures of some reform support and guidance programmes in Ukraine lies also with the donors, because a large part of the reform process was conceived, designed, and guided by donors. Without donor involvement, reform in the post-Soviet countries would have taken a drastically different turn.

Today, technical assistance formats must be reassessed and shifted from consultancy resulting in **advice** to consultancy resulting in **institutional capacity building**. The business of development needs to present the reform process as a special policy craft, both in concept and implementation, bringing policy analysis into the everyday life of every institution. In doing so, the international donor community can expect to achieve a much higher success rate with lasting and productive results.

LE CAS DE L'UKRAINE: L'INDÉPENDANCE ET APRÈS ?

Olivier de Laroussilhe

Commission Européenne - Direction Générale des Relations Extérieures

La sécurité et la stabilité de l'Ukraine figurent en tête des objectifs que s'est fixés l'UE dans ses relations avec ce pays: qu'il s'agisse de la **Position Commune du Conseil** de novembre 1994 dans laquelle l'Union s'engageait à soutenir l'indépendance de l'Ukraine, le développement de la démocratie, la transition économique et son insertion dans l'économie mondiale, ou de la **Stratégie Commune** en préparation pour le Sommet d'Helsinki de décembre 1999. Il s'agira là d'un document politique qui définira le cadre des relations de l'Union avec l'Ukraine pour les années à venir. C'est peu dire que ce document reprend le thème de la sécurité et de la stabilité de l'Ukraine, il est en réalité centré sur celui-ci et il s'efforce d'en préciser les implications et les moyens.

La sécurité de l'Ukraine intéresse l'UE pour quatre raisons principales: ce pays qui aura prochainement une frontière commune avec l'Union est une pièce essentielle d'une architecture européenne de sécurité, l'Ukraine est un élément déterminant de l'orientation future de la Russie¹, le développement d'une instabilité en Ukraine, avec le risque probable de séparatisme et de conflits ethniques ne manquerait pas d'avoir des effets sur la sécurité de l'Europe, enfin la sécurité nucléaire en Ukraine avec pour nom Tchernobyl ne laisse personne indifférent en Europe.

Avant d'examiner en détail les liens entre développement économique et sécurité, je voudrais évoquer les conditions générales d'une stabilisation de l'indépendance ukrainienne.

L'Ukraine, indépendante depuis 1991 doit affronter trois enjeux majeurs:

Il s'agit pour l'Ukraine de définir son identité et préserver son unité, d'enraciner la démocratie et de mettre en place une économie de marché, tout en assurant des conditions de vie décentes à la population. Le bilan est mitigé, encourageant sur les deux premiers points, préoccupant sur le troisième.

La transition vers un état de droit et une économie de marché est incomparablement plus difficile en Ukraine qu'en Europe centrale ou même en Russie, pays qui dispose d'une structure administrative et de ressources naturelles qui manquent ici. Pour la première fois dans son histoire, l'Ukraine bénéficie d'un important soutien international, notamment celui de l'UE et des Etats-Unis, mais l'aide internationale n'a pas été jusqu'ici en mesure de compenser les faiblesses internes de l'Ukraine.

Définir son identité et préserver son unité: les problèmes d'identité prennent aujourd'hui une place essentielle dans l'évolution des sociétés et la place qu'elles occupent sur l'échiquier international, ainsi que l'a bien vu D. Huntington: "L'identité d'un Etat détermine sa place dans la politique mondiale, ses amis et ses ennemis". Le même Huntington voit dans l'Ukraine le type même d'un pays à l'identité divisée ("a cleft country").

Et s'il est vrai que la question centrale pour la sécurité de l'Ukraine au sens traditionnel est la recherche de garanties de son indépendance et d'un équilibre entre ses relations avec la Russie et son rapprochement avec l'Occident, **cette question est sous-tendue par un élément d'incertitude conceptuel qui risque d'être durable: l'Ukraine se rattache-t-elle à l'Europe ou aux slaves de l'Est?**

Il ne semble pas que la définition de l'identité ukrainienne ait beaucoup progressé depuis l'indépendance. La place de l'Ukraine entre l'Est et l'Ouest demeure une incertitude majeure. La volonté de rapprochement avec l'Ouest et avec l'UE exprimée de manière récurrente par le président Kouchma ne convainc pas, dans la mesure où elle ne fait pas l'unanimité en Ukraine et où elle n'est pas suffisamment appuyée par des actions concrètes de réforme économique. Et nous ne sommes pas si loin qu'il semble du sujet de ce colloque: la place de l'Ukraine entre l'Est et l'Ouest dépend en grande partie de sa capacité à mettre en place les réformes concrétisant un rapprochement en termes juridique, réglementaire, économique, commercial.

Enraciner la démocratie est le second défi de la stabilisation ukrainienne. Il est la condition à la fois de la paix civile et du soutien occidental. L'Ukraine a mis en place les fondements d'une démocratie qui fonctionne et montré sa capacité à résoudre les conflits internes par le dialogue politique et le compromis, cet acquis a grandement contribué à accroître sa crédibilité internationale.

Toutefois la faiblesse de la société civile due notamment à une dépendance de plus de trois cent ans constitue un handicap spécifique de la société ukrainienne qui contribue largement au blocage des réformes. Faute d'un développement suffisant de la société civile, le Parlement et l'administration restent dominés par l'ancienne nomenklatura communiste généralement opposée aux réformes de structure. Ce phénomène se traduit aussi par la faiblesse de l'état de droit, la corruption de l'administration, l'emprise des clans sur la vie politique et l'économie.

Depuis 1991 aucune base ne s'est formée dans l'opinion ou le système politique, susceptible de soutenir une politique de réformes. Les partis réformistes et de culture démocratique sont marginalisés et la population accorde peu d'intérêt à la vie politique de leur pays. Le Président ayant une position constitutionnelle plus faible qu'en Russie ne peut gouverner sans le Parlement. L'opposition de celui-ci aux réformes s'est durcie depuis que la restructuration économique menace directement les bases du pouvoir de la nomenklatura.

Enfin la détérioration marquée des conditions de vie fragilise le consensus social. Cette détérioration connaît des proportions inconcevables en Occident avec des salaires réels à 30% de leur niveau de 1990 (salaire moyen dans l'industrie: 48 \$ par mois) et des services publics (traditionnellement étendus) en déroute. Les arriérés de salaires et de retraites atteignent l'équivalent de 2,3 mds \$ (9096 mio Gr). Les Ukrainiens manquent de tout et les nouveaux riches sont de plus en plus voyants. Le coût social extrêmement élevé de la sortie du communisme occasionne même des dommages durables (détérioration de la situation sanitaire, réduction de l'espérance de vie, appauvrissement du capital culturel et scientifique, reprise d'une émigration qualitative, généralisation de pratiques de corruption et de criminalité). Ivan Dziouba, l'une des grandes figures de la dissidence ukrainienne des années soixante a dénoncé l'état de dégradation de toute la culture ukrainienne, sous l'effet de la pénurie économique: plus d'édition de livres, plus de crédits ni de salaires pour l'enseignement et la recherche...³

Mettre en place une économie de marché. C'est le socle indispensable de la stabilisation et ce troisième enjeu nous ramène directement à notre sujet. **La sécurité externe de l'Ukraine au sens traditionnel n'apparaît pas aujourd'hui directement menacée (et c'est une première historique), mais ce pays est bien affecté d'une série de fragilités internes de nature politique et économiques susceptibles d'affecter directement sa sécurité et même sa survie en tant qu'entité indépendante.**

La mise en place d'une économie de marché est à l'évidence le principal point faible de la transition. L'économie cumulait au départ une série de handicaps lourds (dépendance énergétique, vieillissement du capital industriel, poids de l'industrie lourde et militaire, remise en cause des débouchés traditionnels) et l'industrie était à reconstruire. La situation a été aggravée par l'absence de réformes et les erreurs stratégiques commises entre 1991 et 1994. Les réformes accomplies depuis 1994 ne sont pas négligeables, mais l'Ukraine n'est pas encore au milieu du gué et elle a encore été fragilisée par les répercussions de la crise russe de l'automne 1998.

La stabilisation macro-économique réalisée depuis 1994 s'est effectuée aux dépens d'une crise de liquidités (4,5 mds \$ d'impayés par l'Etat) et d'un affaiblissement de l'Etat lourd de conséquences sociales. Le déficit structurel des finances publiques et son financement en grande partie par des bons du trésor à court terme sur les marchés internationaux laissent le pays exposé au risque d'une crise financière. L'étape suivante de la transition, la libéralisation micro-économique a été engagée (libéralisation des échanges internes et externes, des prix et réduction des interventions publiques), malgré des reculs en matière de libéralisation des échanges externes. Mais la partie la plus complexe de la transition économique, les réformes de structures micro-économiques et administratives commencées en 1996 a pris du retard (privatisation et conversion des entreprises, réforme de l'administration, de la fiscalité, du système financier

et bancaire, mise en place d'une discipline micro-économique). **La transformation vers une réelle économie de marché se heurte à de fortes résistances politiques, administratives et corporatistes, liées à la persistance de l'ancienne nomenklatura soviétique aux commandes de l'économie et de la politique.** L'expression de "socialisme oligarchique", avancée par David Snelbecker dont je partage l'analyse, paraît ici pertinente. Le système mis en place est effectivement bien différent de l'économie de marché.⁴

L'ancien secteur industriel et agricole d'Etat qui constitue la base économique de la nomenklatura se maintient hors des contraintes micro-financières et de concurrence en produisant souvent une valeur ajoutée négative (50% des entreprises industrielles et 80% des entreprises agricoles sont déficitaires). Ces entreprises transfèrent leurs pertes à l'ensemble de l'économie (dette triangulaire particuliers/Etat/entreprises supérieure à 138 md Gr. soit 35 mds \$- équivalent à 130% du PNB). Les moyens de cette survie ont peu de rapports avec l'économie de marché: développement d'une culture d'impayés, troc (42% des échanges internes dans l'industrie, beaucoup plus dans l'agriculture), crédits assurés par des relations privilégiées avec les banques, exemptions fiscales spécifiques, ou plus simplement non-paiement des impôts, blocage politico-administratif de l'accès au marché par des entreprises concurrentes.

Les conséquences sont désastreuses: l'économie croule sous une masse de déficits et d'impayés, en l'absence de restructuration industrielle le PIB réel est tombé à 31% de son niveau de 1990, (sans l'économie souterraine, estimée à 50% du PIB). L'investissement est insuffisant pour assurer le renouvellement du tissu industriel. Les investissements étrangers restent faibles: 700 mio \$ en 1998, 2,7 mds \$ en stock sur la période 1989-98, contre 8,8 mds \$ en Russie, 15 mds \$ en Pologne. La libéralisation de l'économie et la privatisation étant inachevées et le traitement réservé aux entreprises étrangères incertain (instabilité du cadre législatif et fiscal, comportement arbitraire de l'administration, corruption, absence de tribunaux de commerce fiables), cette situation prive l'économie d'un apport essentiel de dynamisme.

Cette fragilité économique a été à la fois révélée et accentuée par les effets de la crise russe de 1998. L'Ukraine a été frappée par les effets de la crise russe de 1998 alors qu'elle était en position de faiblesse économique et financière. Si la crise financière, notamment un défaut de paiement (officiel) a jusqu'ici évitée, l'amélioration attendue en 1998 des indices macro-économiques a été remise en cause (stabilisation du PIB et désinflation) et les échéances financières sont particulièrement difficiles (la dette externe venant à maturité cette année s'élève à 2 md \$, le besoin de financement externe est évalué à 2,2 mds \$. Les prêts rééchelonnés en 98 s'ajouteront aux échéances déjà lourdes de l'an 2000. Les autorités ukrainiennes ont imposé aux banques ukrainiennes un nouveau rééchelonnement de la dette interne en février et une restructuration de la dette publique externe est en cours de négociation).

Les conséquences de cette faiblesse économique sur la sécurité de l'Ukraine:

Elles sont de trois ordres et l'on peut s'interroger sur la capacité de l'Ukraine à maintenir son indépendance en l'absence d'une transition économique réussie:

La situation économique actuelle apparaît difficilement tenable, dans la mesure où l'Ukraine ne parvient à éviter le défaut de paiement que grâce à l'aide financière internationale et où l'acquis en matière de stabilisation macro-économique est remis en cause. Les dettes interne et externe continuent de progresser. Par ailleurs la stabilisation macro-économique sans apport de nouvelles sources d'investissement et de création de richesse débouche sur un phénomène d'endettement généralisé des acteurs économiques qui étrangle l'économie nationale et appauvrit la population. En particulier le blocage de la privatisation (notamment dans l'agriculture) laisse subsister un secteur public qui n'est plus compétitif en situation de marché libre, et ne se maintient qu'en s'endettant.

La dépendance de l'économie ukrainienne vis à vis de la Russie persiste. Elle est structurelle et de plusieurs ordres: commerciale: le commerce extérieur de l'Ukraine reste très lié à l'économie russe (23% des exportations et 48% des importations ukrainiennes de marchandises en 98); **énergétique**: l'énergie représente 70% des importations ukrainiennes en provenance de Russie (90% du pétrole et du gaz consommés en Ukraine viennent de Russie ou du Turkménistan). Cette dépendance se traduit notamment par un niveau élevé d'endettement à l'égard de la Russie. L'Ukraine n'est toujours pas en état de payer ses importations énergétiques et continue de s'endetter à l'égard de ses fournisseurs (1,5 mds\$ envers la Russie et 600 mio\$ envers le Turkménistan), malgré plusieurs opérations de rééchelonnement en 1995, 1997 et 1998 (accord de troc dette énergétique contre produits alimentaires). **industrielle**: de nombreuses entreprises ukrainiennes restent complémentaires d'autres entreprises maintenant situées en territoire russe. Dans ce contexte, la proposition russe de convertir la dette en actions de l'industrie ukrainienne doit être méditée. Elle pourrait marquer un retour dans la dépendance russe

Le défaut de réformes économiques et commerciales handicape le rapprochement de l'Ukraine avec l'Ouest et notamment avec l'UE. Ainsi la lenteur des réformes visant l'établissement de l'état de droit en matière économique (propriété intellectuelle, certification, justice commerciale) fait obstacle aux investissements occidentaux, et aux échanges. La tentation en Ukraine de résoudre des problèmes industriels pressants par des mesures protectionnistes de circonstance (augmentation des droits de douane, taxes discriminatoires, et même fermeture partielle du marché comme dans le cas des automobiles d'occasion), conduit également à une multiplication des obstacles aux échanges. En effet la crise de l'appareil de production ukrainien a réduit sa capacité d'exportation sur nos marchés à l'exception de produits de la vieille industrie lourde (acier, chimie lourde, textile) et la capacité de concurrencer les importations est également très diminuée.

Cette situation retarde aussi bien l'entrée de l'Ukraine dans l'OMC que la mise en œuvre des perspectives de rapprochement avec l'UE telles que la zone de libre échange envisagée dans l'Accord de Partenariat et de Coopération. Cet Accord de Partenariat et de Coopération lui-même contient un potentiel de rapprochement avec l'Union qui doit être exploité par l'Ukraine. Il passe par de multiples mesures d'harmonisation et des coopérations en matière commerciale, administrative, réglementaire et son application est soutenue par l'assistance technique de l'UE.⁵

Mais l'aide extérieure n'est pas tout. Et l'expérience de huit ans d'indépendance permet d'identifier clairement les déficiences de la transition en Ukraine: la difficulté de convertir des ensembles militaro-industriels lourds, la faiblesse de l'Etat incapable d'assurer ses fonctions d'arbitrage ainsi que de redistribution sociale, le non renouvellement des élites, la faiblesse de la société civile, le blocage politique des réformes après 96.

Ce constat appelle certaines priorités:

Restaurer la crédibilité et le fonctionnement de l'Etat: réforme fiscale portant sur l'assiette, les taux et les moyens de perception, afin d'accroître les ressources fiscales; restructuration du budget: réduction des dotations à l'économie et meilleure allocation des ressources en faveur des dépenses de santé, d'éducation et d'infrastructures, réforme du système des retraites (notamment création de fonds de pensions autonomes, indépendants du budget); concentration de l'action des pouvoirs publics sur les objectifs essentiels: stabilité macro-économique, renforcement des institutions du marché, régulation des marchés financiers, restructuration industrielle, réforme de l'énergie, politique sociale, infrastructures; réforme administrative: simplification de l'organigramme gouvernemental, formation.

Renforcer les institutions du marché: développement de l'état de droit en matière économique (mise en place d'un droit des faillites, d'un droit des créanciers et de tribunaux de commerce fiables); réformer le système financier (introduction d'un mécanisme fiable de régulation et de surveillance des activités bancaires), amélioration du cadre législatif pour les investissements (code des impôts); poursuite de la libéralisation commerciale: réalisation des conditions d'accession à l'OMC.

Les leçons de la crise russe et les lacunes de la transition ont amené les institutions internationales à procéder à une réappréciation de leur stratégie. L'assistance occidentale sera maintenue compte tenu notamment de l'importance stratégique de l'Ukraine dans la région, mais devra peut-être réduire ses ambitions pour tenir compte de situations de blocages appelées à persister. Les orientations suivantes devraient être privilégiées: assurer une aide humanitaire à la population, éviter une crise financière majeure, poursuivre l'amélioration de la sécurité nucléaire, maintenir l'assistance technique seulement dans les domaines où une volonté de réforme existe, former une nouvelle génération de dirigeants. Il faudra enfin accepter que le processus de transition en Ukraine comme dans toute l'ancienne URSS, soit plus long et complexe qu'on ne l'aurait espéré.

Note

- 1 Comme l'a bien exprimé Z. Brzezinski dans "The grand chessboard", 1997, qui voit l'Ukraine comme un des 5 pivots géopolitiques de l'Eurasie.
- 2 D.Huntington : "The clash of civilizations", Harvard, 1997
- 3 Zerkalo Nedeli, Kiev, 22.8.1999
- 4 David Snelbecker, "The links between Economics, security, stability", June 1999, paper prepared for the NATO colloquium.
- 5 L'Ukraine bénéficie depuis 1991 du programme Tacis, qui a porté sur 560 mecu sur 1991-97, (264 mecu du programme national, 245 mecu pour la sûreté nucléaire, incluant la contribution de la CE au Plan du G7 pour Tchernobyl et environ 60 mecu des programmes Inter-Etats), 265,5 mecu en 1998 et 105,6 m ecu en 1999. L'UE est le premier bailleur d'aide internationale à l'Ukraine, évaluée tous instruments confondus à 3,92 md ecu sur sept ans (1991-97).

COMMENTS ON THE PAPERS SUBMITTED BY DAVID SNELBECKER, VIRA NANIVSKA AND OLIVIER DE LAROUSSILHE

*Alexander Kennaway**

Conflict Studies Research Centre, Royal Military Academy, Sandhurst, UK

David Snelbecker

The Ukraine has been socialised, collectivised and subjected to the Stalinist centralised control system for very much longer than had Poland, Hungary, and the Czech Republic. Poland retained a lot of small-scale, owner-run farms and the consciousness of the methods of private enterprise remained amongst significant numbers of the population. These countries were accustomed to exporting agricultural produce to a discriminating market in Western Europe. The Czechs and Hungarians in particular had a tradition of excellent engineering in some specific branches of industry, which before and during the Second World War were the equal if not better than their West European competitors. This was not true of Ukraine, (nor of Belarus) which are severely handicapped by the continuation of the deeply rooted Soviet mentality and by the limited geographical resources of the country and the obsolete, poorly laid out, poorly designed and managed production, transportation and communication systems.

He rightly draws attention to the ill effects of the system of barter to which one may add the practice of issuing IOUs as a replacement for money. He is probably right in his speculations for the reasons for its continuation. But it did not suddenly come into being with the collapse of the economy and independence. We have to remember that in Soviet times, internal commerce between state owned firms was not based on cash but on book transfers of arbitrarily determined amounts which bore little or no relation to true costs. The Russian Federation and the Ukraine and doubtless most of the other republics in the CIS are still working a largely cashless system, which grew out of the old system. There were two other systems working in parallel:

- External trade with capitalist countries was carried out in cash with the Soviet state taking the benefits, whilst in post-Soviet Russia, Ukraine and the CIS countries a lot of the benefits stay with the oligarchs and their political associates.

* Editor's note. It is with deep regret that we have learned of the sudden death of Professor Alexander "Sasha" Kennaway. A long-term friend and enthusiastic supporter of the work carried out in the Economics Directorate, he will be sadly missed.

- The only part of the system that uses money is that serving the ordinary consumer. In Soviet times the state subsidised most necessities, paying for subsidies from the “surplus value” created within the manufacturing system; it also gained through a sales tax. A certain amount of money was printed and distributed to the populace to buy food and basics, which were also heavily subsidised.

In its last years, the inefficiencies of the Soviet economy resulted in a sharply reducing return on capital investment, a slow inflation and deterioration of the living standards of the people. Gorbachev was the first General Secretary to try to take action as a result of the briefings given to him by his specialists. The failure of his efforts to reform the USSR through a reformed Communist Party accelerated the inevitable breakdown of the economy. The inflation caused by all these inefficiencies and new malpractices is only too visible in the value of money, especially in the three Slav Republics of Russia, Belarus and Ukraine. The oligarchs have exported dollars perhaps to a value of US\$250-300 billion; the populace treats the US dollar as the major currency for internal trade, keeping perhaps US\$50-70 billion in their stockings and under their mattresses. It is ironic to note that this represents an interest free loan to the US Treasury at the same time as the USA is treated to accusations of imperialism! It remains a pious hope for the IMF and for the governments of those countries to demand that taxes be paid in cash until the whole commercial chain abandons the Soviet trading system and uses money for its transactions. Gazprom announced that in 1998 it paid 28% of its taxes in cash, up from 17% in 1997. A totally money based economy ought to lead to a rigorous, open determination of real costs of production and exchange of goods and services. In turn, a culture of cost-effectiveness might begin to grow. But I think this is a pipe dream.

Russia, through its exports of oil, gas and other minerals, earns significant sums in foreign currency, much of which is squandered. The crash of 17th August 1998 made many goods too expensive and has stimulated a modest, unplanned programme of import substitution as well as a reduction in imports. Russia may be able to continue its centuries’ old foreign trade pattern of exporting raw materials to pay for essential technical goods that it is still unable or unwilling to make for itself. Ukraine is not even in this fortunate position.

Many of Dr. Snelbecker’s recommendations for economic reform are sensible. He is right of course that a fundamental change in the economic policies of government is essential but insufficient. He correctly lists the required attitudes in his Table 1. But it is not, as he maintains, **only** “a ruinous economic policy that has prevented the Ukraine from realising its potential over the past eight years.” My comments on Dr Naniwska’s paper apply with full force to Dr. Snelbecker’s argument as well. Fundamental changes in the culture of the firm, management and work force is also required. But I doubt that economists educated in market principles are the right people to do that job, however many are educated and work in Ukraine. Nowhere in successful capitalist countries

are they responsible for success at the level of the firm; they will not wave a Keynesian magic wand. It is harder than that; a whole generation of competent professionals in their own sectors of business who are at the same time good managers is needed. I would also reiterate that to talk of their work force as highly educated is a tragic delusion; they will not perform properly unless they are led by world-class managers.

I would like to make some observations on a few more of his points which to my mind do not take sufficiently into account both the realities of business life in Eastern Europe, and the very stagnation that he observes and which I identify as attitudes frozen in the Soviet past coupled with opportunities to enrich the few rather than the firm and the country. For example, to relax inspection of imports or to accept “blind” the certificates of other countries is to open the doors to poor quality and sometimes dangerous products; there are enough examples of unscrupulous traders importing condemned food from Italy for example.

I also think that much needs to be done to encourage import substitution by domestic manufacture, this ideally needs local manufacture by foreign firms. But in the cheaper ranges, it would be better for the population, for a few years, to have available goods to the old, lower Soviet standards than nothing at all or imports from S.E. Asia through the grey economy. Something must be done to prevent the retention and flight abroad of capital. Ideally of course, the best way is to create the conditions for domestic investors to be confident in making a decent profit by investing in their own country. If they don't, why should foreigners? But we are far from the ideal circumstances where liberal economic policies alone will create the desired results.

Dr. Snelbecker is right to observe that Ukraine - and for that matter Russia - is not a transition economy but one in stagnation, as my own analyses over the past 10 years have consistently pointed out. The three Slav Republics have not taken, as Shakespeare's character Henry V said to his troops at Agincourt “the tide in the affairs of man that when taken at the flood leads to victory”. These economies and governments are led by men who are carried helplessly in a whirlpool constantly driven by the tides of events which they cannot prevent nor harness to the benefit of their country. They remain victims of their own past and of the opportunities presented to the corrupt and greedy by the wrong kind of political-economic policies masquerading as a market economy.

Consequently, Russia will continue to muddle along, probably not returning to a pure Soviet system nor able to take the right steps toward a working market economy. It will probably continue to muddle slowly downward. It can of course afford to do so, given its export of mineral wealth, especially if that is efficiently managed to joint benefit by foreign world class firms. The same is, at best, true for the Ukraine. It would indeed provide an incentive to entrepreneurs if taxes were lower. But in the absence of competent businessmen, this by itself will reduce the income of the state which will almost certainly consider that it

is forced to continue subsidising the loss-making operators as well as trying to maintain a large armed force and to develop its own arms production, particularly to compete in world markets. It is an over-simplification to assert that the USSR was over-industrialised. More accurately, its industry was heavily over-manned and much too orientated to the military. This does not require the range of service industries in finance, distribution and customer service essential for a thriving civilian economy. The defence industry produced good weapons inefficiently and cannot readily be converted to making acceptable civilian goods for many reasons. In a curious way, it received too much investment that was under utilised.

The Ukraine and Belarus with their very limited natural resources cannot afford the current helplessness and corruption. Their survival as independent, unsubsidised states depends upon them making the managerial revolutions that we in Western Europe and the Japanese and South Koreans have made and are still evolving. Without them there is no hope of utilising their “proximity to Western markets”. If the economy continues to decline, Ukraine may not be able to rely on its ethnic homogeneity, which comforts Dr. Snelbecker. This phrase hides some serious divisions which mass poverty and unrest may bring more to the surface. Ukrainians may be Slavs but so are Poles; they both have a long, proud history of distinctively different cultures from that of Russia as well as an equally long history of resisting Russian domination. The population to the east of the Dnieper is largely ethnic Russian while in the Western Ukraine the local population has much more in common with Ruthenians, Poles and other peoples of the former Austro-Hungarian Empire.

Regrettably I think it unlikely that Ukraine will learn how to move toward a more efficient, profitable self-sustaining and reasonably honest economy. There are too many people in high places who do not want to make the changes nor understand how to achieve them. I have explained in my comments on Dr. Nanivska’s paper why I think the forms of Western attempts to help them to learn are wrongly conceived and executed.

The consequences of the likely outcome for Ukraine and for her western neighbours are worse than is the case in Russia. The same is true for Belarus. Russophiles in both countries who may also be nostalgic for the Soviet era may try to reunite these countries with Russia, but they will be an added drain on the overstrained Russian economy.

Vira Nanivska

Dr. Nanivska’s analysis is correct, in that she properly identifies some of the Soviet legacy, wrong assumptions and errors in trying to carry out reform by foreign “advisors” and also by Ukrainians. But we should look more deeply. The economic aspects, particularly, remind one of British failures in the decades that followed the end of the Second World War. We too had a dirigiste economy

as a legacy of war policies, which were followed as a religion by the incoming socialist government. Industrialists also had a similar set of smug assumptions concerning our industrial capabilities, achievements, and managerial and scientific skills. These were unjustified in comparison with the performance of America and Germany.

Experience in Britain and in the former Soviet Union provides ample evidence that a highly educated work-force and graduate population is incapable of adequate performance in manufacturing, agriculture, infrastructure or communications unless it also understands the basic doctrines of a successful market economy and how to apply its education to its achievement and continuous improvement. Until the late 1970s, there was in Britain an almost complete chasm separating academics and graduates in engineering, natural sciences and business from the practice of management and leadership of companies. The former were regarded with suspicion of being mere theoreticians and almost contempt by business managers and directors who themselves had not had a university education and confused knowledge with wisdom. Business leaders tended to be mere accountants. Graduates entering the real industrial world often had to avoid the traps of following out of date practices insisted upon by their seniors whilst learning to challenge them and also to offer workable alternatives. In Britain, it took decades to change the culture of the past. In the former Soviet Union, this process has not even begun. The capture of vast state assets by individuals whose objective has been to enrich themselves rather than to benefit either their company or nation is no advertisement for private enterprise or a substitute for a properly working market economy.

The USSR, including the Ukraine, graduated many thousands of engineers and natural scientists; the theoretical aspects of their courses resemble those of the West but their courses do not integrate theory with application in the multi-disciplinary way that we do. Much of our education provides students throughout their courses with problems that require them to take into account not just theories of mechanics, physics and chemistry, but also the realities of industrial and commercial practice. Our students learn from their professors, who usually have significant industrial experience, and also from practising industrial managers both in the universities and later when they join a company. Young entrants can nowadays learn from their seniors how to work effectively within an environment of constant change and evolution of products, processes and company structure.

This was not the case in the years 1939-1960s, as I and many of my contemporaries knew. But this is still the case in the fSU where factories are dinosaurs designed and built many decades ago and frozen in the mud of Soviet thought and doctrine. Homo Sovieticus and Post-Sovieticus rejects industrial Darwinism! It is afraid of fundamental changes in the Soviet structure believing that it worked before and will work again whilst suspecting that the advocacy

by the West of their own experience is intended to destroy the economic and military base of their countries.

One significant current error made in the fSU is to assume that these old factories are very valuable and are the heart of the national wealth. They are not; the value of assets is only to be measured by the profit that is and can be generated in the future. All but a very few Soviet factories, and then those dedicated to purely military purposes, have any hope of competing, even if they are properly managed. They are badly laid out, with poor and costly materials handling, wasteful of energy, their equipment is often obsolete but even new equipment is frequently misused by management and workers, engineering materials are often of the wrong specification and vary widely from batch to batch. The design of products is too often done without adequate regard for real market requirements, because the design engineers are accustomed only to serving the military where cooperation with the users is good. Designers and production engineers alike are proud of their military work for which they rightly ask respect, but they in turn deny that respect to designers of civilian products because they consider that work too easy and beneath their own skills.

They are wrong; design for a competitive civilian market is actually harder than for the military; I have designed in both fields and that is my experience. Dr. Nativska is right when she says that industrial managers are simply “fire-fighting”, dealing with every emergency such as the lack of a component. By our standards, these factory-based engineers are not doing technical work - they are progress chasers!

In the fSU, one seems to have forgotten Marx’s phrase “theory without practice bears no fruit”. I am afraid that young Ukrainians with a good theoretical education are trapped because their opportunities to learn “practice” is only through their seniors who know only the Soviet past. The figures for employment of graduate engineers and scientists in Russia shows that very few work in factories but in research, administration, government and in other institutes. In the West the exact opposite is the case; such people work where they are most effective. See my paper to the 1994 NATO Economics Colloquium.

The best way to learn good practice is through daily association with competent and experienced seniors on the job. This requires world-class foreign firms to settle in Ukraine, engage young Ukrainians to work with their own senior managers and gradually replace them. No amount of seminars or sitting in business schools is a substitute for this. But the political, legal, fiscal and financial conditions operating in the Ukraine are not attractive to persuade enough firms to settle in Ukraine.

The West, including NATO, makes a fundamental mistake in providing seminars with papers by Ukrainian and foreign experts. The former make set speeches on general lines which are predictable, whilst the latter offer generalisations and sometimes detail which are correct at home but fail to take into account the real circumstances in the Ukraine. Furthermore, no one, not even a person

experienced in the Western system, can apply the suggestions without detailed study and exchange of experiences with practising foreign specialists. We must mount working groups between the Ukrainians who have to acquire new ways of working and the foreign specialists who have to consider the local realities. This will take time; I suggest that a working specialist group should come together for a week or two, leave the participants a month or two to reflect on the problems and recommendations and then reconvene for another two weeks at a later date.

Let me return to the comforting illusion that a large number of educated scientists and engineers will pull the country out of the mire. I give a Ukrainian example. Two years ago I was involved with a seminar in Ukraine to discuss ways of cleaning up the environment. The Ukrainians were mostly from institutes designated as expert in this field. They produced some theoretical papers, but when we put the question - what would you recommend to deal with the specific problems posed by the local administrations? - they retreated into ever more abstruse and irrelevant chemistry. They gave the impression that they had no competence to identify with precision the real problem as it affects the city and certainly they had no idea how best to solve it.

This was reinforced when I visited the water supply system upon which a major city depended. I was given a good analysis of the pollutants in the water. I was then asked whether a British firm could supply a plant to remove them at the well head and at what cost. I replied that it was old, well-known technology and that such a plant might cost around US\$10-15 million. But the radioactivity would remain. We then discussed the problems more generally and the chief engineer mentioned almost in passing that even if such a plant were to be provided - with Western money of course - the water would have to pass through 350 kms of old iron piping to every user of water and that the water would again be polluted by iron oxides, etc. This of course would nullify the point of the plant. I demanded some more data and then suggested that the city should commission small filters to be fitted to lines providing water used for drinking and cooking, leaving bath water to look brown but do no damage to health. This would cost less than US\$1 million and be effective. The engineers would have none of this suggestion; I decided that what they wanted was a new plant which, like a Potemkin Village, would look good and would generate a celebratory party. No one had apparently thought through the total problem until I probed it.

Things are better in the UK, which has been more successful than most European countries in attracting foreign firms. For example, the British factory of the Nissan Car Company is now more productive than its plant in Yokohama; it has fewer rejects and the rate of rework is also lower than in Japan. In Britain it now employs over 3,500 people and only around 20 Japanese. Over 85% of everything in its products are made in UK. Nissan has established its own technical centre, endowed several laboratories in British universities and engages

in cooperative research and development in Britain; it no longer relies on its home base.

Dr Nanivska is absolutely right when she comments that the Ukraine lacked an effective managerial structure since the local authorities were supposed to do what they were told from Moscow, where all the real thinking was done in the Central Committee of the Communist Party. Even today in Russia, the “government” is simply the administrative body that has to carry out the decrees of the Presidential Administration which is an expensive, less effective copy of the old Central Committee! So much the truer in Ukraine, where there was no General Staff for the Armed Forces, no effective governmental body with the experience and capability of strategic integrated thought for government policy, let alone to think through the road from a system commanded by Moscow toward a self-governing, market economy and a politically independent and progressive civil society.

But let us observe that not everything is right with our market economy in the West. It too produces the circumstances for individuals to disregard every interest except their own. Some of their practices in self-enrichment are also outside the law or accepted practice, which unfortunately is itself altered by now social acceptance of such merciless selfish behaviour. Only a deep understanding and personal experience of the Soviet era prevents me from rejecting our current forms of capitalism. We need a free market economy but a properly regulated one in which those who practise anti-social behaviour are caught, dismissed and punished. I can only hope that sooner or later our societies will force a return to the very short periods in our history when we had a more or less ethical business life. History shows that social affairs tend to move in cycles.

Conclusions

I disagree with Dr.Nanivska’s conclusion that the kind of market forces operating in Ukraine are beneficial to its economic development. A grey economy tends to be small scale, involved in trade, often foreign trade, rather than in producing goods that the country requires. Large-scale business such as the production and distribution of oil and gas tends to be in the hands of the oligarchs and does not benefit the country as much as it should and could.

A grey economy does not necessarily convert to a respectable legal one that pays its taxes and contributes properly to society. I agree very strongly with her other conclusions. My comments are meant to reinforce them with more detailed analysis of the situation, problems and possible way forward at the working level. Handicaps to effective economic reform are:

- The absence of a unit of government engaged in strategic thinking, examining the problems in the round and testing every proposed solution against cost-effective measures.

- The fear of change from the old Soviet structures in every branch of the economy, coupled with the suspicion that western suggestions are designed to destroy the security of the State.
- The absence of opportunities to learn through cooperative work with foreign experts. This denies both sides from understanding how to proceed and how it might be possible to use foreign experience in practice. Foreigners should not teach Ukrainians but help them to learn. This process requires that foreigners who may be experts in their own country have to learn how to become experts in Ukrainian circumstances. If they do not, they will properly be labelled as arrogant and unhelpful. I recollect a good Japanese phrase - "there are no professors and students, only students with more experience and those with less".
- The illusions of competence in science, technology and the value of existing industrial structures and factories. The structure needs changing. A commercial firm needs its own R&D department working closely with sales, marketing and technical service organisations; these are also lacking in most firms in the fSU. The old Soviet arrangement of separate Institutes denies them this intimacy, except perhaps in the military sphere.
- Boasting about the nation's wonderful science and technology is unhelpful. Our experience is that even the formerly closed military research institutes have little of value to offer. Mostly they are so isolated from their foreign competitors that they do not know how far behind they are. Blind British boasting led the closure of our shipbuilding industry.
- The absence of legal and financial conditions that would attract foreign firms to settle in Ukraine. This implies not only the passing but also the policing and implementation of laws and tax systems. It also requires the reduction of corrupt practices and the knowledge that these will be prosecuted in the Courts as will the rights of individuals and firms against malpractice by others, including agents of the state.
- Far too much foreign advice has been counter-productive; some of it represents sincere beliefs of macro-economists who lack an understanding of life at the "coal-face" - in other words, at the level of operation of the firm, the farm or the railway and water and sewage plant. Some, indeed, represent nothing more than the opportunity for such people to try out their theories in a country where they are not so subject to challenge as at home. Whatever the reasons, it is obvious that reforms cannot begin by putting in place the superficialities of a free market economy. A stock market is pointless unless one can value real assets, and that requires a proper costing system which allows real profit to be assessed this year and for some years ahead. This does not exist in the fSU.
- A freely convertible currency without exchange controls or limits on export of money leads to the flight of capital that we see everywhere in the fSU. The IMF may desire these freedoms but they should reflect that in UK we

had import controls and exchange controls until the late 1960s and no one accused us of being a totalitarian state to whom the world would not lend money.

Olivier de Laroussilhe

This paper very properly widens the issues beyond those of macroeconomics with which those of Dr. Nanivska and Dr. Snelbecker were concerned and with the micro-issues that I have discussed in my commentaries on those two papers.

Let me say straight away that I share completely all the viewpoints and arguments of M de Laroussilhe's excellent and sobering paper. I shall confine myself to reinforcing some of his points that seem to me those that need the most attention from the Western friends of the Ukraine and from those sincere Ukrainians who are anxious to see workable reforms in the political and economic fields.

I am also pleased to note that the failures of the past 10 years in Russia have caused the Western agencies to review their strategies of assistance. As he so rightly says, foreign aid has not compensated for the internal weaknesses of the Ukraine. I would add that the rush to provide technical and other assistance by the international financial and political bureaucracies produced equally important weaknesses within themselves and contributed heavily to the poor results of such activity. In themselves they were bad enough, but they provoked much justified anti-Western feeling within the fSU which still sours mutual understanding and handicaps the essential work of transfer of professional skills. I have myself more than once published severe criticisms of the waste of such funds, the inutility of many of their projects and the failure to carry out a rigorous audit of cost and benefits. The realities of achievement rarely match stated targets whilst the essential intellectual rigour needed at the outset regarding the aims of a project and of its terms of reference is rarely applied. I have also alluded to the corruption within the Western system and between it and the beneficiaries, but the financial loss due to this is minor compared with the failure to achieve positive results of value within the recipient country. Better late than never!

I also agree with his list of essential areas where reforms are urgently needed. I am especially glad that he and I have both highlighted some critical issues and have not been afraid to call things by their right names, as one says in Russian, to make blunt criticisms. We both observe that there indeed lies a very long road ahead before we could expect a legislative and executive regime which supports and brings into being a civic society, creates the conditions for a sound market economy and allows the Ukraine to play a positive role in its geographic and strategic position between East and West, and I will add, between north and south. I will not comment on the unfortunate and well-known deficiencies of the present government and of Ukrainian society itself, which not only allows

but positively stimulates malpractices that harm the Ukrainian population as well as relations with its neighbours.

Highlights

Identifying and preserving the identity and unity of the Ukraine. The paper asserts that we may be encouraged by progress in this respect. We surely owe it to ourselves to define our criteria by which we judge that position and then examine progress toward achieving those criteria.

Stalin asserted for his own purposes rather than for those of the Ukraine that Ukraine and Belarus were separate states within the United Nations. It is therefore difficult for Russia to find legal grounds for a return to the status quo ante the agreement to dissolve the USSR arrived at the Belovezhchaya Pushcha in 1991. This itself was brought about primarily by Ukrainian nationalists followed by the Belarusians who realised that a declaration of independence by them would not be followed by retribution from Russia, now or in the future. Khrushchev transferred in 1954 the Crimea from the jurisdiction of the RSFSR to the Ukrainian SSR. But this has been the subject of much rhetoric and demands for its return from several chauvinistic quarters in Russia. Ukraine successfully defended its position, but it would be unwise to assume that such demands will not reoccur.

The lengthy arguments over the division of the Black Sea Fleet and the uses of the naval bases and dock yards in Crimean and Ukrainian territory have been long, acrimonious and may also represent unfinished business. Both sides have regarded the Fleet as symbols essential to their national status in spite of the inappropriateness of much of it to the real current defence needs in the adjacent waters. These form an attractive route for smugglers, gangsters and illegal immigration not to mention the prospect of landings by terrorists. A more effective defence against such threats than these old capital ships lies in a squadron of fast patrol boats such as those used by the Swedish navy and by the fishery protection vessels of the Royal Navy used in the turbulent waters of the Irish Sea and the area north-west and east of Scotland, the Orkneys and the Shetland Islands. Added to which it is very costly to maintain in good order so many large and old ships. A frank study of cost and effectiveness would add to the security of the Ukraine as well as benefit its economy.

If the economy worsens much more, the resulting poverty may well provoke thoughts of separatism amongst the ethnic minorities. Western Ukraine was probably better off under the Austro-Hungarian Empire than at any other modern period of its history. There are signs of a laudable rapprochement between Romania, Bulgaria, Slovakia and Poland in regional security matters, problems of ethnic rights and education and in joint economic moves to facilitate their applications to join the European Union. It is not impossible that such moves may embrace the Ukraine, or at least its western parts.

The Crimean Tartars need very sympathetic treatment if they are to be fully integrated after their appalling treatment by the Soviet regime. If these people are not handled sensitively they may well remember their roots and look once more to Turkic States. Monsieur Laroussilhe quotes D. Huntingdon's book "The Clash of Civilisations". Zhuganov, the leader of the Russian Communist Party, relied extensively on this book to support his argument that Russia is a unique civilisation and that this justifies its place as a superpower that can go its own way in a post-industrial world. This appeal is too reminiscent of the Hitler-Himmler myth of German-Aryan uniqueness and superiority to let it go unchallenged. Russia and the Slav nations do have a different mix of attributes that provide the basis for the concept of nationhood, but the claim to a unique civilisation is erroneous and dangerous, especially if Great Russia is to incorporate both Little and White Russia once more. Is eastern Ukraine to become Russia's Sudetenland? The thesis should be challenged intellectually before it is supported by force of arms.

Economic Aspects

Relations with Russia also follow ethnic divides, which are made worse by the economic weakness of Ukraine and its dependence on Russian, especially for energy. The debts mount and are balanced by giving up equity in Ukrainian companies, effectively giving economic sovereignty to Russia. Ukraine needs to carry out an energy audit and economy drive in the use of energy. This has been very successful over 50 years in the United Kingdom which has an excellent agency capable of working in Ukraine and transferring its expertise. Ukrainian coalmines are old, all but a few are incapable of making a profit and therefore consume huge subsidies. There are 80 times more fatal accidents to miners per tonne of coal extracted than there were in the United Kingdom. Mines in France, Holland and Britain have closed, new industries brought in and miners retrained in them. This process took some years supported by a strong economy. Present policies reduce the Ukraine to conditions from which it is impossible to rescue it without serious social problems. Such circumstances produce demands to return to "order, discipline, sacrifice"; democracy becomes an early casualty. So do ethnic minorities who are easy to blame.

The Structure of Government

Laroussilhe is right to point to the lack of structure and experience of government in the Ukraine. But I am not sure that it is necessarily a bad thing that "the Ukrainian President has a weaker constitutional position than in Russia and cannot govern without Parliament". It is true that the Russian constitution in this respect is based on the French model, but Russia lacks the long traditions of French political organisation. The Russian President can and does govern

by caprice and decree; his is a Super-Presidency which can make war without the consent of the so-called government or the Parliament. December 1994 saw the first such assault on Chechnya and we are now witnessing another. His administrative office is a close and extremely expensive copy of the old Central Committee of the Communist Party; it does such strategic thinking as is done in Russia, makes the decisions which the “Ministers” are supposed to carry out. They are more like the Soviet ministers than British ones who form a cabinet and act according to a common policy. No wonder Russia survives frequent changes of prime minister and ministers who are functionaries rather than strategists and decision-makers.

The Ukraine should strengthen the competence and strategic roles of their executive ministers. They should subject their actions to stronger challenge, audit and approval or otherwise by the Parliament rather than strengthen the powers of the President. People who are interested in the history of the structure of government in Russia may care to look at my recent paper, “Continuity and Conflict in the Government of Russia”.

Additional Comments

Countries in the fSU suffer the disadvantages of not only the structure and mentality of Homo Sovieticus but also that of the Tsarist Empire. This inheritance left them in 1991 without any of the essential requirements of a modern state, which would make possible the transition from an inefficient command economy to one that might aspire to compete and survive in a competitive world.

The last decades of the USSR provided through its internal contradictions and weaknesses the basis for the conditions we have seen since its collapse. The progress towards anarchy has been accelerated by the inappropriate advice and pressures from Western and international financial institutions and macro-economists. The real economies of these countries, especially Russia and Ukraine, essentially remain in their Soviet condition but barely produce anything and are actually worthless and bankrupt. At the same time, the predictions of Marx have come true in the fSU, namely that under capitalism the gap between rich and poor will widen. The few rich have seized the opportunities to grab lucrative businesses from the state and to defend huge personal wealth with their coterie of people in power at every level. They do not benefit the economy. It is wrong to talk of transition to a market economy; neither the state nor business have put in place the essential bases to avoid drowning in the socialist mud mixed with robber baron capitalism. Random swimming has no direction.

There is no simple or single solution. The weaknesses are all inter-connected, so it is not possible to improve any one of them by itself. Furthermore it is not in the interests of the people of power and the oligarchs, or of those who aspire to join or replace them, to do so either. For example, you cannot monetarise the economy and thus pay taxes instead of firms using barter and vexels because

that would bankrupt the firms. Bankruptcy would require social support for the unemployed and retraining, but there is no money. Therefore you continue to subsidise loss makers without money so you do not move to a profitable industry, and so on! How do you get out of this trap? What is required is a total change of culture. Experience in Britain after 1945 shows that it took at least 30 years to become a member of the world's top level economic performers. And our industry is still not of the best.

I suggest that the positive basis of British society, law, democracy and openness to foreign expertise, markets and competition enables us to survive and control and reduce to an acceptable minimum the negative factors which the fSU also suffers from, but to a far greater extent. The Tsarist and Soviet empires never had those basic virtues. It is a miracle that Russia has a government at all. It certainly is not a sovereign state if it cannot impose its legal currency as the only means of settling legal commercial debts and establish a proper rule of law for honest business and citizens. Nor is it a democracy ruled by the people for the people if the oligarchs and politicians at every level rule in their own personal interest. The Ukraine suffers even more than Russia because independence left the Ukraine with no structure of government or people with experience of exercising authority responsible to their own nation. This situation is similar to that of the colonies of some Western powers. The present trend to remilitarise will only worsen the economy still more. Russia faces no external military threats, a large visible, powerful army is needed only by the emotional needs of nationalists to "respect themselves". The West would respect Russia more if it developed a strong economy.

Perhaps one way is to start small, with one city or region. Use it as a model for others to copy. It can be done with an enlightened, dedicated, competent, honest governor, mayor and council, industrialists, agriculturists and academics. They can create the right conditions to attract domestic and foreign investment and world class industries into the real economy. They could create a monetarised economy; pay taxes; support the needy; close the hopeless, loss making firms; support and retrain the unemployed; and pay pensions on time. At least one city in Russia claims to have done that. If truly reported we should all go to study it.

TRENDS IN UKRAINIAN ECONOMIC RESTRUCTURING

Natalia V. Berezniak

Head, Euro-Atlantic Cooperation Department, Directorate of the European Union and International Technical Aid, Ministry of Economy, Kyiv

Economic restructuring, because of its influence upon the main tendencies of social-economic development of society, is of decisive importance within the whole system of economic reforms being performed in Ukraine.

A peculiarity of the present stage of economic restructuring is that it must take place under conditions of deep economic crisis, a shortage of money-credit and investment resources, technological decline, the insufficient competitiveness of domestic production, the dependence upon energy imports, the growth of the shadow economy, and finally the use of pseudo-market forms of payment.

The general conception of structural policy for the long-term (10-15 years) envisages the formation of a highly efficient social-oriented market economic system, apt to self-development, which is able to generate labour and business activity, high living standards, and conditions for equal partnership in global economic co-operation.

The most important strategic tasks for this period are the following:

- encouragement of business activity by both businessmen and the population in the revival of the national economy by optimising the structure of ownership, the formation of an effective strata of strategic investors, and finally taxation reform paying special attention to the stimulation of production and investment activity;
- thorough support of development priorities for economy restructuring, especially high tech and other important industrial sectors which are able to positively change Ukrainian economic potential, both in agriculture and industry;
- inculcation of new technologies, speeding up innovation activity oriented towards production renewal in all branches and at all levels ensuring competitiveness on global markets; a reduction in energy and resource consumption, material production to utilise resource and power-saving technologies, along with the curtailment or reform of power and energy intensive production;
- expansion of export sales by entering the world market in those sectors in which Ukraine can compete, boosting the domestic market by increasing production, forming closed technological cycles for end production, re-orientation

of machine-building, metallurgical and chemical industries to achieve better co-operation;

- intensification of the social orientation of the economy and improve the environment, solve social and economic problems on this basis which will provide an essential rise in living standards. Decrease the industrial impact on nature, transition to a balanced use and reproduction of the natural resource factors of vital activity, formation of a rational settlements system, intensification of village and small town activity, improvement of the living standards in the regions.

Proceeding from an evaluation of the present state and real potential of the economy, the main aim of Ukrainian economy restructuring for the medium-term (1999-2003 years) is to overcome the economic crisis and to create conditions for the gradual increase in rates of economic development.

At this stage of the restructuring, it is necessary to concentrate the main efforts on the completion of the following basic tasks:

- to promulgate anti-crisis measures oriented towards the freedom of the financial and credit systems, regulation of money turnover and national currency stabilisation;
- to put into effect institutional transformations, necessary for the efficient functioning of a market economy, to guarantee an effective management and rights of ownership, anti-monopoly regulation and creation of proper business competition;
- to carry out taxation reform which simplifies the system whilst reducing the tax burden for enterprises in the real economy, increase the collection of taxes and stabilise tax revenues to the budget;
- to reduce the use of pseudo-market economic relations, i.e. barter, mutual clearing and other substitutes of economic turnover;
- to stimulate the development of high priority branches, enterprises and production which have or may get competitive advantages in the world market in the short- or medium-term, thereby improving the export potential of the state;
- to improve legislation and to restructure inefficient management, to single out enterprises and production to be re-oriented, liquidated, preserved or converted, including through the bankruptcy mechanism;
- to create efficient regional economic structures.

Creation of the necessary conditions for economic restructuring and transition to achieve positive dynamics of recovery are the main tasks ahead, to be achieved by means of:

- encouragement of investment activity which is to be realised through the internal funds of enterprises, and by both the centralisation of depreciation, banking system reserves and savings, and by attracting direct foreign investment;
- increase of credit to the real economy by commercial banks, especially long-term credit at low interest rates;
- business support, including the removal of artificial administrative barriers;

- increase production of competitive domestic commodities and services; encourage resource saving, technological achievement, effective conversion, and progressive production structural changes;
- promote exports, especially of high grade production;
- revive the financial state of enterprises by intensive amortisation, transfer social sector payments to local government, stop restructuring bankrupt enterprises, increase the share of enterprise monetary funds in the structure of current assets, normalise mutual settlements, reduce the volume of barter operations;
- realise a social policy that is balanced with the real capability of the budget, start a compulsory public social medical insurance, reform pension security.

The Ministry of Economy of Ukraine has worked out the basic parameters for the economic and social development of Ukraine for 1999, taking into account the indices of monetary-crediting policy forecasted by the National Bank. The volume of GDP will account for Hryvnya 124.1 billion, whilst the budget deficit will not exceed 0.6% of this amount. It is hoped to minimise the influence of hryvnya devaluation upon the rise of internal prices. If inflation in 1998 (December to December) was 20%, then in 1999 its minimal level is expected to be 7-8%.

GDP in 1999 will marginally increase, thanks to growth that will only become evident towards the end of the year. Industrial output is forecast to grow by 1.8% - agriculture by 2%. Transport sector will grow by 1.5% and construction by 2.6%. A positive impact of small business upon economic growth is forecast. The number of small enterprises in 1998 exceeded 136,000, accounting for 6% of total employment and 8% of GDP. In 1999, improvement of the business climate will increase the number up to 155,000, providing 1.5 million jobs.

An improvement in the social situation is not expected in 1999. Unemployment will increase to 6.2% because of the legalisation of hidden unemployment. The wage payment fund will increase by 8.9%. Due to unfavourable conditions in world commodity markets in 1998, external trade turnover decreased by 16.6%. For 1999, an increase up to US\$33.6bn is forecast, US\$1.1bn more than in 1998.

Macroeconomic parameters for 1999 require an intensification of economic policy in five specific areas:

- revision of the budget to reduce expenditure by 8%;
- practical and responsible management of the state debt;
- assistance with the financial revival of enterprises by introducing a new taxation and amortisation policy, which should alleviate the situation of commodity producers and release more funds for their development;
- an introduction of the very urgent principle of full payment for resource use. Wages must be fully paid in 1999, and fuel-power resources must be also paid in full. Credits must be returned. Reducing enterprises indebtedness is to be carried out with the help of astringent property means;
- balance commodity export and import volumes.

An analysis of the basic trends and contradictions of the development of the Ukrainian economy indicates the necessity to urgently realise structural transformation. This should be aimed at overcoming crisis phenomena, supporting stabilisation processes, and the achievement of economic growth. These in turn will ultimately guarantee the economic security of Ukraine.

UKRAINE: THE ECONOMY AS A SOURCE OF INSECURITY

Todor Dimitrov

Head of the Centre for Strategic Development, Institute for Advanced Studies, Vienna

State of Affairs

The continuous 10 year economic decline in Ukraine has already caused devastating effects on the quality of life and the prospects for democracy and security. The severe overall macro-economic instability, the slow pace of reforms, weak institutions, the domestic and international debt burdens, a dominant informal sector and crime were already linked into a vicious circle that is difficult to break out of. The absence of the rule of law, checks and balances (civil society), competition and a social safety net represent a severe constraint for both economic and social development in this country, where decapitalisation of assets and human resources, increasing poverty and declining life expectancy create a potential for social tension and unrest.

Official statistics reveal figures of devastation that would suggest that social unrest is almost there, though a closer look at reality shows that a number of hidden buffers still keep society in peace. Indeed, to many people's surprise, Ukraine has not collapsed although official statistics would suggest that it should have done.

Keeping society "intact" in relative terms is partly a reflection of unreported incomes and resources - the proverbial cash in the mattress - to which many people turn in dire circumstances. This implies that the free market is in reality stronger than it might seem on the surface, though not yet strong enough to make it on its own, to become an efficient and dominant reallocator of resources. Its gains have been won against tremendous odds such as unfair competition, prohibitive taxation/regulation and an unreliable financial system.

Therefore, it would be premature to assess the economy and its potential only on the basis of registered data. It would be equally wrong to ignore the important role of the large shadow sector as a second-best core of the economy and as an essential social buffer providing income to otherwise "statistically" dead segments of the population. To this end, before ensuring an environment where a formal economy could survive, it would be counterproductive to fight against the informal sector because it performs an important role of a social buffer - a role that the state is no longer able to ensure.

Some Brakes on Stabilisation

Considering this rather desperate state of affairs uncovers some urgent issues that need to be addressed:

- Current economic disequilibria, combined with crime, highly uneven distribution and devastating living conditions result in a widespread belief that life before transition was better and that apparent “democracy” and “market” produce no good for society. Hence, the danger of (already apparent) opposition to both a market economy in principle and the reforms needed to achieve it. Contrary to widespread perception, the transformation process is neither irreversible nor desired by the public. The cost of transition is clearly not bearable at extremely low levels and Ukraine may have reached a level that cannot be sustained. As a result, vanishing hopes and energy shortages could result in social unrest and violence, which can easily invite new dictatorships and kill democracy before it was born. This does not mean that the people of Ukraine should not pay the cost of a still painful and misleading transition. They have to pay this cost, but a defaulting borrower (as Ukraine is) has to search for compromising win-win solutions where both “creditors” and “borrowers” are better-off compared to a straightforward default of a bankrupt borrower that has to go to jail. Contrary to the old Austrian saying that “the situation is hopeless, but not serious”, one should note that the situation is indeed serious, but not hopeless. Not yet.
- Having a legacy of rigid dictatorship, the people of Ukraine have become used to a higher degree of suffering as compared to other C&EE countries. This implies weak or even an absence of bottom-up civic pressures as well as a lack of will and capacity to change the current situation whereby governments, often in alliance with organised crime, rob society. In other words, unlike in Poland, there is not even an embryonic civil society (or a memory of it), that could put the elite under pressure to force them to become accountable. It is naive to assume that those who fight for power will act in the public interest if there is no pressure so to do from below.
- Hence the need to support more actively the “third pillar” and the SME sector as well as to act on their behalf when the cumbersome issue of IFIs and aid is at stake. In this context, one should also have in mind the traditionally strong sense of dignity and strength that could be found among the survivor nations of the FSU. This implies unpredictable abilities to withstand hard conditions and suffering especially when it comes from “home”. This coincides with social and religious values (orthodox Christianity in Ukraine in particular) that are difficult to reconcile with market rules. Most people in Ukraine would not understand the extent to which capitalism is grounded on Christianity, because they see community socialism as the prime expression of Christianity or do not see any application of Christianity to current economic life, violent and messy as it is.

The Role of State and International Co-operation

The State

It must be acknowledged that while economic efficiency requires both private ownership and competitive markets, Ukraine lacks both. The adverse combination of market forces and monopolistic domination of rulers and power groups results in a grotesque quasi-liberal system, described as “oligarchic socialism” by David Snelbecker. This system, where crony capitalism and rent-seeking monopolies have produced a caricature out of what an open and democratic society was meant to be, is at the core of most problems. It has already discredited the transformation towards a market economy and democracy. It is no wonder that more and more people oppose reform and the market and become sentimental about the way communism was, even at the expense of losing hard-gained and enthusiasm-led independence.¹

Hence the danger of Catch 22: high social costs - no reforms - high social costs - social unrest and human/capital displacement, all these fuelled by the state (non) performance. The state is both weak - when it comes to the rule of law, transparency, accountability and public goods - yet strong when it comes to monopoly, red tape, political lending and the misallocation of resources.

A better understanding of this issue requires a reflection of both the country background and the impact of the ongoing painful transformation. Unlike countries in Latin America, or even China, the state institutions in Ukraine (FSU) used to ensure full employment and provision of public goods/utilities and social safety, however poor these were. There was no private sector, no market mechanism. Therefore, a rapid disengagement of the state appeared both impossible and destructive in many respects, e.g. provoking sound anti-market feelings of those who were most vulnerable - the poor, indeed the majority of population.

One of the often-cited advantages of Ukraine is its well-educated human capital. However, the current disengagement of the state from education is already depleting this resource and the worst of such an impact has yet to come. The issue is that while the state is not able to maintain the provision of adequate services, functions and utilities, the private sector is not ready to take over such responsibility. At the same time, the demand side is also presently rather weak and therefore, without the reallocating/redistributing role of the state, demand cannot meet supply for a variety of public goods (such as education) that are essential for the success of the economy in Ukraine.

There is no doubt that the state has to disengage as an owner of assets and administrator of industries. However, its role as policy-maker, regulator, social peace-keeper (safety net), institutions and law builder, investor in human capital and as the provider of financial system safeguards is badly needed, if market and democracy are expected to function.

International Co-operation - Current Affairs and Policy Implications

The capacity to design and implement sound economic policies depends on a number of developments that need urgent and active international support:

- A critical mass of reforms is needed. This, however, requires two conditions that barely exist in Ukraine. Firstly, bearable social consequences/costs, and secondly, knowledge and commitment geared towards a widely supported goal such as EU membership, rather than to short-term crisis management.
- Easier mobility of people and goods in Poland and Hungary, compared to Ukraine, was also a factor that facilitated earlier adoption of new standards, ideas, and business practices. It would indeed be very unfortunate for a shaky Ukraine to suffer, rather than benefit, from EU enlargement, as it will be further cut off from the flux of the aforementioned mobility and values.
- Once they become actors in the global economy, emerging markets also become very vulnerable towards shifts in international financial flows over which they have no control. The Russian financial turmoil of 1998 has severely affected Ukraine, adding external problems to domestic ones. Therefore, economic stability should also be seen a function of risk management in an international context, requiring concerted efforts of international players at the economic centre in particular. Even a relatively stable economy could destabilise overnight as a result of contagion effects and systemic risks. Security can be washed away and replaced by social unrest as a result of rapid shifts in wealth, as such shifts might reflect a collapsing financial system. A rapid loss of savings and basic social protection as a result of a financial crisis also means a loss of momentum and painful investment that took years or decades to develop. Examples include Indonesia, Brazil, Albania and Bulgaria.

To deal with the above and other issues, there is a clear need for new forms of international co-operation that are geared to results, vision and integration rather than being a piece-meal approach. While EU assistance to Ukraine is essential, it could take the lead in such reorientation if European stability is seen as a more comprehensive objective. It is also important to gear international co-operation and reforms more clearly to improved standards of life in order to restore enthusiasm and support for reforms. Otherwise, lengthy reforms (whether real or virtual) and declining standards do not match often unrealistic expectations and result in evaporating support for reforms, as well as the rise of protectionism, nationalism and authoritarianism. Therefore, the role of aid is often negative if clearly defined objectives do not exist or were not reached, because what remains is mixed feelings, a sense of dependency, incapacity and even humiliation.

While it is clear that aid could not succeed without the proactive role of recipient governments, it has to facilitate and ensure this role. This will require a reconsideration of responsibilities for and ownership of reform, especially if

supranational institutions are expected to play an increasing role, as is the case with the EU.

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Note

- 1 A survey of the Kiev National Institute of Sociology at the Kiev Mhilia Academy, published by Virpati Igaz (01.99) indicated that the respondents approval of private property dropped from 66% in 1994 to 34% in 1997.

TRANSCAUCASUS AND THE CASPIAN REGION WITH PARTICULAR FOCUS ON ENERGY ISSUES

Friedemann Müller

*Senior Researcher, Stiftung Wissenschaft und Politik,
Ebenhausen, Germany*

Transcaucasus and the Caspian Region can be considered as a paradigm for the link between economics and security as well as for new rules determining the political game after the end of the antagonistic East-West conflict. The dissolution of the Soviet Union made the Caucasus visible as the region with the potentially highest density of conflicts worldwide - in an area of only a few hundred square kilometres. At the same time, the exploration of considerable energy resources in the Caspian region opens options for development and prosperity not only for producers but also for neighbouring countries. No other significant energy-producing region is as landlocked as Central Asia and the Newly Independent States (NIS) of the Caspian region. This forces these energy-producing countries to cooperate with neighbours, otherwise their energy wealth cannot be brought to the world market. These neighbours, however, all are uneasy due to the existing conflict constellation. If one takes the five Central Asian states (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan) and the energy producing and ethnically Turkic Azerbaijan as a regional entity, one has a region surrounded by six neighbours:

- **Georgia**, the only country of the Transcaucasus/Central Asia with access to the sea, a country with at least four different (potentially) violent conflicts (Abkhazia, South Ossetia, Ajaria, Dzhavakhetia) due to unsettled struggles for independence or more autonomy;
- **Russia**, the former dominating and in the 19th century colonial power with its conflicts in the strategically important border regions (Daghestan and Chechnya);
- **China**, a geographically remote neighbour also with a crisis region (Xinjiang) on the border with Central Asia;
- **Afghanistan**, with its 28 years of civil war and no internationally recognised government;
- **Iran**, a country at least partly isolated by US sanctions against any major economic cooperation project;

- **Armenia**, which has occupied approximately 20% of Azerbaijan since the war over Nagorno Karabakh (after 1994).

The choice among these neighbours is not attractive, but there are no other alternatives. Cooperation is indispensable but conflicts are the reality. It is quite clear that Transcaucasian Georgia, due to its geographic position (link to the Black Sea and to Turkey) and its political attractiveness (no ambitions to become a dominating power, a relative stable and predictable political system), acquired a preferred position in spite of its several potentially violent conflicts. The Northcaucasian parts of Russia are also to be integrated into a new infrastructure directed towards the world market rather than to the centre of the (Soviet) empire. The struggle for this new infrastructure might fuel existing conflicts, but it could also have a balancing and stabilising effect on the potential for conflict. There is, however, no doubt that a close link between economic development (most of all energy infrastructure) and security in this region is given.

The Economic Challenge: Energy Potential

Media reports often contain data emphasising the importance of the region that derive more from political interests and the desire for media attention than from a serious depiction of the situation. This includes the catchy phrase “the Gulf of the 21st Century” and the repeatedly mentioned 200 billion barrels of oil reserves.¹ However, in order to analyse and understand the interconnectedness of the political, economic and development interests, it is necessary to have as precise a knowledge as possible of both the facts and the expectations.

Resources

John Browne, the chairman of *British Petroleum*, which heads the consortium *Azerbaijan International Operating Company* (AIOC), called the Caspian region “the greatest unexplored and undeveloped oil province in the world”.² Actually, there is still not much information about how large the oil resources of the region are. At any rate, the maximum and minimum estimates are far apart, as can be seen in **Table 1**.

If only the proven reserves were counted, the region would contain somewhat less oil than the North Sea (about 20 billion barrels). If all the possible reserves could be exploited, they would reach a magnitude of about the size of the proven reserves of Iran (93 billion barrels) and Kuwait (94 billion barrels) together. While this would far surpass Iraq’s reserves (112 billion barrels), it would not come close to reaching those of Saudi Arabia (250 billion barrels), much less that of the entire Persian Gulf (600 billion barrels). The world’s proven reserves come to about 1,040 billion barrels. Consequently, the Caspian

Table 1 - Estimates of the exploitable oil resources of the Caspian Basin
(in billion barrels)

	Proven Reserves	Possible Resources	Total Oil
Azerbaijan	3.6	27	30.6
Kazakhstan	10	85	95
Turkmenistan	1.5	32	33.5
Uzbekistan *	0.2	1	1.2
Russia *	0.2	5	5.2
Iran *	0	12	12
Total	15.5	162	177.5

* Only regions close to the Caspian Sea

Source: US Department of State, Caspian Region Energy Development Report, Washington, April 1997, p. 4.

region's reserves can be estimated at a magnitude of between 1.5% and 17% of the world's reserves. All the most recent findings indicate that the actual value is much closer to the lower estimate than to the higher one. In a survey article in February 1998, the Economist still assumed a relatively high level of resources (100 billion barrels).³ Russian estimates, on the other hand, assume about 30 billion barrels.⁴ In its study, the Baker Institute lists more recent Western estimates for the Caspian oil reserves at 15 to 31 billion barrels and just under 3% of world reserves.⁵

The natural gas resources were better explored and more thoroughly exploited during the Soviet era than the oil resources. Thus, the figures and estimates of proven and possible resources are closer to one another than in the case of oil, as **Table 2** demonstrates.

The proven natural gas reserves have a share of about 6% of the world's natural gas reserves at a total of 141 billion cubic meters. If all the possible natural gas resources were to be realised, the natural gas reserves would come to 12.5% of the proven world reserves. It is also very likely that the region's natural gas reserves are at least twice as large as its mineral oil reserves.

Production

The mineral oil production in the three newly independent states has declined steadily from the beginning of the 1980s to the present. In Kazakhstan, production reached a nadir in 1994 with a volume of 20.3 million tonnes. Thereafter, production rose continuously to 25.7 million tonnes (1997). Turkmenistan bottomed out in 1996 with a steady production of around 4 million tonnes. Azerbaijan reached its preliminary nadir in 1997 at 9.0 million tonnes. Due to the even

**Table 2 - Estimates of the exploitable natural gas resources
in the Caspian Basin**
(in billion m³)

	Proven Reserves	Possible Resources	Total natural gas
Azerbaijan	0.3	1.0	1.3
Kazakhstan	1.5	2.5	4.0
Turkmenistan	4.4	4.5	8.9
Uzbekistan *	2.1	1.0	3.1
Iran *	0	0.3	0.3
Total	8.3	9.3	17.6

* Only regions close to the Caspian Sea

Source: US Department of State, Caspian Region Energy Development Report, April 1997, p. 4

more drastic reduction in the domestic consumption in the first half of the 1990s, these three countries' net exports increased at that time from 0.3 million tonnes (1990) to 10.1 million tonnes (1995). However, these production levels are not large enough to attract international attention.

Table 3 demonstrates that given an average expected development, these three countries' exports could reach as much as 30 million tonnes in the year 2000, 93 million tonnes in 2010 and approx. 160 million tonnes in 2020. In view of the expected production decline in the North Sea and other areas, these are certainly relevant magnitudes. Presumably, these countries' production will amount to 3% to 4% of the world production in 2010 and possibly 5% to 6% in 2020.

While Kazakhstan will remain the region's largest mineral oil producer, its expected domestic consumption is so large that presumably Azerbaijan will catch up with Kazakhstan as an exporter in the long run because of its lower domestic consumption. If one credits the "high case" scenario propounded by the International Energy Agency, after the year 2010, Azerbaijan will be able to export considerably more mineral oil.⁶

Not only did the natural gas production of these countries sink drastically in the first half of the 1990s, as **Table 4** shows, but, unlike the case of mineral oil, net exports also declined. This was a result of the production decline in Turkmenistan which was forced upon the sector by the fact that the only system of transport for Turkmen gas, namely the Russian network of pipelines, was only made available to Turkmenistan at a reduced level.

Accordingly, the net export of these three countries, which was just below 60 billion m³ in 1990 and had fallen to under 20 billion m³ by 1995, should rise to 46 billion m³ by the year 2000, to 75 billion m³ by 2010 and to 115

**Table 3 - Oil production, consumption and net export
of the Caspian states**
(in million tons)

	1990	1995	2000	2005	2010	2020
Kazakhstan						
Production	25.2	20.5	42.5	62.5	87.5	145.0
Consumption	27.2	10.4	17.8	29.0	38.5	68.0
net export	-2.0	10.1	24.7	33.5	49.0	77.0
Azerbaijan						
Production	12.3	9.2	14.0	27.5	57.5	105.0
Consumption	8.6	7.0	10.2	13.0	14.9	23.9
net export	3.7	2.2	3.8	14.5	42.6	81.1
Turkmenistan						
Production	3.4	3.5	8.0	8.7	9.5	11.0
Consumption	4.8	5.7	6.5	6.7	7.0	8.0
net export	-1.4	-2.2	1.5	2.0	2.5	3.0

* The given data are average values of the "high case" and the "low case" scenario.

Source: International Energy Agency, Caspian Oil and Gas 1998, p. 51.

**Table 4 - Natural gas production, consumption and net export
of the Caspian states**
(in billion cubic meters)

	1990	1995	2000	2005	2010	2020
Kazakhstan						
Production	7.0	5.9	8.9	13.5	22.0	27.0
Consumption	14.7	12.5	13.8	17.2	23.2	27.0
net export	-7.7	-6.6	-4.9	-3.7	-1.2	0
Azerbaijan						
Production	9.9	6.7	7.4	14.2	19.2	26.0
Consumption	13.6	7.3	7.4	9.2	11.0	17.9
Net export	-3.7	-0.6	0	5.0	8.2	8.1
Turkmenistan						
Production	84.3	35.6	39.8	55.1	80.8	123.7
Consumption	14.5	9.8	9.5	10.7	12.9	17.0
Net export	69.8	25.8	30.3	44.4	67.9	106.7

* The given data are average values of the "high case" and the "low case" scenario

Source: International Energy Agency, Caspian Oil and Gas, Paris 1998, p. 52

billion m³ by 2020. This means that the net export level of 1990 will not be regained until sometime between 2005 and 2010. Nearly all of these exports will come from Turkmenistan. Kazakhstan will consume as much natural gas as it produces, and Azerbaijan can only hope to export about 10% of Turkmenistan's export potential.⁷

The region's natural gas production will presumably reach about 5% of worldwide gas production by 2010. The largest part of the natural gas earmarked for export will come from the part of the region east of the Caspian Sea. For that reason and due to the need for pipelines to transport gas, the problem of transporting the product to the consumer will be even more difficult than in the case of oil.

Transport

The neglect of the Caspian energy region by Soviet economic planners also affected the crumbling transport system, besides which, no pipelines led anywhere but to Russia. In Soviet times, the oil transport system consisted primarily of two structures. The first was an oil pipeline, desparately in need of repair, which led from Baku via Grozny in Chechnya to the Russian port of Novorossyisk on the Black Sea. The use of this pipeline was finally interrupted by the first war in Chechnya (1994-96). In accordance with a decision taken in October 1995 on the transport of "early oil" - in other words, the oil that will be produced in Azerbaijan until the Main Export Pipeline will be available after 2003 - the pipeline from Baku to Novorossyisk has been renovated. It has been in operation since November 1997 until the beginning of the second Chechnyan war in August 1999. However, even during this period, oil transport was interrupted due to illegal actions within Chechnya several times. Now a 200 km by-pass around Chechnya is under construction. It should be completed in 2001. The second link from Caspian oil fields to the Russian mainland was a connection to the Kazakh oil fields (among others, Tengiz) in the north-eastern region of the Caspian Sea. This pipeline, like the one to Novorossyisk, was not only in need of repair, it also did not have enough capacity to transport the renewed growth in production. A large diameter pipeline is now under construction from Tengiz to Novorossyisk. The decision of October 1995 on the "early oil" divided the expected annual amount of 10 million tonnes available in Baku until 2003 among two pipelines. Besides the pipeline to Novorossyisk, another pipeline was partly renovated, but mostly constructed new: from Baku to the Georgian Black Sea terminal Supsa. Like the Russian pipeline, its capacity is about 5 million tonnes per year, but can be extended to 12 million tonnes.

In the case of natural gas, on the other hand, Turkmenistan was so tied to the Russian network that the then high capacities of over 80 billion m³ could be piped directly into it. In the 1990s, Russia's gas monopoly *Gazprom* continuously reduced the amount of natural gas it allowed Turkmenistan to pipe into its

network for transport to the West. Since March 1997, this transport service has ceased altogether. The reason for this can be sought less in the technical inadequacies of the network than in *Gazprom's* desire to hamper potential competition. *Gazprom* is especially unwilling to allow Turkmenistan to deliver gas to the European market west of the CIS. On December 29 1997, a 200km pipeline from Turkmenistan to Iran was opened. Initially, this will have a capacity of 2 billion m³ annually, but in the coming years this is to be increased to 8 billion m³.

Contracts have been signed or building has begun on the following pipelines:

- **Tengiz-Novorossiysk.** The *Caspian Pipeline Consortium* (CPC) was founded as early as 1992 to build this pipeline with a capacity of 67 million tonnes per annum. At that time, the participants were the states of Kazakhstan, Russia and Oman. For various reasons, foremost of which was Russian disinterest, there were repeated delays in the planning of the project. In 1996, the consortium was reconstituted (the final signing of the agreement took place on 16.5.1997), the shares of the three states were reduced and various oil companies such as *Chevron*, *Mobil*, *Lukoil* and *Rosneft* were accepted into the consortium. Since then, planning has progressed somewhat more rapidly, including the negotiations with the Russian transit regions regarding the transit routes and fees. Construction is expected to begin in 1999 and be completed in 2001.
- **Uzen-China.** On September 24 1997, a comprehensive accord regarding the tapping and transport of Kazakh oil was reached between the Chinese and the Kazakh governments. This accord contains an agreement on the construction of a 3,000-km pipeline from the Uzen field (east of the Caspian Sea) to Western China. This pipeline is scheduled to be completed by the year 2005. In 1999, however, the Chinese government stalled the preparations for the construction due to the high investment costs.
- **Turkmenistan-Pakistan.** The investor *Unocal* has withdrawn in 1999 from a contract signed in 1997 on the laying of a natural gas pipeline from Dauletabad (Turkmenistan) via Afghanistan to Multan (Pakistan) due to continuing political instability in the transit country of Afghanistan.

No contractual agreements have yet been reached on the other pipeline plans. This is especially true for the construction of the *Main Export Pipeline* (MEP), the transit route of which has been subject to a great deal of argument for many months. Four possible routes are favoured by four different states (Russia, Iran, Georgia and Turkey). The U.S. government, Turkey and Azerbaijan had already made great efforts to get a deal signed for a route from Baku to the Turkish Mediterranean port of Ceyhan by October 1998. The investors, however, initially refused this option due to its comparatively high costs. During the OSCE summit in Istanbul on 18 November 1999, the presidents of Azerbaijan, Georgia and Turkey signed in the presence of President Clinton an agreement which expresses the intention to construct this pipeline and which includes a commitment by

the Turkish government to cover the costs of the pipeline on Turkish territory beyond the calculated \$1.4 billion. Whether this is sufficient to make the investors provide the required oil quantities and to take over the remaining financial risk is still an open question.

Legal Status

The argument over the legal status of the Caspian Sea has calmed down somewhat in view of the fact that Russia has moved some distance toward the opposing position of Azerbaijan. Originally, following the dissolution of the Soviet Union, Russia, like Iran, wanted to impose a condominium solution, which would have resulted in a joint exploitation of the offshore oil fields. Both Azerbaijan and Kazakhstan opposed this idea, since most of the offshore resources would have been located on their sovereign territory in the case of a sectoral division of the sea. The Russian government protested vehemently against the “Deal of the Century” signed in Baku on September 20, 1994, in which Azerbaijan claimed the offshore fields of Azeri, Chirag and Guneshli as its property and handed them over to a consortium for exploitation. However, the Russian government did not carry out its threat, expressed in a memorandum to the United Nations, to use force if necessary to restore the status quo ante. It did not even prevent the Russian company Lukoil from taking a 10% share in the “Deal of the Century”.

In November 1996, a compromise was almost reached in the negotiations between the states which would have contained a clause that a 45 mile wide coastal zone and thus almost all the offshore oil fields would be attributed to the individual nations and only the centre would be administered in condominium.⁸ Azerbaijan was the only country that did not accept this compromise. In the meantime, Azerbaijan seems to have succeeded in getting the whole of the resources in the Caspian Sea bed divided up sectorally. This is, at any rate, the implication of a bilateral agreement between Russia and Kazakhstan signed in Moscow on July 6 1998 which draws the border between the two countries in the Caspian Sea. The agreement awards Kazakhstan practically the entire Caspian Shelf with its considerable oil resources.

However, this contract refers only to the seabed, not to the water. Citing ecological reasons, Russia would like to adhere to a condominium solution for the water in the Caspian Sea. Given the importance of fishing, especially for caviar production, there is substantial motivation for the states to agree upon an ecologically sound management of the water. However, it would not be necessary to accept the legal status of common ownership in order to achieve this goal. An agreement on common standards and possibly also a common management of water usage (shipping, polluting the sea via dirty river runoff, directly polluting the sea, oil pollution) within a regime of sectoral division could also be envisioned.

The assumption that Russia is striving for a condominium solution mainly in order to gain a veto position against the laying of a Transcaspian oil pipeline is probably correct and indicated by the head of the corresponding working group at the Russian Ministry of Foreign Affairs, Yuri Merzliakov.⁹ Such an oil pipeline is definitely not in the Russian interest because it would present an alternative to transporting Kazakh oil through the CPC pipeline to Novorossiysk. The US, on the other hand, is pushing for the construction of a Transcaspian pipeline for both oil and gas. Firstly, in order to prevent Iran from participating in the transport of either East-Caspian oil or gas, and secondly, in order to have as much oil as possible on hand for a pipeline from Baku to the Turkish port Ceyhan. This would establish an infrastructure that would obviate almost all dependence upon Russia.

Iran, which until the Russian-Kazakh agreement of 6 July 1998 held a common position with Russia in favour of maintaining and administering the larger part of the Caspian Sea in condominium, considered this contract an affront by the Russians. In the meantime, Iran has taken the position that either the whole of the Caspian Sea should be held in condominium, including its mineral resources in the seabed, or it should be divided sectorally, but it is against a differentiation between water and seabed. Thus, Iran is now much closer to the position of the newly independent states, because a return to a general condominium solution is unthinkable, given the fact that offshore exploitation has already been contracted out and begun. Iran has begun to take measures to define its sector. In December 1998, Iran signed a contract with *Royal Dutch Shell* and the British company *LASMO* regarding geological and geographic studies of an offshore field, Iran's claim to which is being challenged by Azerbaijan.¹⁰ However, at present none of the parties are exerting great pressure for a multilateral agreement on the legal status of the Caspian Sea because most of these countries can manage quite well with the current practice, at least for now. The US is less comfortable with the present situation, but it is not included in these negotiations. It is especially interested in having the Transcaspian pipeline perceived as a realistic option, in order to present viable alternatives to the Iranian route.

Stability and Security

It is obvious that - leaving aside, for the present, the numerous ethnic conflicts - economic and social stability in the region is linked to the efficient exploitation and transportation of energy resources. Furthermore, an adequate development of the energy sector in order to advance the overall economic development of the region - including an efficient distribution of income - is a precondition for economic and social stability. This, however, requires different measures of which the most important are:

- the observance of the rule of law in a region where traditionally the heads of clans, particularly the presidents of states, are acting as if they exist above

the law. An efficient economy, however, needs the rule of law to give (domestic and foreign) investors security for their cost/benefit calculations and to make sure that fair competition can be guaranteed, otherwise the inefficient actors might get an advantage. Without the rule of law, investment will be insufficient;

- cooperation between neighbouring states under agreements that are compatible to the international framework of business conditions that can in turn guarantee a reliable cost calculability and fair competition. The more neighbouring states that are included the better since this would enlarge the rather small markets of individual states whilst also creating alternative options so as to choose the most efficient one. As integration spaces like the EU show, more competition does not mean that there are winners and losers, but that all would benefit from the extended economic space;
- the states should take responsibility to ensure that economic actors can operate under conditions that also make them internationally competitive. In this sense, the states should protect economic activities against inadequate tax or infrastructural costs and against criminal activities; it is of special importance that the governments are enforcing laws and international agreements.

Even if this catalogue sounds a little idealistic in a region without a tradition in democracy and market economics, there is a strong force underlining these requirements that is the pressure of global competition. It is a matter of fact that investments are directed into this region only if private investors feel that the costs of producing the oil and natural gas and of transporting it to the consumer are lower than the fluctuating world market price. Access to energy sources is no longer an economic or political advantage in itself, at least not in the short- and medium-term (and definitely not in the long-term). Only energy that can be offered to the world market with profit creates jobs and prosperity.

This is the message of globalisation which has certainly not yet entered into the consciousness of those who still dream geopolitical games or feel rich just because of the presumed resources under their own soil. There is, however, some evidence of a growing consciousness of these facts. Nevertheless, it is not an easy task to step from an understanding of the need to apply the rule of law and international cooperation to its actual implementation. Traditions, lack of education and individual interests, especially amongst those who became rich from monopoly profits, are major obstacles in this regard.

The change of Russian policy in the region concerning the legal status of the Caspian Sea and the acceptance of competition concerning the pipeline infrastructure happened not under the pressure of any state but because of the eventual realisation that Russian policy can only block activities. It cannot create an economically advantageous situation by disregarding international economic competition.

In this context, the strong political impact of US policy on economic issues does not seem to be successful in the long run. Zbigniew Brzezinski argues in a way that reminds one of the pre-globalisation era:

*“American foreign policy must remain concerned with the geopolitical dimension and must employ its influence in Eurasia in a manner that creates a stable continental equilibrium, with the United States as the political arbiter”*¹¹

If this doctrine is applied, the result might be just the opposite of a stable equilibrium. Isolating Iran, containing Russia and promoting Turkey may lead to a monopoly situation which is inefficient in the sense of being globally competitive, and unbalanced because it prevents the use of alternative solutions. In addition it would produce losers in the sense of a zero sum game and thus provoke suspicion instead of cooperation under conditions of fair competition.

Whether integrated and competitive economies have a positive impact on the many mostly ethnic conflicts in the region is an open question. As we know from other regions in the world, ethnic conflicts can be so deeply rooted that the carrot of an incremental improvement of the economic situation has no sufficient attraction to settle the conflict.¹² It makes, however, a significant difference as to whether or not a country is excluded from building a regional network of infrastructure due to an unsettled conflict, such as with Armenia. If there is any leverage to move Armenia towards a fair compromise on Nagorno Karabakh, it is the choice between economic isolation and being integrated into the growing network of regional cooperation. Armenia must be aware that the infrastructure is designed now, and sometimes an infrastructure - such as the Silk Road - lasts for centuries.

The Caspian energy resources provide a unique chance for a region undergoing transformation to develop. It has already attracted more foreign capital than Russia and the European CIS countries together. “Norway or Nigeria” are the extreme options. If the region recognises that prosperity can only be reached on the basis of integration, cooperation, fair competition and peaceful settlement of conflicts, the region is better equipped for a stable development and regional security than other regions of the post-Soviet space and Asia. The risk is high, however, that deficiencies in applying the rule of law, the ethnic conflict potential and the forces in favour of criminal distortions of these economies will prevail. In this case, the economic dynamics will not protect the region against instability and insecurity.

Notes

- 1 See for example, Caspar Weinberger and Peter Schweizer in: Caspian Access Is Crucial for the West, *International Herald Tribune*, May 10, 1997, p. 6.
- 2 Turkistan-Newsletter of February 26, 1998.
- 3 "On a cautiously optimistic estimate, the Caspian Basin contains at least 100 billion barrels of oil", *The Economist*, 7. February 1998, Survey, p.6.
- 4 Aleksey Gromyko, Novaya "velikaya igra", *Nezavisimaya gazeta*, August 20, 1998, p.8.
- 5 "Proven oil reserves are pegged at between 15 billion and 31 billion barrels, about 2.7 percent of total world proven oil reserves." Baker Institute Study, *Unlocking the Assets: Energy and the Future of Central Asia and the Caucasus*, No. 6, April 1998, p.1.
- 6 International Energy Agency, Caspian Oil and Gas, Paris 1998, p. 33.
- 7 International Energy Agency, Caspian Oil and Gas, Paris 1998, p.33.
- 8 OMRI Daily Digest, Part I, No. 219 from 12.11.1996.
- 9 Iurii Merzliakov, Legal Status of the Caspian Sea, International Affairs, Moscow, Vol. 45, No. 1, 1999, (pp. 33-40), p.38.
- 10 Turkistan-Newsletter, Vol. 98 No. 204, 15.12.1998.
- 11 Zbigniew Brzezinski, The Grand Chessboard, American Primacy and Its Geostrategic Imperatives, New York: Basic Books, 1997, p.xiv.
- 12 S. Neil MacFarlane, A role for the EU in Preventing Ethnic Conflict, in Reinhardt Rummel, Claude Zullo (eds.), Rethinking the European Union Relations with the Caucasus, Nomos Verlagsgesellschaft, Baden-Baden (1999), pp.57-78.

TRANSCAUCASUS AND THE CASPIAN REGION WITH PARTICULAR FOCUS ON ENERGY ISSUES

Neil MacFarlane

*Director, Centre for International Studies, St. Anne's College, University
of Oxford, UK*

A comment on the paper submitted by Friedemann Müller

Introduction

The link between energy and security in the Caspian Region is a complex one. Dr. Müller has provided a very able analysis of it, leaving me with few targets of opportunity. I should like to divide my remarks into four sections. The first concerns the definition of security itself and its relation to energy development in this region. The second involves changes in the Caspian energy equation and their possible security implications, as well as their impact on the broader set of issues raised by Dr. Müller. The third concerns the relationship between the state and the market as it concerns Caspian energy development. The fourth is the relationship between developments in the Caspian energy sector and broader issues of **internal** social and political stability.

Definitions of Security

I should like to start with the meaning(s) of security, since I believe this lays the basis for what follows. One aspect of the paper that might have been developed further is the definition of security itself. The topic presumes a connection between energy development and security (and stability) in the region. Yet that relationship is not addressed in detail.

The subject matter of security has been in considerable dispute over the past two decades. The traditional focus of security studies has been how states (and groups of states) address external military threats. Some 16 years ago (see, for example Ullman, 1983), increasing doubt emerged in the academic literature as to whether this was a sufficient or appropriate focus. Why should the state be the principal focus of security when, ultimately, security resided in the individual human being? (Buzan, 1991) Why should the security of the state be privileged in analysis when in many instances the state itself was a principal

threat to the well-being and physical survival of its citizens? (Ayoob, 1991) Why should military aspects of security be privileged in discussions of the subject when it was increasingly clear that economic trends, or environmental (Homer-Dixon, 1991) or health issues posed equally or more significant threats to human beings. The result was an explosion of the literature that expanded conceptions of security both in terms of referents (beyond the state to the individual, the community, the ethnic group, the region, the globe) and issue areas (economics and welfare, the environment, health, migration). Seminars such as this one are reflections of this trend.

I do not want to comment on the merits and demerits of this expansion in detail. Instead, I think it is worthwhile to dwell on just what the essential meaning of security is and then to address what significance energy issues have in the consideration of security in this essential sense in the region in question. As far as I am concerned, security is, in its most fundamental sense, about the presence or absence of threats to the core values of individual human beings. These core values generally include life (survival), truth (that promises once made will be kept), and property (stability of possession) (Bull, 1977). The security of the state is privileged because the state is the agent that (ideally) ensures the security of individual human beings. In Hobbesian terms, individuals cede sovereignty to the state in return for protection.

This definition of security presumes an understanding of threat. Threats to individual (and, by extension, state) security can be military, political, economic, social, cultural, environmental, or, for that matter, medical.

How is energy sector development related to security in the Caspian Basin region? The development of the region's energy resources has positive and negative effects on the security of the region and the people living there. On the positive side, revenue from the export of energy plays an important role in stabilising the region's economies and in allowing the states to address the needs of their peoples. In the future, it may possibly play a more substantial role, though much depends here on how revenues are allocated and spent, as is clear from Dr. Müller's comment on the Norway to Nigeria spectrum (p.220). I shall return to this issue later.

The negative side of the relationship between energy and security in the region is the fact that competition over energy resources may cause inter-state conflict. This is evident in Dr. Müller's discussion, for example, of the arguments over the legal status of the Caspian sea floor and water column. Many other plausible examples are evident in the region. Many, for example, believe that the failure to conclude a political settlement of the Karabakh conflict reflects the Russian desire to retain leverage over Azerbaijan's energy sector development. Others have argued that one source of the war in Chechnya in 1994-96 was the Russian perception that its capacity to exercise leverage over Caspian Basin (and particularly Azerbaijani) energy development was limited as a result of its lack of control over the Chechen Republic. When the AIOC agreed with

Georgia and Azerbaijan on the construction of a western (Baku-Supsa) pipeline, Georgian officials were told by their Russian counterparts that Russia would never allow such a pipeline to be built. It is not surprising that Georgians are convinced that one factor underlying the military rebellion in western Georgia at the end of 1998 was the impending opening of the Baku-Supsa line.

One final conceptual point. The other referent in the seminar title is “stability.” Rather than going into an extensive discussion of its meaning, I would simply note that stability does not necessarily conduce to security in this region, or elsewhere. If one accepts that the essential point of reference in consideration of security is the individual, then it is easy to conceive of situations where stability does not coincide with security. Chile under Pinochet was stable, but hardly secure from the perspective of the individuals who were tortured and murdered by this regime.

The last question to be addressed in this section is how the energy-security-stability nexus affects NATO. In the early years after the collapse of the USSR, the quick answer would have been very little. NATO powers perceived few significant interests in the region, and tended to defer to Russia in the management of security issues there. This has changed for several reasons. First, it became clear that Russia’s regional policy was less benign than we had hoped. Second, the war in Chechnya and the decay of Russia’s military raised increasingly important questions about Russia’s capacity to manage regional security issues. Third, by 1995-96, several key NATO states and not least the United States had grown increasingly aware of the region’s energy potential. To judge from American declaratory rhetoric, the United States was coming to see the region as a matter of vital interest (MacFarlane, 1998). Moreover, American and European firms had become heavily involved in investment in the region and lobbied for a more active policy role there by NATO member states. The EU, meanwhile, has become strongly involved through the TACIS TRACECA project in regional energy infrastructure development. NATO itself was becoming increasingly involved with regional states through the PFP and the EAPC. Finally, several of the region’s states, frustrated by Russian, UN and OSCE failure to deliver political settlements to their conflicts, began to look to NATO for answers. The Georgian discussion of repeating Kosovo in Abkhazia, or the Azerbaijani discussion of repeating Bosnia in Karabakh, are interesting in this regard. Azerbaijan and Georgia both perceive NATO to have a role in protecting the region’s energy infrastructure.

Change in the Caspian Energy/Security Equation

In view of this heightened interest and engagement, it is appropriate for Dr. Müller to have spent considerable time in assessing the actual and probable levels of energy resources in the region. His cautious estimate of reserves is a useful corrective to the hyperbole that characterises much discussion of the

region. In view of this realistic estimate of the region's potential impact on global energy markets, it seems odd that American policy makers in particular should emphasise so heavily the national security interest in securing access to the region's energy resources.

Several updates on the situation so clearly described by Dr. Müller are in order. The first is the evolving record of results from oil exploration in the sector of the Caspian Sea claimed by Azerbaijan. Here, two major efforts (CIPCO and NAOC) turned up dry. The third (Shah Deniz) produced a major find but it was gas, not oil. There are two significant implications of this record. In the first place, this confirms Dr. Müller's proposition that "the actual value [of oil reserves] is much closer to the lower estimate than to the higher one" (p.212). This has immediate implications, moreover, for Baku-Ceyhan. It strengthens considerably the argument for a Trans-Caspian oil pipeline to link to Baku-Ceyhan. Most people I talk to in the industry now doubt whether Baku-Ceyhan is viable without a Transcaspian link of some kind. That said, I am somewhat more sanguine than is Dr. Müller about prospects for the Baku-Ceyhan line, since price changes since the paper was written make it a more attractive and commercially viable proposition. I suspect that the question with regard to this project is not so much "if" as it is "when." To the extent that pipelines for Turkmen (and now Azerbaijani) gas move forward using an Azerbaijan-Georgian route to Turkey, this increases the likelihood of a Baku to Turkey oil line, since the right-of-way costs can be distributed across the two projects. Moreover, the delay in the decision has apparently caused Turkey to compromise further on licensing arrangements and transit fees. This alters the cost projection favourably.

The major BP-AMOCO gas strike strengthens Dr. Müller's point (p.212) that the region's gas reserves are likely to be substantially greater than are those of oil. It also raises important issues plausibly related to regional security. The structure of interest surrounding the Trans-Caspian gas pipeline was reasonably clear prior to this discovery. Turkmenistan needed an outlet to its major potential market (Turkey). The United States was (and apparently remains) opposed to Iranian options, and has managed to place significant barriers in the way of their development, while inducing Turkmenistan to consider seriously the Western alternative. Azerbaijan had an interest in its being built, given its own (shrinking) gas deficit, and because of the likelihood that it would obtain significant transit revenues. Russia opposed the Trans-Caspian alternative since, if built, it would reduce Russia's influence over Turkmenistan.

Azerbaijan's arrival as a major potential player in global gas markets has introduced substantial ambiguity into this situation. In the first place, the logical market for Azerbaijani gas is also Turkey. This creates a potential conflict of interest between Azerbaijan and Turkmenistan that will complicate co-operation over pipeline issues. It is worth stressing that Russia is also a competitor for the Turkish market (viz. the Blue Stream project for a pipeline from Russia across the Black Sea to northern Turkey). Consequently, Azerbaijan's arrival

on the gas scene may worsen Russian-Azerbaijani relations still further, as well as reducing whatever interest Russia might have in co-operating to further a settlement of the Karabakh question, an interest that has already been undermined by recent events in Daghestan and the closure of the northern route through Chechnya (Ruseckas, 1999).

States and Markets

The third theme I would like to pick up is the relationship between states and markets in the Caspian energy sector. This should be no surprise to Dr. Müller, since we have been amicably arguing about this for three years. Since time is short, I shall limit myself to a few general remarks. Dr. Müller clearly believes that, in the context of globalisation, when states attempt to resist market forces, they lose. I would be betraying my profession if I did not take up this challenge. I don't think the conclusion is as clear-cut as he proposes. With regard to ILSA and Iran, for example, it is clear, as the paper argues, that there are leaks in the sanctions imposed by the US on Iran. That does not mean they have failed. Despite the apparent advantages of Iran as an export route, and despite the interest of many (including US) oil firms in Iranian options, the United States has effectively closed Iran out of the oil pipeline game. That is unlikely to change unless there is a political rapprochement between the two countries. Second, with regard to Baku-Ceyhan, although it is true that the US and Turkey have not managed to override oil company reservations thus far, as I note earlier the game is not over yet. Moreover, the policies of the Turkish state (e.g. the position taken on major new oil transport through the Bosphorus) and the US (e.g. their apparent opposition to an MEP through Russia or Iran) has had significant dampening effect on other contenders such as Baku-Supsa, Iran and Russia. It is true that in the contest between states and markets, states do not get everything they want. But the same is true with market forces. And it is undeniable that states have exercised a significant influence over energy development decisions and that they will continue to do so.

Third, I cannot resist noting an unresolved tension in Dr. Müller's argument with respect to the state. He argues that the economic forces of globalisation are driving politics. This is to some extent true. Yet further on he argues that for the market to succeed, the state must provide appropriate regulatory and legal structures. "Without the rule of law, investment will be too low." And indeed, this is one critical reason why no one takes the northern option seriously anymore. The Russians cannot deliver the kind of environment in the northern Caucasus that would permit predictable operation of pipelines. This would appear to suggest that market forces depend on the state. My own rather sloppy view on the relationship between states and markets is that both are important in driving outcomes. In some instances one is more important than the other.

It is probably not useful to attempt to generalise beyond this about which is more determining of practical results.

The Energy Sector and the Future of Regional Security in the Caspian Basin

One area of the paper deserves amplification. As Dr. Müller notes, revenues from energy can play a key role in the revival of the region's economies. This is already evident to varying extent in the main energy producing countries (Azerbaijan, Turkmenistan, Kazakhstan) and to a lesser extent in Georgia. To the extent that energy development generates higher levels of general employment and prosperity, this should have a stabilising and security-producing effect. Two problems are already evident, however. First, although some people are already enriching themselves from energy, there has been little positive effect as yet on the population as a whole in these countries. From 1991 to 1997, the human development indicators of the countries of the southern Caucasus and Central Asia fell from a uniform 0.92 to a range between 0.58 (Tajikistan) to 0.72 (Turkmenistan). In terms of HDI global rankings, the region's states slipped from a uniform 31 to a range between 85 (Turkmenistan) to 115 (Tajikistan). (UNDP, 1998) There has been a deep decline in the general standard of living, with little evidence of any turnaround. Energy development has been sold as a panacea for many of these ills. Expectations have been dramatically raised.

Moreover, even if they are equitably distributed (which seems unlikely), energy revenues will not make a real difference for at least five years. The combination of elite enrichment, mass unemployment and poverty, and disappointed expectations raises important questions concerning the political stability of the governments of the region. This problem may well be aggravated by the region's looming problems of political succession.

A second obvious problem is that, from the perspective of energy development, there are in the region haves and have nots. This would suggest that greater effort should be made to embed Armenia in structures of regional economic co-operation and energy infrastructure.

Conclusion

By way of conclusion, two basic policy issues emerge from the above and from Dr. Müller's paper. In the first place, it is worthwhile for NATO to think systematically about its role in the region, since demands for greater activity are likely to emerge both from the regional states and from major NATO members. Second, NATO's role in the region should probably be seen not in isolation (viz. the PfP emphasis on interoperability and civil military relations), but as part of an integrated effort on the part of Western European (e.g. the EU, the CoE, and the EBRD), European (the OSCE) and international (e.g. the

UN “family”) institutions to address the political, economic, and social dimensions of energy development in the Caspian Basin.

Acronyms

AIOC	Azerbaijan International Operating Company
CIS	Commonwealth of Independent States
EAPC	Euro-Atlantic Partnership Council
NATO	North Atlantic Treaty Organization
OSCE	Organisation for Security and Co-operation in Europe
PFP	Partnership for Peace
TACIS	Technical Assistance to the CIS
TRACECA	Transport Corridor Europe Caucasus Central Asia
UN	United Nations
UNDP	United Nations Development Program
US	United States
USSR	Union of Soviet Socialist Republics

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TRANSCAUCASUS AND CASPIAN REGION WITH PARTICULAR FOCUS ON ENERGY ISSUES

Matljuba Fazilova

Institute of Strategic Research of Uzbekistan, Tashkent

A further comment on the paper submitted by Friedemann Müller

The Caspian region is very promising for European markets, given an expected capacity of 8 million barrels of oil per day by the end of this century. European countries have tried many times to get high quality Caspian oil (Britain during World War I and Germany during World War II). At present, more than 30 Western corporations are negotiating for oil licenses. Therefore, the Caspian region's potential for oil production is considered as a geopolitical factor of global importance.

Conflicts

Friedeman Müller in his report emphasised that the region is characterised by a high level of conflict. Today, this list can be expanded to include conflicts in Dagestan and Chechnya. The author is right in his opinion that the struggle over new infrastructure could just as easily exacerbate existing conflicts as stabilise the current conflict situation.

Projects and Measures to Ensure Security

States in the region endeavour to control the situation and believe that one of the projects that might help them to solve their economic problems is "TRASECA". To facilitate implementation of this project, the GUUAM organisation was established in 1996 by Azerbaijan, Georgia and Ukraine. Moldova in 1997 and Uzbekistan in April 1999 also became members of this organisation.

The objectives of this organisation - identified at a meeting in November 1997 - are as follows:

- to develop a common approach to conducting peacemaking operations;
- oppose separatism;
- render mutual support in settling regional conflicts;
- ensure reliable sources of energy supplies;
- set up trans-European-Asian transport and industrial corridors;

- work out common approaches to members' involvement in international organisations with respect to problems of mutual interest;
- jointly establish closer relationships with Western countries through preparation and subsequent incorporation into trans-Atlantic and Western European institutes.

At the same time, founders of the organisation believed that it should promote communication between its members and European economic structures and implement the transport project "TRASECA", which will connect European countries with the countries of South Asia through transport infrastructure and communications. The President of Uzbekistan in his speech at the Conference "Great Silk Road" held in Baku said that the development of a Europe-Caucasus-Asia corridor would ensure stability in the region and facilitate further economic development. Besides, the creation of new transport corridors as an alternative to the Northern Corridor will reduce dependence on the latter and provide an opportunity for customers to choose the most profitable option of transportation. Therefore, such projects can be considered as prospective and important policy decisions of the countries through which these corridors will pass.

As was emphasised in Friedemann Müller's report, if the region recognised that its welfare can be achieved on the basis of integration, cooperation, fair competition and peaceful settlement of conflicts, the region would be better able to guarantee future sustainable development and regional security - compared to other regions of the former Soviet Union and Asia. Unless a legal basis has been developed, ethnic conflicts and criminal distortions will prevail in the regions' economies. Only economic development of the region can protect it from instability and tension.

The subject of Friedemann Müller's report is very important for Uzbekistan because of the proximity of the Caspian region to Central Asia. Uzbekistan has substantial interest in the transportation of energy resources to world markets and in the possible use of new communication routes for its own trade with other states. The efforts of Uzbekistan to strengthen economic and trade cooperation, to develop transport communications, and to improve human and democratic values will all facilitate the sustainable development of the Caucasus, Caspian and Central Asian regions.

Finally, it is necessary to focus on the effects of energy policy on changes in climate. The exploration, exploitation and production of energy has an increasing impact on climatic changes, which has become a global problem. Given the fact that climatic changes seriously threaten sustainable progress, all countries should strive for implementation of the Plan of Action adopted in Buenos Aires to accelerate adoption of the Kyoto Protocol to the UN Framework Convention on climatic change. It is crucial to take measures to reduce exhaust emissions and other greenhouse gasses through the rational and efficient use of energy. It is also necessary to employ ecologically safe technologies of exploration, exploitation and production. Both legal measures and effective economic mechanisms are also required to ensure the rational use of energy.

SOUTHERN CAUCASUS WITH PARTICULAR FOCUS ON ENERGY ISSUES

David Aptsiauri

*Director of International Economic Relations,
Ministry of Foreign Affairs of Georgia*

Since the end of the Cold War, the Caucasus region and indeed the whole former communist block have been undergoing dynamic change, which looks set to continue into the next millennium. In the 21st century, the region's role and significance will grow substantially due to its size, strategic location at the crossroads of Europe and Asia, natural resources, economic potential and gradually emerging coherence. It is becoming obvious that the 21st century is going to be the most difficult for mankind in overcoming existing problems, including global risks such as real threats of ecological disasters, economic turmoil and financial crises. Given this, the most important issue is to create a universal system of economic security for the 21st century, which aims at preventing these economic risks from occurring. However, the economic security system could not be maintained without sub-regional as well as regional and interregional cooperation that requires a solid basis on a global scale.

Modern international relations concentrate mostly on the economic aspects of cooperation and acquire more and more economic essence. We frequently hear about the new models of economic security of the 21st century, indeed, this is quite understandable and justified because economic strength is a powerful enough force to solve the most difficult contradictions and problems. In this regard, the WTO allows for a qualitative increase in the economic dimension that will finally and definitely facilitate the process of intensification of structural transformation in those countries which in the last decade have chosen the way of the market.

At the same time, it is difficult to expect successful development of the Southern Caucasus in the future without addressing regional political and security concerns that significantly overshadow regional relations. Demand for security is very high in the region and therefore cooperation on some political and security issues could be very productive. In this regard the establishment of a certain "Commission on Security" to provide a mechanism for security cooperation, to conduct field visits to conflict areas and to elaborate recommendations for their peaceful settlement would be a very useful development.

Newly Independent States that emerged after the collapse of the Soviet Union are now concentrating their efforts on finding an appropriate place in the world

economy. The emerging global system is very new. The post-war architects have been guided by a central idea - that a durable international peace could only be built on the foundations of interdependence. Economic freedom - free markets, free trade, free movement of goods, capital and ideas - have become a prerequisite for political and social freedoms around the world. Bearing this in mind, the countries of the Caucasus and Caspian regions have already started to turn these principles into reality. In order to realise their whole potential, these countries need to successfully cope with many problems and challenges. The latter include persisting political tensions and unresolved inter- and intra-state conflicts, economic problems and limited capacities for economic growth.

Nowadays Georgia is facing similar problems. In this regard, one of the key elements of Georgia's policy is to tackle these problems in order to preserve and develop democratic principles in the country. Within this context, it is necessary to consider the position and role of small countries in a globalising world. We have to find the proper solution for small countries in the system of international relations keeping in mind both their potential and their comparative advantages. Georgia considers its participation in sub-regional, regional and inter-regional economic processes as a necessary element towards acquiring an international role. Taking into account today's realities and the strategic location of Georgia, we believe that the transition possibilities of Georgia can be regarded as something of benefit to both itself and the international community.

Since Caspian energy transportation issues are very much linked to the fate of countries in the Southern Caucasus, the importance of the latter are growing. The natural wealth of Caspian countries, together with the strategic location of the Caucasus, present a great potential for the region to become strong both economically and politically. The exploitation as well as export of natural resources of the Caspian can be regarded as an excellent opportunity to progress with and complete the transformation process, which is directly connected to the economic and social stability of these states.

However, both internal as well as external stability will be the main factors promoting democratic principles in this region. Today, as these countries undergo complex processes of democratic development, market reform and civil society consolidation, the utilisation of their potential in the international arena is the most important task to be implemented. The first steps have already been completed towards this goal. For example, the close cooperation both with and within such solid organisations as the UN specialised agencies, the EU, OSCE, and NATO will undoubtedly further contribute to the growing role of the Southern Caucasus region. Having transformed itself into an international organisation, the Black Sea Economic Cooperation (BSEC) has succeeded in establishing a role within the international arena. Increasing BSEC-EU interaction will further add to the increasing role of the Black Sea region as a whole.

In this connection, I would like to emphasise several positive achievements of Georgia regarding the transformation process, indeed, accomplishments that

have facilitated its accession to the WTO. Since a new constitution was adopted in 1995 and democratic elections for President and Parliament were held, Georgia has enjoyed rapid growth in both its economic and social affairs. The most important fact is the harmonisation of its legal system to international standards. The Civil, Tax and Customs Codes have all been adopted in compliance with international requirements. Work has also started on the transformation of the old Soviet system of standardisation and certification to a new system corresponding to international standards. One of the priorities of Georgia is the development of its infrastructure mainly in the field of ports and roads. Statistical data demonstrate the rapid improvement of the Georgian economy. In 1997, real growth in GDP was 11.3% against 10.6% in 1996 and 3.3% in 1995. Annual inflation was held at 7.3% in 1997. Price liberalisation has been completed. The national currency (Lari) introduced in 1995 is stable. In 1998, real GDP growth was 2.9%. Finally, Georgia's foreign debt has been entirely restructured.

The most significant task for Georgia is to take an active part in regional projects. The first regional project - construction of the Baku-Supsa pipeline - has already been completed. Great attention has recently been focused on the development of the "Transport Corridor Europe-Caucasus-Asia" (TRACECA), which is sometimes described as a restoration of the "Great Silk Road". The fact that this route, which would run through the Black Sea and across Georgia to the Caspian Sea, would shorten the sea routes connecting Europe with Asia by approximately 8,000 kilometres is an indication of its importance. Because Georgia will be a key country for the transport of both energy and material goods along the Silk Road, close collaboration between Georgia and the main international institutions would significantly assist the realisation of this project.

In this regard, economic independence and prosperity will play a significant role in overcoming the numerous ethnic conflicts that we face in the Caucasus and the Caspian region. Moreover, the resource rich Caspian states have relatively small populations, so most of their oil and gas is likely to be exported thereby making the Caspian a useful counterbalance to the Middle East. Existing transportation links do not meet requirements and new routes need to be found. In theory, new pipelines could go in almost any direction. Southern or eastern routes could serve the Asian markets, northern routes would boost Russian influence in the region, whilst western routes could serve the European market that will need to import more energy as North Sea production falls early in the next century. In this regard, the main question is, "where the export pipelines should run?" This issue of pipeline diplomacy is frequently clouded by opposing commercial and political interests. To maintain the secure transportation of these resources that would facilitate economic development processes in the whole region, the most crucial point is to build confidence and mutual trust among all the countries in the region. Bearing this in mind, the most acceptable choice could be the construction of multiple pipeline networks that will allow the Caspian states to balance their external interests.

THE CASPIAN/CAUCASUS REGION WITH PARTICULAR FOCUS ON ENERGY AND WATER ISSUES

Kairat Abuseitov

*Director of the Multilateral Cooperation Department,
Ministry of Foreign Affairs, Republic of Kazakhstan*

This is my first experience of participation in the NATO Economics Colloquium, and it is my understanding that is also a first for my country. I am very happy to be here because of the high quality of the participants and the important subject matter. Moreover, the economic dimension as well as the ecological dimension of security are urgent topics at the moment and are also vital problems for Kazakhstan, whose future is directly connected to economic development and economic stability.

At the end of the 20th century, the Caspian-Caucasus region plays a very important role in the world economy and world policy. Due to new political realities, the Transcaucasian region and the Caspian Sea region can be considered as a common area, with a number of problems that have to be resolved in the interest of all states of this region. Central Asia is a significant part of this common area and located at the epicentre of instability. Many regional problems reflect in concentrated form the development of the situation on a global level.

I agree with Dr. Müller, who mentioned that the interests of the USA, Russia, China, Turkey, Iran, and Western European all collide in this region. But it is very important to take into consideration the direct and indirect interests of the Asian-Pacific states, the oil monarchies of the Middle East, and also India and Pakistan. All these countries have different interests and specific approaches to regional development.

The Republic of Kazakhstan has significant fuel and energy resources and we are going to intensify the development of large new deposits in order to increase oil and gas recovery. The potential value of mineral raw materials is evaluated by experts at US\$8.7 billion. But “the big oil” of Kazakhstan is located in the centre of the Eurasian continent and far from the main transit routes. This is one of the specific features of its development and at the same time it is an international problem because resolving the transportation issue of Kazakhstan mineral resources is in the interests of many states.

The extraction of Kazakhstan’s hydrocarbons is directly connected with the solution of two important problems:

- **The determination of the status of the Caspian Sea.** The absence of precise borders and the presence of territorial disputes have a negative effect upon the intensification of exploration and development of Caspian resources. The position of the Republic of Kazakhstan on the legal status of the Caspian Sea is unequivocal and invariable, based on a sectoral delimitation using the middle line. Any other points of view, including the concept of the “point jurisdiction”, are considered as elements restraining the national interests of the Republic of Kazakhstan and as such are considered as a threat to the political and economic stability of the region. Kazakhstan has already undertaken active steps in that direction and has signed on July 6, 1998 with Russia the agreement on the division of the northern part of the Caspian Sea. Although this agreement is considered by other countries of the Caspian region ambiguously, we nevertheless believe that it will further the development of the process of acquiring a legal status for the Caspian Sea.
- **Defining the route of and then constructing the pipelines.** Dr. Müller has provided a very good analysis of this problem and clearly described all pipeline routes. I would like just to shape the general approaches of my country to this important and very complicated issue.

The problem of transportation has important significance in the field of oil deposit development. Defining the priority of any pipeline direction, the Republic of Kazakhstan is guided first of all by the strategic purpose and specific targets of economic development. The selection of the pipeline route should first and foremost be a commercial decision based upon factors such as cost and security of delivery.

Within the framework of the multi-variant concept of oil-export routes from the Caspian Sea, now we have several options which are divided into two groups: “already considered export routes” and “long-term variants of export routes”. The first group includes the transportation of “early oil”; the basic export pipeline of Baku-Ceyhan; the Caspian Pipeline Consortium (to Novorossisk, through Baku); and the pipeline Turkmenistan-Afghanistan-Gwadar (Pakistan). The second group includes the pipelines which are going through the Caspian Sea from Tengiz as well as from the city of Turkmenbashi to Baku; Eastern Turkmenistan-Southern Kazakhstan to China, and Western Kazakhstan to China. It is necessary to point out that Kazakhstan considers pipeline projects as a subject of partnership, and as a guarantee for the stability of international relations. At the same time, our approaches are very pragmatic and free from any political prejudice.

It is obvious that economic, social and ecological stability in the region is connected to the effective operation and transportation of its energy resources. At the same time, the production and realisation of mineral raw materials depends on the above mentioned components.

Among the problems of Caspian power sector development, it is necessary to mention the negative effect of regional conflicts (Nagorny Karabakh, Chechen

and Abkhazian). Specific challenges to the security of the Caspian region and all Central Asia are the direct and indirect results of the ongoing conflict in Afghanistan. The destabilising effect worsens the situation in Tajikistan and encourages Muslim extremism in the north of Central Asia and in Kyrgyzstan.

In this connection, it is now urgent to realise the initiative of the President of Kazakhstan, N. Nazarbayev, on the convening of the Conference on Interaction and Confidence-Building Measures in Asia. By signing the Declaration on the principles guiding relations among CICA member states at the Conference of the Ministers of Foreign Affairs of the CICA, member states have confirmed their aspirations to develop an effective mechanism to prevent conflict and enhance security.

After the disintegration of the Soviet Union, Central Asian countries have faced a number of unsolved problems in the sphere of economic measurement and environment. Within the framework of this forum, I would like to focus your attention on a very important regional problem.

If the depletion of mineral resources is a more or less long-term issue, water resources management is becoming more urgent and a subject of a great concern to Central Asian countries. Unfortunately, it is very difficult to change the mentality of the past and to realise that water is an extremely vulnerable and limited resource in the region. Water resources are considered not only as sources of drinking water, but also as a means of obtaining electric power. Experts predict that the existing level of water usage and existing approaches to water resources management will result in a constant water deficiency, first of all in the regions with a high density of population. Water consumption doubles each decade and such a tendency will continue.

A large part of the territory of Central Asia, approximately 90%, belongs to the arid zone with low humidity and extremely limited water resources. This limitation creates serious problems for the sustainable development of the region and for the protection of the natural environment on a global scale. The development of mineral raw materials, of industry and of agriculture requires the more efficient and rational use of water.

The largest consumers of water in many countries remain agriculture, mining and processing industry. The growing need for food and mineral raw materials compels the expansion of the irrigated agricultural area and the intensification of natural minerals production. Both are accompanied by the irrevocable withdrawal of water from rivers and reservoirs.

The solution of the water problem under conditions of limited and decreasing supply demands essentially new approaches to water resources management both at the national and international level. First of all, it is necessary to conduct significant work on the rationalisation of water usage, the realisation of long-term water saving programs, and the use of ecologically safe technologies. At the same time, the strategy of water usage should be the responsibility of suppliers as well of consumers.

The strategic purpose of water policy in the region is the realisation of long-term complex measures which are directed towards the elimination of the negative consequences of limited water resources and the creation of conditions for economic growth, the resolution of social and ecological problems, and the settlement of interstate water relations.

THE LINK BETWEEN ECONOMICS, SECURITY AND STABILITY IN THE SOUTHERN CAUCASUS

Fikret M. Pashayev

*Head of Division, Department of International Economic Organizations,
Ministry of Foreign Affairs, Republic of Azerbaijan*

Today we are discussing very important issues concerning the link between economics, security and stability. In this context, the main question is how security and stability can ensure economic development and how economic development can promote peace and security in certain regions. Consideration of the link between these three factors can help decision-makers to take the necessary steps in order to provide co-operation and economic integration.

The link between economics, security and stability becomes more crucial when applied to the region of the Southern Caucasus. During recent years this region has become very important due to a number of factors. One of the main factors is the existence of considerable energy resources in the Caspian region that creates good opportunities for rapid economic development through the attraction of foreign investment. The other major factor is that this region has significant transit opportunities that could provide the necessary co-operative links between East and West.

On the other hand, the difficulties of transition from command to the market economy and the consequences of existing military conflicts remain an impediment to economic development. Moreover, useless competition, rivalry and potential conflicts that derive from geopolitical interests in the region continue to threaten the possibilities of exploring substantial natural resources for the world economy. Thus, the region of the Southern Caucasus is both very attractive and complicated at the same time.

Azerbaijan, which is situated in the heart of the region of Caucasus and Central Asia, has experienced extremely difficult conditions in its early years of post-communist political and economic transition. Following the collapse of the Soviet Union, Azerbaijan inherited an ineffective command economy and broken productive, financial and trade links. As a result, the economy suffered from serious macroeconomic imbalances.

A new leadership of Azerbaijan in 1993 brought new legislation concerning different aspects of development. New governmental structures have also been established. The general economic policy of Azerbaijan was based on liberalisation,

private sector development and moving the country to a market economy as quickly as possible. As a result, substantial progress was achieved in not only stabilisation of the macroeconomic situation in the country but also in the attraction of considerable foreign investment. In 1994-1998, a total sum of US\$5.7 billion was invested in Azerbaijan, including US\$4 billion of foreign investments. In 1998, more than US\$1.4 billion was invested into the economy, which is 1.13 times more than in 1997. The foreign investment prognosis for 1999 is estimated at US\$1.8 billion.

This inflow of large foreign investments into the economy of Azerbaijan could be explained by the following reasons:

- Potentially rich oil and gas reserves in the Caspian Sea basin.
- The government of Azerbaijan created good opportunities for investment: the law “On the protection of Foreign Investments” was adopted in 1992, tax privileges were offered, local documentation requirements were simplified.
- Availability of skilled labour power at competitive costs.
- Global competition in the oil industry and the possibility of risk-sharing among big multi-national companies.

This last reason has special importance. In the context of globalisation, the large multinational corporations invest in the new potentially rich markets not only for the purpose of future profit, but also due to the philosophy of competition in order not to lose competitiveness in industry. In potentially rich but politically unstable regions, the multinational companies have to compete and to co-operate at the same time in order to reduce the risk of possible losses. Risk-sharing contracts are being considered as a very good opportunity for that purpose. As for the host country, Azerbaijan can through diversification of investors make incoming capital more internationalised which expands the common political and economic interest in the exploration of Caspian oil. The diversification of investors can also increase the total volume of foreign investments.

Here we come to the very important proof of linkage between economics, stability and security. The more foreign investment the countries in the region receive, the more stability and security is needed. Implementation of oil projects requires stability and co-operation. Otherwise, the huge investments could be lost as a result of instability and conflict. This means that existing conflicts in the region should be settled as soon as possible on the basis of international law.

The history of commercial production of oil and gas in Azerbaijan extends back for more than 120 years. By 1901, Azerbaijan was producing half of the world’s oil and the industry had attracted such legendary business names as Rothschild, Rockefeller, Siemens and the Nobel brothers. To date, 68 oil and gas fields have been discovered (43 onshore and 25 offshore). More than 1.35 billion tons of oil have been produced.

The real development of the oil sector in the post Soviet period began in 1994, when the government signed a contract with a consortium of international

oil companies to begin a programme for rehabilitation and development of Azerbaijan's oil fields, namely Azeri, Chirag and Guneshli. The oil reserves of these fields are estimated at 500 million tonnes. Since then, Azerbaijan has signed 19 contracts with the participation of large oil companies from various countries. Today, 33 oil companies from 14 countries are taking part in the implementation of these contracts. These countries are the US, UK, France, Italy, Norway, Russia, Turkey, Japan, Saudi Arabia, Belgium, Germany, Iran, Spain, and Canada. Projected investment in the development of the energy sector by multinational oil companies is estimated at about US\$40 billion.

In 1997, Azerbaijan produced 9.1 million tonnes of oil and 6 billion cubic meters of gas. In 1998, oil production amounted to 11.6 million tonnes and expectations for 1999 are 14.4 million tonnes. The prognosis for the year 2010 is 46.9 million tonnes of oil. Recently, huge gas reserves have been discovered in the Shakhdeniz oil field. This allows us to cover internal consumption and export to the world market 20 billion cubic meters of natural gas annually.

One of the issues which has been discussed during recent years was the legal status of the Caspian Sea. The opponents of rapid development of oil and gas fields in the Caspian region refer to the unsettled problem of the status of Caspian Sea. They consider the condominium solution as the only possibility to protect the Caspian Sea ecologically. But in reality, their purpose is to postpone the implementation of energy projects that can substantively improve the economic position of the newly independent states in the region, ensuring their security and stable growth.

Azerbaijan is opposed to the condominium solution and the idea of joint exploitation of the offshore oil fields. The position of Azerbaijan is that the Caspian Sea is divided into its respective sectors, over which the littoral states have full sovereignty. Each coastal state has the exclusive rights in its sector on biological resources, water surface, shipping, exploration of the bottom of the sea, mineral wealth, etc., in accordance with the generally recognised rules and principles of international law and formed practice. Azerbaijan is for the full division of the Caspian Sea, which presupposes the division of the seabed as well as the water surface and its depth.

Another important issue for the countries in the region is the transportation of energy resources to world markets. Large investments in oil exploration require a sound and reliable system of transportation of energy resources. The necessity of such a system derives from the fact that the oil-rich countries of the Caspian region are land-locked and the existing or future oil and gas pipelines should pass through the territories of several newly independent states.

Consequently, in such a complicated region as the Caucasus, success in stable transportation of energy resources requires the existence of more than one pipeline. Diversification of transport routes allows not only for the transport of growing amounts of oil and gas, but also minimises the risk of existing and potential conflicts in the region. This was a reason why Azerbaijan insisted on

the transportation of “early oil” using two pipelines. In October 1995, the decision to use pipelines Baku-Supsa and Baku-Novorossiysk has been adopted. In 1996, the government of Azerbaijan signed relevant agreements with the governments of Russia and Georgia.

Today, Azerbaijan uses the newly constructed oil pipeline Baku-Supsa and the existing pipeline Baku-Novorossiysk. Both pipelines lead to the Black Sea. The pipeline Baku-Supsa came into operation on April 17th 1999. The capacity of this pipeline is 6 million tonnes a year. The Baku-Novorossiysk pipeline has been renovated and has operated since November 1997 with a capacity of 5 million tonnes a year. Unfortunately, recent developments in Chechnya and Dagestan again raised the question of stability in this part of Russia that makes oil transportation questionable. Thus, diversification of transport routes is one of the ways to ensure stability in exploration and transportation of energy resources.

As for the construction of the Main Export Pipeline, the government of Azerbaijan has chosen as a priority the pipeline linking Baku with the Mediterranean port of Ceyhan in Turkey. The negotiations on this pipeline came to fruition with the signing of the Ankara Declaration on 29th October 1998 by the US, Turkey, Azerbaijan, Georgia, Kazakhstan and Uzbekistan. This pipeline is expected to have a capacity of 45 million tonnes per year.

Of special importance for Azerbaijan has been the issue of the transport of hydrocarbons from Kazakhstan and Central Asia. Today, Kazakh oil is already being transported through Azerbaijani territory. The future prospective is for the construction of Transcaspiian oil and gas pipelines that could substantively improve the transportation issue for the land-locked Central Asian countries.

As a state located at the cross-roads between Europe and Asia, Azerbaijan is keenly interested in securing access to the Trans-European and Trans-Asian transport networks that would facilitate development of industrial and trade links between the countries of the region, improving access to markets and increasing integration links. A crucial place in the realisation of this concept of an East/West corridor lies with the implementation of the TRACECA and INOGATE programmes.

In this context, the “Baku Declaration”, which was adopted at the international conference held in Baku in September 1998 and devoted to the restoration of the Great Silk Road, has great significance. The European Union, the initiator of the TRACECA programme, estimates that annual freight turnover via the New Silk Road will rise from 4 million tonnes in 1998 to 34 million by 2010. This project could be considered as an effective instrument for the assurance of security and stability in the region of Caucasus and Central Asia.

The discovery of considerable energy resources in the Caspian region creates possibilities for development and prosperity not only in the countries of Caucasus and Central Asia, but also in the countries whose companies are currently actively involved in the exploration and transportation of these resources. Azerbaijan

considers the exploration of its energy resources to be an important tool for the strengthening of Azeri sovereignty, security and independence. Such activity fosters regional security as well. But the secure and full implementation of energy projects in the southern Caucasus is dependent upon conflicts in the region being resolved on the basis of international law.

Finally, allow me to express the hope that the exploration and exploitation of the energy resources in the Caspian region will soon enable the newly independent countries of the region to further strengthen their economic position and to make substantive moves toward creating a market economy. This will benefit all partners involved in the implementation of energy projects.

ECONOMIC AND STRATEGIC STAKES IN THE CASPIAN ENERGY MARKETS

Mariano Alierta

*NATO Parliamentary Assembly,
Sub-Committee on East-West Economic Cooperation and Convergence,
Rapporteur (Spain)*

Overview

One axiom of the post-Cold War order is that the international system has moved from an uneasy stasis to chaotic fluidity. In this much altered climate, certain regions which once languished in relative obscurity behind the Iron Curtain are now garnering far greater attention. The Caspian region is a case in point. As countless articles in the Western press have suggested, the Caspian is attracting increasing attention from business leaders and strategic thinkers alike who see the region in terms of its great economic potential but who worry about the strategic challenges it poses. The confluence of opportunity and risk as well as the apparent interest of the world's most powerful countries in the region has inspired some to describe what appears to be the emerging rivalry for influence and riches as a reincarnation of the Great Game - the strategic rivalry between Victorian Britain and Czarist Russia for the riches of India and the East.¹

Such comparisons, while convenient and certainly intellectually stimulating, can also be misleading. As a point of departure, it would be ill-informed to use any colonial paradigms to describe the situation in the Caspian region and, by extension, to assume that the region's governments will be passive players in the now developing "game". To the contrary, the states around the Caspian, while beset by daunting internal problems, are deeply marked by the region's past inclusion in the empires of distant states and consequently seem determined both to preserve their newly gained sovereignty and to ensure a degree of control over their economic development. The interest of some outside actors like Europe and the United States, moreover, lies not only in the development of the region's energy potential and in insuring their own access to that energy. Their policy also recognises that their economic and strategic goals are most likely to be achieved if stable, self-confident countries emerge along the Caspian littoral which are capable of advancing economic and democratic development, promoting peaceful relations with their neighbours and preventing their own subjugation at the hands of any single outside player. Thus one distinctive element of the current Great Game is that local players want to ensure that no

single outsider exercises regional hegemony, while some outsiders want to see the emergence of sufficiently resilient, stable and democratic societies capable of entering the global economy with confidence. This is not to say that a clash of interest is not in evidence. The region is beset by clashing interests, and keeping a lid on this cauldron while developing its energy potential represents its greatest challenge.

Strategic Issues

Indeed, the Caspian-Caucasus is a region of almost unspoken instability and upheaval. This area has witnessed some of the worst violence to befall the successor states of the Soviet Union. The region's borders are ill-defined, and, decades ago, Soviet leaders made sure that the borders of the region's Republics did not coincide precisely with ethnic and religious divisions.² Once the Soviet Union collapsed, the consequences of this policy became evident. War and civil strife broke out throughout the region in Chechnya, Nagorno-Karabakh, Georgia, Dagestan and most tragically in Chechnya. Turmoil on this scale has helped draw great powers into the region but has also inspired a degree of circumspection on the part of foreign investors who must carefully weigh risk and opportunity. Not surprisingly, the Caspian is sometimes characterised as a buffer zone between Russia and Middle East or as an energy-rich "vacuum" that the laws of physics and international relations suggest is unsustainable; the Great Powers driven by their economic and strategic interests will, in this view, invariably be drawn in.

The states around the Caspian littoral are deeply insecure; the region itself is unstable, it has long been dominated by outside powers and there is a sense that these outside powers aspire to reassert some degree of control over it, particularly given its energy potential. While several of the region's leaders enjoy decent relations with Russia, others like Azerbaijan's President Heidar Aliyev worry that Russia's traditional hegemonic aspirations are driving Russian regional policy. President Aliyev's concerns, of course, are partly inspired by Russian support for Armenia in its struggle with Azerbaijan, and this has inspired his government as well as several others to turn to the West not only for investment, but also security.

Russian Interests

Russia has many interests in the Caspian region, and these interest are obviously a critical element behind the government's decision to wage a relentless war in Chechnya. Nevertheless, Russian leverage in the region as a whole has waned to a certain degree. Iran, Turkey and China have emerged as more important trade partners with the region and the West is playing an ever more important role in the region's energy sector.³

The Russian view of the Caspian is also a fractured one. While ultra-nationalist groups advocate reasserting Russian hegemony in the region, more sober-minded Russian gas and oil industrialists want to play a key economic role there without necessarily reasserting sovereignty over former Soviet territory. The business elite, which supports key political groups operating in Russia, is perfectly willing to exploit the fact that the Caspian pipeline infrastructure is largely oriented toward the markets of the former Soviet Union. For Russian industrialists, this pre-existing condition has been greatly advantageous, and has granted them leverage over potential competitors. Above all, the Russian energy moguls want to ensure stable export markets for their oil and gas, which is a vital source of scarce foreign exchange earnings and tax revenues for the Russian state and windfall profits for them. Russian business thus sees the Caspian region as ripe for development for large energy concerns like *Gazprom* and *LUKOIL* but it also fears competition from region gas and oil producers.

Both the Primakov and Putin government have seen the Commonwealth of Independent States (CIS) as a potential source of stability in the Caspian, although that moribund body has hardly fostered strategic coherence. Moscow is also strongly opposed to the extension of NATO or American security guarantees to Caspian regional actors and has reacted with anger to Georgian and Azeri aspirations to engage NATO help in defending local energy infrastructure.⁴ Pipeline politics in Russia are thus complex, and companies such as *Gazprom* play an active (and sometimes contentious) role in Russian politics.⁵ These firms do not intend to lose vast potential markets in Turkey and Europe to Caspian producers. *Gazprom's* European income, for instance, compensates for the losses in the domestic market where barter is the predominant form of payment. In the words of one analyst, "*Gazprom* and the whole of the energy sector subsidizes the rest of the Russian economy."⁶ Moscow's economic interest in the region is thus unlikely to wane as long as such a substantial component of its income is generated by the oil and gas sectors.

For its part, the Russian military in recent years has not been particularly focused on energy issues at all, but rather has expressed anxieties that instability on Russia's southern borders would spill into Russian territory where overlapping ethnic and religious divisions have the potential to explode into more serious strife.⁷ This, of course has already happened in Chechnya and Dagestan, and the grave difficulty the Russian state's has confronted in reasserting its authority in those cases underscores the complex challenge it faces in preserving a strategic foothold in the region and the potential dangers that could pose to other states in the region. It is worth mentioning that Russian troops are currently based both in Armenia and Georgia and have actively supported ethnic Armenians in the war over the enclave of Nagorno-Karabakh.⁸ In short the existence of important gas and oil reserves, the fact that there are Russian minorities living in the region, and an historical legacy of a strong Russian presence there ensures

that Russia will continue to discern important national interests in the Caspian and Transcaucasus.⁹

Russian tactics in the region compound its difficulties. The war in Chechnya is unlikely to produce any long-term solutions and Russia has been accused of fomenting ethnic disputes in countries, like Azerbaijan, which have refused to co-operate with Russia on an array of economic and strategic issues.¹⁰ But if this is the case, they are playing a risky game as ethnic battles are hard to control, risk drawing in other powers, and can raise international stakes in local conflicts. The oil and gas factor obviously compounds this already dangerous problem. At the same time, if the “Islamic Revival” in the Middle East has abated somewhat, it is just beginning to gather strength in Central Asia. Russia is not well positioned to contain these forces and seems to offer the region very little to fill the vacuum left by the Soviet collapse.

American Interests

The United States could never benefit directly from Caspian gas, and even oil from the region is more likely to be shipped to Europe and Asia than to the United States. But oil, of course, is a fungible commodity, and new discoveries in one part of the world will drive down global prices. Thus, as a net energy importer, the United States sees economic benefits from the development of the region’s energy potential. That American multinationals, like *Amoco Corp.*, which have invested heavily in Azerbaijan’s oil development, are seeking to play a key role in this development is also a critical component of the US government’s perspective on the region. US industry has already invested more than \$2 billion in the three largest oil producers in the region, and will certainly invest much more if exploration yields results.¹¹ The United States has also been a guarantor of international access to fossil fuel, and as such, naturally perceives an important set of issues at stake in the Caspian region.

The American strategic vision is partly shaped by an optimistic view that some modicum of stability can be achieved for the Caspian partly through a much enlarged Euro-Atlantic Community. This community would extend into distant Central Asia, and overlaying institutions like NATO’s Euro-Atlantic Partnership Council (EAPC), the Organisation for Security and Co-operation in Europe (OSCE) and the EU would all contribute to regional integration. Indeed those institutions are all playing a role in the region. It should be noted that NATO relations with the Caspian began with the signing of the Conventional Forces in Europe (CFE) treaty in 1990. Following the Soviet Union’s collapse, NATO established deeper security contacts through the Partnership for Peace (PfP) and the EAPC, and the region’s forces have subsequently participated in joint exercises.

It is also true, however, that the United States wants to ensure that Russia is not in a position to dominate the region militarily and economically. American officials have expressed deep concern about Russian conduct of the war in Chechnya, and US policy is clearly aimed at creating alternatives to Russian hegemony for regional actors.

The Americans have also long sought to isolate Iran, but Europe is not likely to be a willing partner in such a policy, particularly if the government in Tehran continues to move in a moderate direction. Indeed, the US view of Iran differs from that of Europe, which has already begun to restore diplomatic relations with Tehran to encourage the Khatami government, which is proving more reasonable than its revolutionary predecessors. Khatami's lifting of the Fatwah against the British writer Salman Rushdie and moderate victories in recent local elections could mark a turning point in the European-Iranian relationship. In March, Iran signed a \$1 billion deal with *Elf Aquitaine* and *ENI* to refurbish the Doroud offshore field in the Gulf which suggests that American efforts to restrict large foreign investment in Iran have partly broken down.¹² The US approach to Iran is far more cautious, and the Iranian leadership equally worries that any lessening of traditional anti-American rhetoric would invite the wrath of Iran's conservative clerics who still exercise great power in Iranian society. Finally, the US policy in the region is also informed by other national interests and aims particularly at halting the growing transshipment of arms and drugs.

European Interests

European interests in the region are largely, though not exclusively, economic. Its energy companies are investing in countries which they anticipate will become major exporters of energy to Europe. European leaders would not claim at this juncture to have fundamental geo-political interests in the region. The European Union is seen as a generally positive presence in the region, and has worked to foster a greater degree of regional co-operation. But until Europe has the machinery for developing and carrying out common foreign and security policies, its activism will be somewhat limited and its most high-profile players will come from the business community. Europe, however, welcomes the opportunity to develop new sources of energy in order to reduce its reliance on Middle Eastern and Russian energy and European governments provide diplomatic support for their energy companies operating in the region. Like the United States, the European Union hopes to help foster regional stability and promote the development of democratic institutions in these new states.

Europe has a long history of exchange with the region, and the European Union's Transport Corridor Europe-Caucasus-Asia (TRACECA) initiative to upgrade regional transport infrastructure suggests that many European leaders expect to use these traditional commercial ties as a foundation for a common policy toward the region.¹³ Most EU governments would not object strenuously

to the construction of a pipeline through Iran even though the United States is strongly opposed to doing so. This is obviously an important source of division between Europe and the United States, and the Europeans have complained bitterly about the threat of US imposed sanctions on companies doing business with Iran.

Turkish Interests

Turkey's interest in the region is far greater than any other European or North American state. It shares a common cultural and linguistic heritage with the dominant ethnic groups of several Caspian states, and these ethnic ties underpin Turkey's economic, strategic and environmental interests. Turkey undoubtedly sees the Caspian, Southern Caucasus and Central Asia as regions where it can and should be a player. Some argue that Turkey's sometimes uneasy relationship with Europe gives it few options but to increase its activism in the region. But the EU-Turkish relationship is rapidly improving so this contention may no longer be relevant. Last summer the Turks called for a NATO-led peace force in the Caucasus region, something which the Russians strenuously opposed.¹⁴

Turkish relations with the states of the region are generally quite good, and Turkish entrepreneurs are operating with some success in the Caspian. Indeed, Turkey has emerged as a leading investor in the region. Turkish firms are working on both energy production and transportation projects that could bring profits to investors, while helping Turkey meet its ever-mounting energy demand. Turkey currently enjoys a trade surplus with the Caspian states. The government clearly hopes to develop new sources of energy supply to meet rapidly expanding domestic demand and to emerge as a key energy transshipment hub for both economic and strategic reasons.

The Turks are also strongly opposed to increasing oil transshipment through the already crowded Turkish Straits, fearing that an accident would pose a serious hazard to millions of Turks living along the shores as well as to the priceless historical, cultural, and environmental patrimony of that coastline.¹⁵ The Turkish Straits simply cannot absorb any more tanker traffic. Partly, for these reasons as well as broader strategic interests, the government favours transshipment through the Mediterranean, and have endorsed the US-backed projects like the Baku-Ceyhan pipeline. The Turkish, Azeri and Georgian authorities have recently signed four agreements to undertake this project and on 18 November 1999, the Presidents of Azerbaijan, Georgia and Turkey and Kazakhstan signed the Istanbul Declaration to complete this project by 2004. US President Clinton signed these agreements as a witness but there is now a dispute with Georgia regarding future transshipment fees. At the same time, Turkey has made arrangements with *Gazprom* to initiate the "Blue Stream" project which would supply Turkey via a pipeline through the Black Sea. *Gazprom* is

competing with Central Asian countries for the access to, and possible control of, the Turkish gas market.

Iranian Interests

Iran too perceives vital strategic and economic interests in the Caspian, and its leaders are certainly disposed to use religious ties to further their ends. In fact, their rivalry with Azerbaijan's secular government does have religious overtones, and the Iranians have willingly exploited the fact that most Azeris are Shi'ite Muslims. The Iranians would like to play a role in moving Caspian energy to market. They oppose American-supported projects which would make Baku the focal point of Caspian energy exports. Iranian ambition will thus continue to meet American resistance. Iran is also conducting important trading relations with several of the region's states. For example, it is undertaking oil swaps with Kazakhstan, whereby Kazakhstan supplies crude oil to northern Iranian refineries in exchange for Iranian oil deliveries in the Persian Gulf, which can then be exported on world markets. Since Kazakhstan is not investing directly in Iran and because the trade is in hydrocarbon swaps, it has so far skirted the American sanctions regime. Turkmenistan has built a natural gas pipeline to Iran which links its western fields to industrialised northern Iran.¹⁶

Chinese Interests

Surprisingly, China has also become an important player in the region. It hopes to develop new sources of energy to meet rising domestic and Asian demand and to reduce its dependence on ocean-bound energy imports. China has been building up its naval forces partly to guarantee continued access to imported energy; yet it is looking for other energy options as well to ensure, for example, that a naval blockade could never paralyse the national economy. It is precisely this logic that allows the Chinese to justify such massive projects as the *Three Gorges Dam* which is costing billions of dollars but which, on paper, should give China new energy options. This same rationale partly accounts for Chinese policy in the Caspian. It has been the largest investor in Caspian energy projects and is now developing plans for an extremely long pipeline to help meet burgeoning national gas demand. But like Russia, Chinese regional policy must also contend with the emergence of Turkic speaking states that could galvanise its own discontented and culturally oppressed Turkic minorities living along the Tajikistan, Afghanistan and Kyrgyz Republic's borderlands. So far, however, Turkic states have sought to ease tensions with China. In the Fifth Turkic Summit in Astana, Kazakhstan, Uzbek President Karimov cautioned that Turkic unity had limits, noting that supporting the Uighur minority would endanger relations with the "Great China".¹⁷ China, like Russia, does not welcome greater NATO engagement in the region.

Energy Markets and Oil and Gas Reserves

World oil prices will remain a critical variable in Caspian economic development. From January to December 1998, global crude prices fell to around \$11 a barrel.¹⁸ This price collapse precipitated industry-wide restructuring which dramatically stretched out exploration and development schedules in the Caspian.¹⁹ Production elsewhere in the world was on the rise and, because oil is a fungible commodity, increased production contributed to falling prices globally. So too did declining demand, which reflected not only more efficient consumption patterns, but in recent months, the downturn in Asian economic growth. Low prices combined with the very high cost of building certain proposed pipelines seemed to render the possibility of rapid energy development highly problematic. Large oil companies were well aware of the risks, both economic and political, and tend to make investment decisions with great caution.

Several recent unsuccessful exploration drills have reinforced investor caution. Although Azerbaijan has been producing oil for over 100 years, its recoverable reserves in fields now under production is only 2.6 billion barrels. Recent exploration has turned up more gas than oil. This is not good news for Western drilling consortia as there is no large domestic market for gas and no pipeline in place to export it to markets of dynamic demand.²⁰ Exploration in Azerbaijan is currently concentrated on the very deep Shah Deniz reservoir near Baku.

On the other hand, the rise of the price of oil to \$22 a barrel once again has forced investors to reassess prospects for the region. The promise of a sufficient return on investment as well as government encouragement explains why the Baku-Ceyhan pipeline agreement was recently signed.

Yet while prices may be high today, potential investors are unlikely to forget the recent free-fall of oil prices and are now disposed to proceed with greater caution in the Caspian. Given today's price uncertainty, it often makes more sense to continue investments in geographically favoured states with proven oil reserves, such as Saudi Arabia, than risk developing production and distribution facilities in a region fraught with supply and political uncertainties., Saudi Arabia in particular is pursuing a policy to discourage investment in the Caspian, so that it may retain its jealously guarded place as the world's first supplier of petroleum. Caspian oil politics are hence tied not only to a regional "Great Game", but also to global oil politics.

Pipeline Politics

Oil is virtually worthless without a means to move it to blue water, and gas is a valueless commodity without a pipeline grid to deliver it to consumers. Currently Caspian oil is pumped through two small pipelines that end in the Russian Black Sea port of Novorossiysk and the Georgian Black sea port of Supsa. Neither of these pipelines has sufficient capacity to accommodate a

dramatically increased flow of oil, and there is still the problem of getting this oil to blue water. Turkey strongly opposes increased tanker traffic through the crowded Turkish Straits for safety and environmental reasons, and has announced that the number of tanker crossings in 1999 will be cut - a move which put some pressure on oil companies to move more rapidly to a financing arrangement on the Baku-Ceyhan pipeline.²¹ The AIOC, a *BP-Amoco*-led consortium had wanted to increase the volume of oil pumped through the recently upgraded Baku-Supsa line, while the Azeris want a guarantee of that company's support for the eventual construction of the line to Ceyhan which will be needed if a significant quantity of oil is pumped.²² The AIOC initially saw this option as far too risky given the level of proven reserves in the Caspian, but the oil price hike has helped change its posture. The US Ambassador initially insisted that Turkey would have to compensate companies for cost overruns on the estimated \$2.4 billion project.²³ The United States was worried that further delay on the Baku-Ceyhan pipeline would lead to the construction of other pipelines which would invariably render it less justifiable in cost terms. The American government sees this proposed pipeline as a prized strategic asset, and this is precisely why the administration pushed so hard for its construction.

Naturally economic factors are critical to shaping decisions about new pipeline construction. Firms financing those pipelines need to assess both the potential volume of oil or gas that might be pumped through the system and the price that energy will command on the market. Getting exports to the international market from the eastern Caspian would cost up to \$7 a gallon, and Turkmenistan and Kazakhstan need oil prices at \$15 a barrel to make their oil economically viable.²⁴ Some optimistic proponents of various projects use numbers which intimate that a particular pipeline would command a high percentage of all the oil or gas produced in the region. But if several pipelines are built, those optimistic figures would change dramatically, and the potential volume for any one pipeline would consequently fall. There is also the fact that Caspian proved oil reserves are still relatively low and may not justify the huge outlays needed to build a complex pipeline infrastructure. If world demand is slack and if oil production remains relatively cheaper for the foreseeable future in regions like the Middle East and the North Sea, then investing in expensive pipelines in the Caspian region may not seem particularly attractive over the short to medium term. Furthermore, any eventual lifting of sanctions on Iran and Iraq would further depress world oil prices, and could therefore further delay much needed investment in the Caspian.

One must also consider the inherent risk of laying pipelines across politically unstable regions where warring factions might possess the means and motives to attack pipelines. The recent turmoil in Dagestan and Chechnya raises new concerns about a Baku-Novorossiysk pipeline, traversing the troubled northern Caucasus.²⁵ Throughout last year, there were repeated interruptions of oil flow in Chechnya, a development which in April prevented Azerbaijan's *SOCAR*

from selling any oil. It then renegotiated prices with Russian pipeline operator *Transneft* in May. Unfortunately Russian policy in the Caucasus has failed to resolve the litany of problems besetting the region, including the rise of fundamentalist, Islamic movements, crime and attacks on the pipelines. The use of Islam as an ideological weapon by both insurgents and the Russian government is likely to perpetuate the Caucasus crisis.²⁶ Georgia is quite wary of Russian intentions in the region, particularly in light of Russian support for Abkhazi separatists. Accordingly the government of Eduard Shevardnadze supports the development of new pipelines to reduce its reliance on Russian infrastructure. Shevardnadze told journalists in Tbilisi on 22 February that a “special unit” had been created to guard the Baku-Ceyhan pipeline.

To understand the political-geographical-economic dimensions of the pipeline problem, it is first necessary to recognise the fundamental technical difference between oil and gas pipelines. Oil pipelines can deliver crude oil directly to refineries or to transhipment points where it is loaded on ocean faring ships for distant delivery. Gas pipelines, however, must deliver energy directly to market. There is therefore no global market for gas; only regional markets exist. Perhaps the most dynamic potential market for Caspian gas is Turkey, and Turkish energy needs are expected to grow significantly over the coming twenty years. Turkish consumers already suffering from energy shortages, and electrical brownouts are relatively common. The dilemma, of course, is that a large gas producer, like Turkmenistan is remote, and pipelines will be expensive to build. The signing of the Turkmenistan-Turkey-Europe Gas Pipeline agreement in October 1998 is a step both toward helping Turkey meet its energy needs and linking Turkmenistan to dynamic gas markets. In November 1999 a “Declaration of Principals on Intergovernmental Agreement for Implementation of the Trans-Caspian Natural Gas Pipeline Project” was signed by the Presidents of Turkmenistan, Azerbaijan, Georgia and Turkey. The emergence of Azerbaijan as a producer of gas may eventually pose a challenge to countries like Turkmenistan, which rely on Azerbaijan for transit facilities.

It is tempting to understand the laying of pipelines for the delivery of Caspian gas and oil as simply posing a strictly economic and technical set of challenges. But to do so is fundamentally misleading. Politics and strategic calculations are playing a fundamental role in this arena as well. Indeed, international pipeline construction tends to be driven as much by strategic and political considerations as economic ones. The Chinese, for example, have signed a memorandum of understanding to build a 3,000 kilometre multibillion dollar gas pipeline from Kazakhstan to the Chinese province of Xinjiang.²⁷ This represents an extraordinarily expensive infra-structural investment that may never pay economically. But as suggested above, the Chinese feel a strategic imperative to diversify their energy sources and open new alternatives to reduce their current need to import energy through the South China Sea. It should be noted that the Chinese do not sharply

differentiate economic and strategic objectives. Many analysts have argued that strategic interests are a critical impetus to building the Baku-Ceyhan pipeline.

Russian Influence and Pipeline Projects

Clearly many Caspian states want pipeline grids that will give them options other than exporting through the Russian system. Relying on the Russian pipeline system has not been a happy experience. There is evidence that some Russian officials use Caspian reliance on this pipeline system to dictate commercial terms to them. For example, Russia granted Turkmenistan access to its pipelines provided Turkmeni officials agreed only to sell in bankrupt CIS states, while *Gazprom* kept for itself clients in Western Europe capable of paying hard currency for their energy bills.²⁸ Russian officials thus see Caspian states as potential competitors to its leading energy firms, like *Gazprom*, which, it cannot be forgotten, are critical to state financing.

The problem for the Russians is that such blunt use of its infrastructural leverage is actually encouraging the construction of alternative pipelines that will reduce this leverage over the long term. If Russia wants to remain a player, it will have to extend relatively equal treatment to Caspian producers while beginning to tackle the many organisational and regulatory deficiencies which make its system so unattractive to foreign oil and gas producers.

The Baku-Ceyhan Pipeline

Turkey wants pipelines to help it meet national energy needs, bolster its own regional strategic leverage, diversify its supply base and lower the risk of environmental and traffic-related catastrophe in the Turkish Straits associated with the potential for more oil tanker traffic through those extraordinarily crowded and narrow waterways. Like the Americans, the Turks are also strongly advancing the case for a Baku-Ceyhan pipeline, arguing that this would provide a safe economical and environmental means of bringing oil to the Mediterranean. The proposed Baku-Ceyhan line would provide an alternative to transporting oil across Iran or through the Russian pipeline system.³⁰

Azerbaijan, Georgia, Kazakhstan and Uzbekistan have all announced their support for the development of the Baku-Ceyhan line which ideally would move 50 million metric tons of oil per year to the Mediterranean,³¹ and the United States has offered Turkey \$833,000 to support the planning process.³²

The Local Economies

Post-Soviet Caspian economic development is so far a story of misplaced expectations. The legacy of Soviet rule continues to burden the region's

economies. Decades of misallocated capital, irrational pricing, centralised control and highly inefficient energy drilling techniques have left their mark. Exploration contracts signed by the Soviet Union with international businesses were terribly disadvantageous to the region, and only recently have governments begun to demand contract re-negotiations.

While the signing of oil and gas contracts has created a new class of extremely wealthy power brokers throughout the region, most inhabitants live in poverty. Unemployment and decay are apparent everywhere, and if anything, the region has suffered from de-industrialisation over the last decade. War too has left its mark, not only in terms of added budgetary pressures, but in uprooting entire regions and creating serious refugee problems. Baku, for example, has seen an enormous influx of refugees from the war with Armenia, and their presence has placed an enormous burden on that city's creaking social services and housing infrastructure. The effects of the war in Chechnya will be felt throughout the region for years to come.

The legacy of Soviet economic rule is not a happy one. Decades of capital misallocation and price distortion have left an almost indelible mark on the region's infrastructure which is uniquely ill-suited for the rigours of global competition. There is, for example a marked shortage of drilling platforms and equipment in the region, and there are few prospects that this situation will change quickly. The high costs of bringing in the right equipment constitutes a genuine bottleneck to energy exploration, and this is why it is taking so long to follow up on signed contracts.³³ Moreover, the old industrial base of the region was oriented for trade with the Soviet empire, and that empire no longer exists. The collapse of traditional markets has been devastating, and the obliteration of the social welfare, public health, and educational systems that the Soviet Union offered has led to a crisis of expectations that tempts broad social unrest. School-leaving age has declined drastically throughout the region, and thus the human capital so important to long-term economic development is not being sustained. That the region's educational systems are producing unskilled labour with no job prospects obviously has long-term implications for political stability.

It is far from certain that even if the region becomes an important exporter of energy, this will have a necessarily munificent effect on the society as a whole. Some have characterised the extractive energy business as conforming to a classic enclave-style pattern of development in which "backward linkages" to the rest of the economy can be quite limited. Moreover, there is also a risk of eventually catching "Dutch disease", an economic malady in which the value of the local currency rises as a result of large oil or gas exports. But this appreciation renders locally produced manufactures and agricultural goods less competitive on international markets, a process which can hasten de-industrialisation and put farmers out of work. Indeed, rapid currency appreciation often makes imported food cheaper than domestic food. The sudden loss of

farmer income, in turn, can create tremendous social and economic polarisation, mass internal migration to cities and, ultimately, political instability. It should be noted, in addition, that agriculture in the Caspian region has already suffered enormously since the collapse of the Soviet Union. This has placed even greater burdens on the leaders of countries which are proving unable to feed themselves and lack the foreign exchange to buy sufficient quantities of food on international markets. Food expenditure has accordingly risen to 70% of household income, and malnutrition is on the rise.³⁴

Insofar as national economies come to rely on the export of a single commodity, externally induced commodity price shocks can have disastrous implications on rigid economies which have few means to “hedge their bets” against such developments. This is particularly true for those countries which are not able to save a high percentage of commodities-generated revenue and which face political pressures to spend those earnings as quickly as they enter the national coffers. The World Bank and IMF are working with Azeri officials to develop the necessary infrastructure to handle an influx of petrol dollars. The Caspian region is also notoriously inefficient in energy use. It requires roughly 1.2 tons of oil to produce \$1,000 of GDP, compared to an efficient country like Norway where the ratio is 0.2 tons of oil to \$1,000 of GDP.³⁵ This suggests that without important structural change and micro-economic adjustment, the countries of the region may be compelled to consume an unduly high percentage of their primary foreign exchange earning commodity.

The low level of regional economic activity has driven many to turn to the black market and criminal activities. Heroin smuggling has become a big industry in the region. Afghan opium is moving through Tajikistan and Turkmenistan, while poppy production is rising in Kazakhstan and the Kyrgyz Republic. Undoubtedly the lack of economic opportunity is contributing to the corruption and criminalisation of local economies, a development which is rendering the prospects for putting local economies on a solid footing all the more remote.

Aid and capital inflows to the region have been paltry. The IMF has provided some assistance, as has the World Bank’s recovery programme. Strict IMF conditionality has put several governments in the tough position of either cutting away the tattered vestiges of public welfare or facing loan termination. Uzbekistan, for example, lost access to IMF credits when its budget deficits soared.³⁶ Last summer the IMF warned Azerbaijan that restructuring agriculture, creating stronger financial institutions, regulations, and budget cuts are essential to macro-economic stability, particularly given the country’s dependency on uncertain oil prices.³⁷

The Caspian region is rife with political problems. The collapse of the Soviet Union did not herald the coming of democratic order, and many of today’s elites were yesterday’s apparatchiks. The groups that gained power have tended to cling to it, and the absence of party alternation in government and the varying degrees of repression in countries like Kazakhstan, Azerbaijan, and Turkmenistan

have only spawned endemic corruption and alienation. While Western governments grumble about this, little public complaint is heard from Western oil companies that have forged close relations with the region's governments.³⁸ The problem is that today's repression can and will most likely yield to tomorrow's instability.

Despite these very serious problems, there have been some positive signs over the past two years. The GDP of most Caspian countries have begun to grow, although this hardly compensates for the precipitous decline earlier in the decade. Indeed, in 1997 the GNPs of Azerbaijan, Georgia and Tajikistan were one third of the level in 1989.³⁹

Recommendations

It would be mistaken to view the Caspian region as a new Persian Gulf and accordingly to over-emphasise its strategic value to the industrialised world. To begin with, its reserves remain unknown, and even if they should turn out to be substantial, they are more likely to resemble those of the North Sea than those of Saudi Arabia. Attaching too much strategic import to the region could overextend both American and European commitments to a highly unstable region in a game that will also involve to varying degrees Russia and China. This could create situations in which, once their strategic stakes have been declared, outside powers could lose their flexibility to adjust to changed circumstances. Flexibility would be further sacrificed if outside powers begin to tie themselves inextricably to particular political groups or factions. Indeed, the political situation is likely to remain unstable, particularly given the high preponderance of autocratic regimes employing time-tested Soviet methods to cling to power. Over-enthusiastic efforts to prop up this or that regime could hypothetically lead to a quagmire where outsiders find themselves ever more enmeshed in local turf battles. Their involvement would tend to raise the stakes of local power struggles and potentially make it more difficult to develop exit strategies. It is for this reason that Zbigniew Brzezinski has labelled the region the "Eurasian Balkans".⁴⁰ This is one reason why the West is deeply worried by Russian actions in Chechnya.

Western governments should be cognisant that an important threat to stability in the Caspian region is not the hegemonic aspirations of any single power, but rather the perception that other powers will be tempted to make a play for hegemony, a possibility that, in turn, will inspire pre-emptive or defensive counter-initiatives by other states. This could lead to a regional escalation of tensions that, on the face of it, are unwarranted. Dialogue and confidence-building among regional and extra-regional actors are essential as this region grows more important economically.

That said, Western support for new pipeline options seems perfectly justifiable, at least from a strategic perspective. Multiple pipelines would grant new

openings for regional players and could foster improved regional inter-dependence. This too is even more self-evident given events in Chechnya.

Caspian states should not bet all their financial and political capital on a heretofore elusive oil and gas boom. That boom might not materialise for some time, and perhaps never will. In the meantime, further industrial and agricultural reforms are essential to alleviating regional poverty. Indeed, economic diversification is a central component of building a stable and sustainable economic foundation. To bet on oil as an *industrie industrialisante*, to use a phrase once favoured by the Algerian government, is only likely to increase dependency on oil prices and pipeline politics. Central Asian countries could learn much from the problems of other oil-driven states, in the Middle East or Africa, in coping with the economic problems common to such countries.

The *Silk Road* project is a promising and prescient initiative. Given the lack of linkages among Caspian states, the creation of a sub-regional group similar in structure and purpose to Black Sea Economic Co-operation would be most helpful. The *Silk Road* secretariat in Baku might be a good first start. It will provide a new means for the region to co-operate in forging relations with outside powers and setting up some machinery for economic co-operation and dispute resolution among themselves. Other regional institutions are expanding: last April, during the festivities for NATO's 50th Anniversary, the leaders of Georgia, Ukraine, Azerbaijan and Moldova met with Uzbek President Islam Karimov at the Uzbek Embassy in Washington, and announced that Uzbekistan was to become the fifth member of GUAM, forcing the alliance of former Soviet republics to change its acronym from GUAM to GUUAM. GUUAM member countries seek to expand their co-operation as part of the TRACECA project, the Euro-Atlantic Partnership Council and NATO's Partnership for Peace programme. They also seek to pool their efforts against local threats such as terrorism, secessionism and religious extremism.⁴¹

Greater flexibility in Western policy toward Iran is needed. While recognising that the Iranian state has not abided by rules of international conduct through its past support for terrorism and in its violation of human rights at home, today Iran could well be in the midst of an important transition. A struggle appears to be underway between moderates and more extremist groups. This is not to say that the West should rush to sign contracts with Iran. Iran must be convinced that its reintegration into the international community hinges on definitively ending those practices which led to its exclusion in the first place. But the time for dialogue is fast approaching. The West should be prepared to support positive domestic changes in Iran by showing a willingness to re-establish economic ties. If events move in this direction, lower cost options for moving Caspian oil and gas could materialise.

The Russians for reasons of geography will continue to perceive certain vital strategic interests in the region and will feel these more profoundly than the Americans. Indeed, the Russians do have legitimate concerns that regional

instability could create problems within their own territory; but of course, any Russian temptation to destabilise the region for short-term economic gain should be discouraged. Indeed, such behaviour on the part of Russia has only lowered its leverage there and will certainly discourage the region's states from forging healthy economic ties with it. The Russians must find ways to make its pipeline system available without using it to club its competitors. Russia must recognise that if it wants to remain a player in the Caspian market, it must be able to provide services to the region that do not tie the hands of the Caspian states and local and foreign businesses. At the same time, a proliferation of redundant pipelines would undermine the economics of their infrastructure.

Deepening Western dialogue with other political forces in the Caspian region through EAPC and the NATO Parliamentary Assembly would be welcomed. Along these lines, it might be very fruitful to organise NATO PA Rose-Roth Seminars in the region.

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THE FUNDAMENTALS OF ECONOMIC STABILITY AND SECURITY IN CENTRAL AND EASTERN EUROPE

Todor Dimitrov

*Head of the Centre for Strategic Development,
Institute for Advanced Studies, Vienna*

The Link between Economic Stability and Security

While opinions differ when reviewing factors of economic stability and development, there is clearly a common endorsement of the belief that economic stability is linked to security. Therefore, addressing the issue of security in Albania and Ukraine, speakers actually focused on the search for solutions to the severe economic problems of these countries.

Indeed, “economic security is constructive - building a strong economy within” by opening of borders and “military security is defensive - keeping one’s enemies out”, as stated by David Snelbecker. This implies an eventual policy conflict - economic dependence from the “enemy” is undesirable, as it was during the cold war. Hence the importance of the ability to determine identity and threats in a post-Cold War globalise economy, where it is much more difficult to find out who is the “enemy”. To this end, one should note the interdependence of economy and security, noted by Ambassador Comanescu, i.e. it is not only that a secure environment requires a healthy economy, but also that economic policy and development depend on how secure the environment is, both in real and “perception” terms. The perception, or definition of “friends” and “enemies”, determine the political and economic orientation of a country while reality (such as regional instability) affects military spending and opportunity costs such as capital flight.

It is important to recognise the complexity and reflexivity of the issues of economic development and security as they could easily enter a self (re)inforcing relationship. The policy implication is that it is essential for the infant nominal democracies of Albania and Ukraine to achieve a sense of identity, supported by an integrated economic and security policy. Furthermore, it is important that such a sense of identity develops within an environment in which the role of borders diminishes, as the latter could offset the inconsistency of state attitudes in distressed countries.

Another need is to combine efforts to improve economic performance with efforts to establish social and international cohesion and co-operation, as the

latter affect the flow of both financial and human capital. In other words, ensuring a stable economic environment needs domestic and international networking that would abolish barriers to trade, ideas and factor flows.

Economic Stability Endangered

Very volatile economic environments have become a serious source of concern and instability in a number of countries, Albania and Ukraine included. These environments are marked by severe overall macro-economic instability, a slow pace of reform, weak institutions, high domestic and international debt burdens, a dominant informal sector, and crime. Another common denominator is the absence of the rule of law, of checks and balances (civil society), of competition, and of a social safety net. The outcome is hence very discouraging: decapitalisation of assets and human resources, increasing poverty and marginalisation, declining life expectancy, and mounting social tension. In other words, all the necessary fertilisers for insecurity and a loss of will for further reforms.

All these features are generally recognised by most authors. What might need further clarification is how long and how much the erosion of quality of life could continue before it results in the sort of social unrest and anarchy that have occurred in several post-communist countries, including Albania. If one looks at current statistics, it is already difficult to explain why and how societies in countries like Albania and Ukraine continue to maintain relative peace and stability, despite the devastating costs of their reforms, or indeed the fact that there has been no reform. To many people's surprise, these countries, like Russia after the 1998 turmoil, have not collapsed entirely. It is important to understand why - otherwise forecasts and policy recommendations will fail.

One policy issue is though clear. It is necessary to fight against the factors that informalise the economy and not against the informal sector itself, because this performs an important economic and social role, especially when the absence of adequate governance and rule-of-law prevails. Another policy issue is to help the informal sector to become part of a modern and efficient registered economy when the institutional environment allows. This also implies a better estimate and understanding of the informal sector capacity, since this might be strong but not unlimited. In other words, it is essential to know when and why society is facing social unrest and collapse due to unbearable costs. Meanwhile, the free market in such countries will continue as it is: messy, opportunistic, secretive, and violent. This erodes the will to have a market in the first place.

Root Causes of Current Economic Problems

The state - good or bad

The state in many South-Eastern and FSU countries is both weak, when it comes to rule of law, transparency, accountability and public goods, and strong

when it comes to monopoly, red tape, political lending and misallocation of resources. This dual nature of the state is probably the source of disagreement when its role is being addressed by speakers: opinions clearly differ from a straitforward neo-liberal approach of downsizing the state by rapid disengagement from economic and social life (David Snelbecker), to views that see strong state intervention as a key need for building/enforcing the institutional/regulatory environment that is essential for sustainable economic growth and social development (Prof. Genc Ruli and Dr. Vira Nanivska).

Both groups have strong arguments. On one hand, the poor performance of the state as a regulator and allocator of resources. On the other, the harmful effects of an unfettered market such as deregulation, an absent social safety net, rent-seeking, crime-oriented privatisation and the drain of assets.

While it is clear that the state has to remove itself as an owner of assets and administrator of industries, its performance as policy-maker, regulator, social peace-keeper (safety net), institutions and law builder, investor in human capital and as the instigator of financial system safeguards is badly needed. The often-stated fact that the state has limited skills and capacity to cover the above needs is no justification for its abolishment or marginalisation. It justifies the acute need for public administration reforms, bottom-up pressure for change, training, and international hands-on support.

The old Washington consensus for economic development based on simplistic measures such as “liberalise everything, privatise everything and then pull back” might have achieved figure-based stability in Chile, but obviously do not work in C&EE. Here, governments cannot pull back as this only enlarges the vacuum within which monopolies and organised crime thrive, thus adding to social tension and unrest.

It is a role of the state, backed by civil pressure, assistance and public support, to ensure that markets deliver efficiency and stability. This requires more than low inflation, it requires sound financial regulation and its enforcement, competition policy, and policies to facilitate investment in technology and human capital. It also requires that resources match policy objectives, otherwise the key objective of improving the quality of life (by comprehensive, sustainable socially fair and democratic development) becomes divorced from the means to achieve it, such as GDP growth. GDP growth, monetary stability and functioning markets become meaningless if not geared to the ultimate objective of a better, safer, value-adding life.

It must be understood that state policy and its enforcement, with the hands-on support of the international community, have to keep the economic and social costs of transformation under control as these can be devastating. When lives and families are disrupted, money replaces intrinsic values as the only means for survival, poverty spreads, crime increases, and overall living standards decline. When this leads to social and political turmoil, security is gone.

Economic performance, security and global integration

David Snelbecker explains that “oligarchic socialism” did not appear in Central European Countries because market-oriented enterprises (mostly SMEs) became widespread and strong at the early stages of reform and the economies were open to international trade and contact with the rest of the world. While this is true - a result of civil society and market features that were present in Central Europe even decades ago - the issue is how to overcome the weaker starting conditions and policy capacity in countries like Albania and Ukraine that suffer from both geographical and cultural isolation from the rest of the world, the EU in particular. It should be mentioned that even in Poland and Hungary, transition costs are still high, ups and downs continue and decisive bail-outs were essential, e.g. about 50% debt forgiveness for Poland, despite its relative economic strengths compared to most other states in C&EE.

As to the capacity to design and implement sound economic policies, it has to be stressed that a number of factors that actually widen the existing gap, rather than close it, deserve more attention in the context of international co-operation:

- For achieving an impact, a critical mass of reforms, hence resources, is needed. This means that while reforms have to be enforced, bearable social consequences/costs have to be maintained. Furthermore, a widely supported “carrot” such as EU membership and hands-on international support geared to strategic goals such as EU integration will be essential.
- One should note that EU-associated states in C&EE have benefited from both domestic mobilisation towards a comprehensive objective (geared to results rather than means, i.e. a better standard of living, realistic or not) and a more streamlined international support geared to EU-matching institution building, as argued by Vira Nanivska in her paper.
- Easier mobility of both people and goods in many countries proved to be an engine for positive change, facilitating earlier adoption of new standards, ideas, and business practices. Therefore, a more imaginative approach to EU enlargement has to prevail if security of Europe is indeed the ultimate goal.
- As emerging markets are very vulnerable towards shifts in international financial flows over which they have no control, there is a clear need to address issues of risk management in an international context, as the step from financial to security crisis might only be a short one (remember Indonesia in 1999).

A key implication is clear: concerted action against contagion effects and systemic risks is needed to arrest both the domestic and international spread of social devastation. In this regard, market forces are insufficient, regulation and governance are needed as well as bail-outs that do not spread moral hazard. Easy to say, difficult to ensure. However, when such measures are not enforced, it is essential to maintain formal and informal social buffers, such as a targeted

fight against poverty and support or at least acceptance of the shadow/barter economy respectively. It is not barter trade that causes weak financial and fiscal systems, but the other way around.

International aid - dust in the wind?

Often, to cover all the requirements for reform to be successful, international aid has a key role to play. This role appears to be highly debated and controversial - opinions vary from describing aid as marginal or as essential. It is also accused of spreading moral hazard and dependence. The EU assistance to Ukraine is seen as sizeable and effective in the paper of Mr. de Laroussilhe. He believes that the EU, as a large donor, has substantially contributed to a better policy direction after the 1991-1994 strategic policy mistakes of the Ukrainian government, though admitting that aid should be restructured in order to achieve focus on fields where more progress is observed. He also states that objectives should become more realistic as otherwise false expectations erode credibility. On the other hand, there are many critics of the EU and other donors' assistance, stating that aid programmes have been inefficient, inappropriate, and have had little or no impact. This position is expressed by Vira Nanivska in her paper.

To achieve a realistic assessment of the role of aid one should consider that commitments to aid often play a steering role by ensuring direction and support that are seen as an incentive by both policy makers and the public. This is clearly the case when the donors' commitment is tangible, e.g. the commitment to enlarge EU membership as mentioned above. In other words, prognosis and expectations geared to improved standards of living bring enthusiasm and support for reforms. However, lengthy reforms (whether real or virtual) and declining living standards do not match the often unrealistic expectations and result in evaporating support for reforms, as well as the rise of protectionism, nationalism and authoritarianism. Therefore, the role of aid is often negative if clearly defined objectives do not exist or were not reached, because what remains is mixed feelings, a sense of dependency, incapacity and even humiliation.

This does not mean that aid could succeed without the proactive role of recipient governments. It does, however, mean that aid has to anticipate and ensure this role. There is no doubt that ownership of reforms should be national. However, if support is international, the responsibility for failing measures has to be shared. If the governments of Ukraine and Albania have to take the drivers seat in the collapsing reform vehicle and aid has to guide them from the next seat, it is not efficient or fair if the driver knows that only one airbag is installed - to protect the donor.

As argued by Dr. Nanivska, it is time for reconsidering and restructuring aid if any impact is to be expected. A key need is a more comprehensive gearing of aid towards impact and goals. Public administration reforms, SME support, third pillar support and policy advice are among the key goals, but to achieve them it is necessary to build sound national capacities, both institutional and

human, as well as ensuring the higher mobility of people and ideas outside the limited frame of aid.

Another essential task is to ensure more transparency and streamlining by not mixing demand-driven (official) with supply-pushed (de-facto) approaches. Focus, vision, responsibility and better accountability are needed within a new global context of values that should not be dual (e.g. supply should be geared to impact rather to promoting the implementing agents).

Aid should be seen as an investment in the future for common safety and prosperity, rather than remain piece-meal, lobby-pushed and cosmetic. It has to create the critical mass of resources that would ensure transformation, otherwise it will be wasted. It has to demonstrate cases of excellence and disseminate best practices. In order to ensure this, it has to have a critical mass of resources as well. While it is difficult to determine, current aid budgets of 0.1%-0.2% of annual GDP clearly cannot have an impact on distressed economies as empirical evidence suggests that budget deficits of such magnitude do not make a difference.

Policy Conclusions

As capitalism needs more than private ownership and money values, it is essential to ensure a widespread acceptance and performance of rules and safeguards that result in competition, a social safety net, security and predictability. This requires a new role of the state and international aid, as well as the development of domestic human and institutional capacity. It also means that privatisation and liberalisation should be accompanied by regulation and enforcement - otherwise results will remain discouraging.

All policy measures have to be geared to bearable social costs and their impact on the quality of life, not on means per se, such as inflation and growth. To this end, the fight against poverty and social exclusion should go hand in hand with the fight for competitiveness and efficiency. Sound international networking and integration will be essential to achieve this.

In a situation of distress, simple policy instruments should prevail. This implies the abolishment of multiple licenses, taxes and confusing regulation that fuel corruption and force businesses into the shadow sector. An SME-friendly environment is at the core of economic and social success. Hence the need for adequate investment in human capital, networking and mobility of people, ideas and capital. This also requires a diminishing role for state borders.

A certain level of economic development has to be achieved and international support is a critical starting point. Only then will policies and democratic governance become feasible vehicles for growth and stability. Hence the need to abolish unfeasible aid conditionalities in pre/post crises situations. To this end, international aid could play an essential role if a new, realistic mode of content and delivery takes place. In critical situations, this might require aid

agents to assume more responsibility and risk, in proportion to that faced by the recipients.

Stability can easily be eroded by systemic risks, such as financial systems default. Therefore a focus on preventing domestic and international contagious effects is essential. This requires due diligence, early warning, supervision and regulation because markets do not protect themselves. Markets need frameworks and institutional back-up, as well as an evolution in concepts and instruments in an ever-changing environment.

No miracles, no perfection. Keep on trying with the support of research, debate and openness of approaches. Do not wait until the situation becomes hopeless and desperate, when the competition of arms replaces the competition of markets.

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ECONOMICS AND SECURITY: COMMENTS AND A SUGGESTED FRAMEWORK

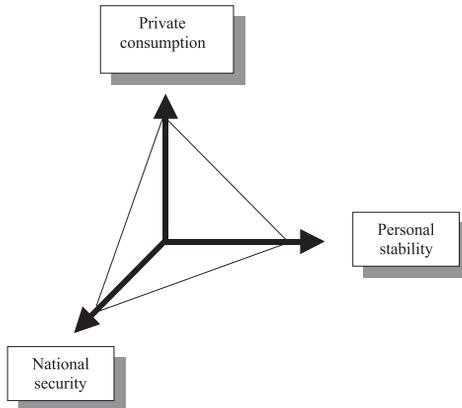
Martin C. Spechler

*Professor of Economics, Indiana University,
Indianapolis, Indiana, USA*

Despite the many excellent observations made by the speakers at this Colloquium, there remains a lack of clarity about the relationship between “economy” and “security.” Though some have called this “obvious,” I believe that the relationship is complicated and often subtle. A review of some of the best ideas at this Colloquium will show how complicated the relationship is at present in Eurasia.

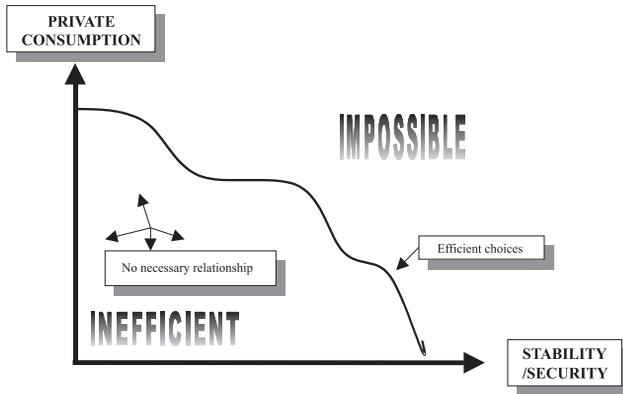
Economists have long recognised that any economic system may aim at more than one objective. Among them are growth of consumption, equity, stability, and the preservation of peace.¹ “Economy” is not an objective itself, but rather the rational pursuit of some combinations of these objectives, where (static) efficiency means achieving maximum current welfare from existing capabilities. Since a society has several possible objectives, it must somehow consider the choice among them. Given adequate attention to equity and other objectives, therefore we may conceive the three dimensional surface representing the possible combinations of consumption (whether provided by private or public goods), stability (meaning the avoidance of the unexpected²), and national security. (See **Figure 1**)

Figure 1 : The Consumption-Stability-Security Surface



If we were somehow to collapse the stability and national security objectives into one variable “security,” we would have a two-dimensional frontier, similar to the familiar production possibility curve of elementary economic theory. (See **Figure 2**)

Figure 2 : The Consumption-Security Frontier



Along the consumption-security frontier, we see efficient choices of maximum consumption at each and every level of security, and vice versa. The precise form of the efficient trade-off is not well defined, however, hence the wavy representation of a generally downward sloping line.

The point of this theory is to show that the relationship between consumption and security depends on the state of the economy. In most transition economies, which have a large degree of inefficiency, policy measures may improve both consumption and security or may improve only one or the other or may in the worst case actually detract from both objectives. Only when the economy is efficient is there a necessary trade-off between security and consumption, such as when a society decides to provide universal health insurance or last-resort public employment for all working age adults. Both would sacrifice consumption for increased security. Enhanced GDP might not lead to greater national security. Of course, a society which is on the efficient frontier may drop below it owing to unwise economic policies, but social choice among the ultimate objectives is necessary and may of course change with circumstances. Some countries habitually emphasise employment security at some expense of consumption - Germany, for instance - while others have tried to expand consumption instead of spending on national defence - Japan, for example. The USA and the former USSR have chosen to spend on national security at the sacrifice of consumption; needless to add, these choices were not always made democratically. The USSR, unlike the USA, provided a high degree of personal stability (fixed prices,

generous pensions, free health care and education) at a further sacrifice of personal consumption.

Several of the most important ideas raised at this Colloquium show the use of this framework and are worth emphasising in any case. Dr. Andrei Klepach asserts that the Russian need to preserve national unity requires higher defence spending, while its suspicion of foreign direct investment reflects a fear of loss of national patrimony or of control over peripheral regions. The severe concentration of FDI in a few regions, as reported by Keith Bush, poses a threat to central control. Professor Alexander Kennaway says that Russia's desire to remilitarize and to increase arms sales comes in considerable part from the military-industrial complex, though, not necessarily from a broad social consensus. Mr. Bush adds that arms are among the few items that Russia can successfully export at this time, so emphasis on their production need not be inefficient. Where large plants are isolated in small cities, as has occurred in Russia, local governments press to keep these open at all costs - another move which emphasises security, but not necessarily at the expense of consumption or efficiency, to the extent worker families would have to be supported anyway.

Mr. Gérard Wild stated that the need for personal stability and equality had been reinforced among the Russian people by the Soviet practice of high social consumption and provision of health, education, and housing, albeit at a fairly low standard. Mr. Wild also made the excellent point that Russia's concept of security has been conditioned by its long history of openness to foreign invasions on all sides.

Prof. Silvana Malle and Dr. Rostislav Kapelouchnikov both stressed the long-term inefficiency of protecting jobs. But Russians' preference for stability and security at the expense of consumption is not necessarily inefficient. Kapelouchnikov's data indicate that Russians easily abandon unattractive jobs in fact, though they retain job rights to return. They sometimes take critical equipment with them! This indicates that new enterprises would have little difficulty recruiting skilled workers. Indeed, highly skilled nuclear scientists are all too likely to leave Russian nuclear establishments to work for rogue regimes abroad. Hence "creative destruction," in Joseph Schumpeter's terminology, is not necessary to establish new activities when the economy is massively inefficient, as is the case in Russia. Only when the economy approaches the consumption-security frontier would it have to destroy low productivity capacity in order to liberate resources for more productive uses.

Turning to papers dealing with the Balkans and Caucasus region, several presenters urged the advantages to their countries of integrating with the European Union and with NATO. The promise of such accession, even if remote in time, is seen as a stimulus to continued reform and liberalisation. But only the representative from Georgia gave any attention to regional cooperation and integration, which could occur more readily and arguably would have greater benefits in widening the regional market, allowing economies of scale in

manufacturing, facilitating transportation and competition in the domestic market, and so forth. Since Adam Smith, economists have believed that the division of labour, a key to increased productivity, is limited by the extent of the market. Hence, as American and European prosperity amply demonstrate, a larger free market contributes to prosperity and a better choice among objectives. In other words, the relevant frontier in **Figure 2** would be shifted further to the north-east. Dr. Friedemann Müller considers such cooperation unlikely at the present because of political conflicts and suspicions among the newly independent Caucasian states. The GUUAM grouping does not include Armenia because of its unresolved dispute with Azerbaijan over the Karabakh. Such regional conflicts are why outside investors and groupings are embraced. To some extent, the earlier Visegrad and Baltic groupings too have lost credibility and interest, as some of these countries prefer the larger and richer European groupings.

When it comes to growth based, at least at first, upon the export of oil and gas, as is the case in the Caspian Basin, national security and consumption are complementary, not a trade-off. Pipelines, pumping stations, and ports assume security. The integrity of the Baku-Supsa pipeline cannot be guaranteed without the policing of Georgia and Armenia, states that are on or close to the export route. The unreliability of the Baku-Novorossiisk pipeline through Chechnya demonstrates this elementary fact. Dr. Kairat Abuseitov of Kazakhstan particularly stressed this point.³ All representatives from the Caucasian states, notably Dr. David Aptsiauri and Prof. Neil MacFarlane, call for cooperative arrangements which will benefit all states from the transit revenues due to increase once oil throughput increases during the next decade. What is more, multiple exit routes - including the Baku-Ceyhan corridor promoted by Turkey and the United States - reduce the possibility of pressure from any regional power upon the small states of the region.⁴ Competition would also permit lower fees and more reliable revenues.

In the present author's opinion, too little attention was paid at this Colloquium to non-traditional threats to security and stability which undoubtedly also threaten consumption and general prosperity. These include criminal gangs, terrorists, drug smugglers, and rogue experts on nuclear, biological, and chemical warfare who are available for hire by states opposed to the present world order, as expressed in the UN Charter. North Korea, Iran, Iraq, and Libya are all declared enemies of members of the United Nations and NATO. Such declared hostility cannot be dismissed lightly.

General economic distress doubtless makes non-traditional threats more likely, as governments cannot control malefactors or provide alternative employment, but it seems improbable to this observer that a general palliative will be effective and propitious. We simply cannot provide enough resources to revive the lagging countries of the former Soviet Union, nor can we be sure when they will do so on their own. Rather, specific remedies, such as the Nunn-Lugar program to buy and disable ICBM's, are to be sought. Cooperation of the NATO allies

with Partnership for Peace countries as well as Russia is essential to dealing with the common threats. Full cooperation, though, will require reducing suspicions about spheres of influence, unilateral advantages, hegemonialism, and so forth. To be frank, recent NATO actions in the Balkans may have engendered such suspicions in Russia. A great help in reducing suspicions would be renewal of nuclear force reduction talks between the United States and its NATO allies on the one hand and the Russian Federation, on the other. Another would be the confirmation and strengthening of the ABM treaty to protect both the NATO countries and their neighbours to the east from missile threats from rogue states.

Notes

1. John Michael Montias, *The Structure of Economic Systems* (New Haven, Connecticut: Yale University Press, 1977). This is known to specialists as the Koopmans-Montias framework.
2. The most significant forms of instability are involuntary unemployment and unexpected inflation of the general price level. During hyperinflations or repressed inflations the lack of goods normally available is another form of instability.
3. Dr. Abuseitov extended the point to water supply security, a crucial consideration for down-river states such as Kazakstan and Uzbekistan.
4. As Dr. Müller comments, Russia accepted sectoral division of the Caspian undersea resources when its threat to use force was ignored and the littoral states acted to lease out concessions in their sectors. An agreement was signed in July, 1998. This **fait accompli** has been accepted by Russia, which now has a stake in Azerbaidjani oil exploitation.

THE LINK BETWEEN ECONOMICS, STABILITY AND SECURITY IN A TRANSFORMING ECONOMY

Katarzyna Żukrowska

Institute of Development and Strategic Studies, Warsaw

Introduction

Links between economics, stability and security were defined differently before the Cold War, during it and now today as they adjusted to consecutive stages of international relations. This difference resulted in different security models as well as different economic models. In the past, the security model was based on balanced confrontation between the powers or superpowers and their allies. This was the case both in a multi-polar and bipolar world. Currently, security is based on interdependence and cooperation between states and is enhanced by globalisation, liberalisation and established institutional structures.

Economics in the past was based on a national, and to a large extent self-sufficient model, which naturally excluded the possibilities of significant external cooperation. Protection against external competition was considered to be one of the tools of state economic policy. This in turn led to partial isolation on the one hand, while on the other it increased susceptibility to economic depression.

Security now depends to a larger extent than ever before on internal rather than external factors. The lack of an external enemy can even be considered in specific conditions as one of its features, which on its own can be regarded as destabilising. This does not mean that we should regret that the old system has been replaced by a new one, even though the new system magnifies internal conflicts to a much bigger size that would have happened in the Cold War era. This is true first of all in most post-communist states, mainly those which were multinational, incorporated minorities or faced religious or cultural conflicts. Remedy for this was found in a quick departure from the old system as well as from transition depression, setting the economy on the path of accelerated growth.

In the past, the security model was based mainly on hard security dimensions (military), while the soft dimensions (non-military) played a limited role. In the contemporary stage of international relations, the roles of both soft and hard dimensions have changed, which means that the “soft” are now taking the lead. This is happening on two levels: international and national. In some states, the process is not smooth because of economic and/or political instability.

Hard and Soft Dimensions of Security and the Linkage between the Triad

The linkages between the triad security-stability-economy in the case of hard security dimensions (military) are rather clear and obvious. A state can cover the costs of military expenditures when its economy is strong and healthy. Moreover, it is easier to spend money on military purposes in the light of a more or less realistic threat from outside. Decisions to spend money on defence are taken easily when there is pressure among states to do so. Financial sources can be used to cover the costs of weapons imported from abroad.¹

Some experts argued (Knorr) that in such circumstances wealth is thus tantamount to mobilisation potential, if not in the short term then at least in the medium or long run.² According to this line of reasoning, says B. Moller, the economic power of a nation inevitably constitutes a latent threat to its adversaries, hence the desire not to contribute to the economic development of one's enemies or opponents, if need be, even embargoing trade with them. This view was popular in the USA throughout the Cold War period, including the period of detente in the 1970s. Further on, Moller points out a paradox, that this concept is in sharp contradiction with liberal views of international trade (A. Smith, D. Ricardo, etc.), which assumed that trade has beneficial effects in reducing the threat of war.³ And he is correct in his reasoning, although the conformity is only partial, as can be found in American economic policy that in many respects was protective.

Nevertheless, the foreign policy of the USA - especially its role in international organisations as well as in international scientific cooperation - can furnish us with evidence of practices which were clearly contradictory to some protective activities that could be found in economic policy at the national level. This brings us to the finding that, because of political reasons and internal tensions, it is easier to use at the same time two contradicting policies: (1) protective at the national level; (2) liberalising at the international level. The result of a combination of the two is rather clear since it calms down tensions on a national level and brings liberalisation despite the applied moves. The effectiveness of such a policy is guaranteed by the fact that undertaken decisions are put into practice with a certain delay that releases the authorities from the responsibilities of power and confronts new governments with the results of certain commitments undertaken by its predecessors.

The hard dimension of security has not totally disappeared, although the role of this factor is changing. First of all, the new security system is interdependent and cooperative, which means that states cooperate in the sphere of security. Moreover, they start to cooperate closer in arms production, which stimulates standardisation of arms or even globalisation of arms technology, which in turn follows the pattern of globalisation in civilian technology. This finding is based on much evidence, suffice to enumerate the most important:

- Shrinking internal and external demand for arms supplies fostered international cooperation in arms production. This was additionally speeded up by growing costs of technology, the asymmetry in sales between the US and EU (or Europe-NATO), and by Article 223 of the Treaty of Rome which still excludes the necessity of competition (no request of open international tenders) in arms procurement in the European Single Market.
- The end of the Cold War enabled a departure from the idea of self sufficiency, deriving from a temporal approach to certain security arrangements.
- The lack of a need to be neutral in the international arena.
- The increasing share of dual-use technologies in arms production.
- New systems of technology transfer controls that are universal and open to post-communist countries.

In the case of soft dimensions, the linkages are relatively more complicated as it is difficult to be precise in defining what are the soft (non-military) dimensions of security.⁴ In the case of hard dimensions (military), a country is safe when it has enough arms to defend itself within a coalition, as self-defence is to some extent impossible in the contemporary world. Even small coalitions will not prove to be sufficient in terms of cost effectiveness. In other words, a country cannot be secure by building-up its military potential on its own or in a small group of interested states. This finding is based on two assumptions: on the one hand, high military expenditures compete with other expenditures within the state budget limiting the wealth of the nation, while on the other hand intensive armaments counteract with the extensive development of international trade, a factor creating wealth and stability.

Factors other than solely military have to be taken into consideration when the non-military dimension of security is studied.⁵ One can mention a list of factors that seem to be important here, such as:

- **Size of the country.** The smaller the economy, the easier it is to change and vice versa.
- **Stability of the economy.** The problem here is ascribed to the applied strategy and its effectiveness as well as to the difficulties faced in introducing changes.
- **Stability of the political system.** This does not mean that systemic transformation requires stability of the government (as the Polish practice proves). More important is the continuity of the strategy of systemic change.
- **Relations with neighbours** should be stabilised and proper.
- **Ability to adjust** to changing internal and external conditions.
- **Institutionalisation of external relations.**
- **Opening-up of the economy** and the scale of interdependencies which form mutual interests.

These elements do not only matter in the case of developed market democracies but they also play an important role in transition economies. What has fostered such a situation? Generally, there are four reasons: (1) rejection of the command and distributive system by countries where it was applied; (2) changes in the

former Soviet Union itself; (3) changes in the relations between the former two superpowers; (4) changes in the architecture of international organisations.

In the literature, there are three principles taken into account that brought about changes to the former Soviet foreign policy. They embrace:

- The liberalisation of external relations and dimension towards democracy.
- The will for interdependent economic relations with the West.
- Influence of international law and international organisations, which has shaped the CSCE system.⁶

These changes have brought post-communist states onto their path of building democracy, which is being done in an accelerated manner helping to overcome the delays caused by the Cold War era with its divisions into two spheres of influence.

Democracies rarely engage in war. The link between economics and security was always rather obvious. Stability in this context can be seen in two ways: as political stability and as economic stability. A lack of stabilisation in one of the mentioned fields, let alone both, can be dangerous as has been proved by historical precedent. The most dramatic illustration of the existence of such linkages can be found in the 1930s, when deep financial crises caused an increase in unemployment and gave ground for fascism in Germany and elsewhere. The economic experience proceeding World War II led economists to certain conclusions, which resulted in the creation of a special safeguard system of international organisations, which are commonly known as the Bretton Woods System (1944).

The Bretton Woods Institutions: namely International Monetary Fund, General Agreement on Tariffs and Trade and Bank for Reconstruction and Development (commonly known as World Bank) with surrounding institutions like the International Financial Corporation, became in a short period a symbol of the division of the bipolar world. They were established to foster interdependence among separate economies, and to promote mutual trade and economic development. This was conditioned by liberalisation, both internal and external.

Currently, the system of international organisations has gone through deep reform, which embraced: (1) depoliticisation of international organisations; (2) democratisation; (3) universalism. Organisations representing non-democratic and non-market concepts were closed down. This has happened with COMECON (CMEA), the Warsaw Treaty Organisation and COCOM. Some other organisations were reformed or changed. This was the case with GATT/WTO, NATO, EEC/EU, CSCE/OSCE, etc.⁷ All these changes indicate that the new system of international organisations sets aside structures that were established in the period of Cold War that reflected divisions. The new system supports solutions that are common in their character.

Protected (read national) economies are not able to liberalise. Generally, liberalisation is in contradiction to protection and national self-sufficiency. The two tendencies traditionally opposed one another. A national, protected economy

experiences deeper crisis when the economy slows down. All this was proved in the first years after the war and the first years of EEC integration can serve as the best example to illustrate this. As a result, liberalisation (read integration) was accelerating in periods of prosperity and slowing down in stages of low growth. This proved that liberalisation needs some type of standstill arrangements, which would stop the achieved stage of liberalisation from being reversed. Moreover, it became clear that autonomous steps could be reversed, while international arrangements are more stable.

International economic organisations and their roles in liberalising international relations were not performed without obstacles and controversies. Nevertheless, they have flattened the cycle of economic fluctuations by liberalising trade, reducing tariff barriers as well as removing remaining obstacles to trade that acted in a similar way. They have expanded liberalisation into new areas like capital flows, services, intellectual property, agricultural products, food, textiles and leather products, namely sensitive goods. Step-by-step, this all led to a closer coordination of economic policies amongst the group of leading economies.

At the same time, those countries which are now in transformation were developing according to their own rules. Companies in their case functioned without competition. The main stimulation tool was ascribed to central plan. The positive effect of the model of the centrally planned economy was ascribed to achievement of full employment. This picture, as we all know, was an artificial mirage and a camouflage of certain occurrences:

- Full employment in reality was over-employment.
- The model resulted in an economy of deficit, in which supply was not sufficient to cover demand, forcing people to save when they wished to consume.
- The state pretended to pay - the workers pretended to work.

This vicious circle was broken by systemic transformation in which international organisations played an important role. It is worth stressing that this role was important but not crucial. The leading role was played by national governments, which have transferred part of their sovereignty to international institutions and prepared the national economy for integration into the mainstream of the world economy with its institutional arrangements, market forces and competition. International institutions gave advice on how to change and what should be changed, applying the results of their own practical experience gained in the process of recovery after World War II and in cooperating with developing economies. The results of this cooperation between international organisations and transforming states are obvious, although differentiated from state to state and from economy to economy. These differences occur because:

- All countries were not starting their reforms at the same moment. Some were early starters, others were late comers.
- Existing differences at the starting point of reform.

- Some understood what the advisers from international institutions were saying, others not.
- Some prepared detailed reform plans, which were consecutive and conditioned not only in one field but also interdisciplinary, again others not.

After the end of the Cold War, it was clear that the economy of each post-communist state was like a turtle lying on its back, desperately needing external help to get back on its feet. The same is true with the national economy of each East-Central European country, which needs an external force to push it onto the proper track.

The early experiences of Poland, Hungary, and the Czech Republic show that international organisations know their job and are able to lead a transforming country from production decline to growth. The organisations are not only furnished by special forces to do so, but they are experienced as to how this should be done. The prescription given by international organisations involves the government of each nation state which has to prepare all the details of transformation, including: (1) changes to institutions; (2) changes in the tax system; (3) liberalisation of foreign trade; (4) liberalisation of prices; (5) decentralisation of state administration; (6) restructuring of the state budget on the side of revenues and expenditures, and so on. The international organisations supply the transforming countries with a framework of systemic changes, and they give their experts and experience gained in applying strategies in different regions of the world economy (Latin America, Asia, Africa and less developed economies in Europe).

In sum, let us try to define what are the soft dimensions of security. It becomes clear that they embrace:

- A well established and properly functioning market economy which is preconditioned by liberalisation, both external and internal.
- A well established and properly functioning democratic political system.
- Internal institutional arrangements.
- Established relations with neighbours.
- External institutionalisation.
- Acceptance of systemic reform measures by the voters - this is a precondition for the achievement of social stability.

Three Stages of Economic, Security and Stability Models

The link between economics, security and stability should be viewed dynamically, which helps us to understand the current state and linkages between the triad, also indicating the goal towards which we are heading. This analysis is limited to the 20th century, in which we can generally distinguish three consecutive stages of international relations that have influenced the examined triad - before, during, and after the Cold War. Looking closer at the security model, we find that it changed in the three phases according to the presented pattern:

- **Multipolar model**, based on the military dimension, in which economics clearly played a secondary role. The defence doctrine in this period was based on self-sufficiency, which was followed by self-sufficiency in production. Attempts to create coalitions led to confrontation because they were based on political common interests, which did not last long and were not stable.
- **Bipolar model**, established after World War II, lasted about 45 years (1945-1989), during which the economic dimension slowly gained importance leading to a situation in which the ground was prepared to take over the lead from the military dimension. The security model in this period was based on deterrence.
- **Nonpolar model**, established after the dissolution of the SU and WTO (Warsaw Treaty Organisation), evolved from a **unipolar construction**, which was a **transition solution from the bipolar model**.⁸ In the unipolar model, the main role in international stability is ascribed to the USA and NATO, but at the same time an important role is played by remaining international organisations, namely: EU, OCSE and WEU. Moreover, the decision as to whether to intervene because of humanitarian reasons lies with the Security Council of the UN. Stabilisation of the nonpolar model is conditioned by the increasing role of international organisations as well as further liberalisation of international relations. It is also crucial to create certain balanced powers within the system, which can be achieved by political integration of the EU and the establishment of closer economic ties between the EU and US as well as with Russia and Ukraine. This should be achieved in certain consecutive stages according to the model just presented, which fosters first integration of strong markets before weak markets are liberalised.

Thinking about contemporary security models in terms of unipolarity is an inheritance of Cold War rhetoric, since there are no clear spheres of influence of the remaining superpower and regional powers. This new solution will not bring us back to multipolarity as it will not result in new divisions into spheres of influence, based on different political and economic concepts. New centres of power will embrace the EU, Japan, China and Asian countries, Russia with CIS (Commonwealth of Independent States), Ukraine. We can also expect that South American states can also form an additional centre in such an arrangement, if they decide to integrate. This can be evidenced by the newly signed Rio Agreement between EU and Latin America. The idea of nonpolarity sounds a bit strange for researchers engaged in security problems, but if one adds additional information about overlapping international organisations and their role in regional or global stabilisation, the idea gains more acceptance and looks realistic. It also finds support in changes introduced into the system of international organisations.

The economic models were also changing in the above-mentioned three consecutive stages of international relations, illustrated by three consecutive security models. Generally this can be shown three economic models that match the three mentioned security models:

- **Protective**, national model, based on self-sufficiency.
- **Slow departure from protectionism** and the opening up of the economy at regional and global levels, forced by the Bretton Woods Institutions and by regional arrangements (European Community, EFTA, OECD, NAFTA) as well as on bilateral terms.
- **Advancement of liberalisation in a globalised world**, in which economies and states become more and more **interdependent** (creation of WTO). It is clear that a country can gain advantage from globalisation under conditions of economic liberalisation (both internally and externally), which is a consequence of the development of trade (not limited to commodities but embracing also sales of intellectual properties and services) and capital transfers.

Taking the three models of security and economics, we can come to certain conclusions regarding stability:

- Post-war experience shows that democracies with an established middle class did not go to war and can be considered as stable economies.
- In most developed economies, the post-war period has resulted in the opening-up of the economy, which had a direct impact upon the shape of economic cycles, which became flat with long periods of growth followed by short and shallow depressions.
- Growth in liberalised economies, just as depression in national and protective economies, is quickly exported from one economy to another.
- Trade stimulates growth and wealth. Globalisation helps those countries that need to overcome the technological or underdevelopment gap to catch-up. This has been clearly proved by the experience of EEC integration, where the less developed countries have to some extent caught-up with the more developed economies.
- Depression also spreads as it did before, but its depth is limited by stand-by agreements concerning liberalisation, which make it more difficult to return to protectionist habits. Before, depression resulted in increased protection, which in turn had a negative impact on the size of production and exports thereby prolonging the depression. With liberalisation fostered within the framework of international organisations of both a regional and global character, this problem is eliminated.

In the case of post-communist countries, one has to face a huge **paradox**. On the one hand, there is no doubt about the existence of a development gap between the advanced democracies and those countries that have only recently embraced democracy. On the other hand, a strategy of catch-up has to be preconditioned by destabilisation of the economy, caused by liberalisation (internal and external) introduced in the stabilisation package. Liberalisation embraces the same policies as in the developed democracies, but also includes some additional moves, such as the introduction of currency convertibility, the decentralisation of foreign trade, and the liberalisation of prices. Liberalisation

in certain conditions can be dangerous for stabilisation. These conditions embrace the following situations:

- Mistakes can be made in introducing a stabilisation package.
- Numerous elements of a stabilisation package may be anathema to the politicians who have to introduce them, which produces hesitation and only partial fulfilment of the programme.
- Success of a stabilisation package demands deep knowledge about the economy and its interdependencies. It requires sequencing as well as the matching of different steps in different fields (economy, law, institutions).
- Hesitations and bottlenecks in the introduction of tough macrostabilization measures can result in disinformation as governments seek to cover-up the social side effects of such policies.

The most important problem to be overcome in introducing a macrostabilization package is linked with old knowledge based on a national and protective approach to the economy. The current stage of international relations requires first of all a redefinition of the notion of opening-up the economy, the scope of which cannot be measured any longer by the share of turnover in GDP. Using this indicator, one could say that the US has a closed economy, while Luxembourg's economy is open. This indicator is no longer sufficient. A more sufficient indicator embraces reduced barriers to international economic contacts, which cover:

- Custom duties for industrial commodities (embracing also sensitive goods).
- Liberalisation of services and capital flows.
- Intellectual properties.
- Free movement of labour.
- Exchange rate policy.
- Harmonisation of laws, institutions, taxes, state aid, intervention and its monitoring.
- Intensiveness of competition.

To prove the correctness of this view, one should look closer at the process of the creation of the Single European Market since 1987. Similar observations can be made after analysis of the adjustments introduced by all countries that are candidates for membership in the EU.

Links Within the Triad in Developed Democracies

In developed countries, the triad (economy, stability and security) is not so clearly seen as in the economies of East Central Europe. This difference can be explained by the fact that economic stability was achieved in Western Europe over a longer period of time and the process was stimulated by the introduction of gradual measures. Few people now remember that inflation was a problem in Germany, UK or USA. The same remark can be made about the cyclical development of the economy, which brought about deep depressions and social

destabilisation on a large scale, characterised by mass unemployment and bankruptcies.

Some signs of a lack of equilibrium in the markets of developed economies can be found in the statistics of unemployment, currently the highest they have been for a long time. Generally, the unemployment rate in the EU falls between 10-11% on average. This is because of high figures in Spain, Germany, France, Italy and Greece - much lower levels in Denmark, UK, Canada and the US. This is ascribed to deregulation, which will continue as seasonal workers come and go. Most of the reforms within the sensitive sectors were carried in the late 1970s and 1980s. This enabled changes in industrial policy, which is becoming more market oriented in that traditional intervention measures like subsidies and tax exemptions are phased out. In other words, this involves a departure from vertical towards horizontal intervention, which aims to achieve better flexibility of the producers. Despite the high unemployment rate, those countries also have an established middle class, which is not eager to be engaged in any action that could destabilise the security of the state. A comfortable life does not stimulate tensions; poverty does.

A list of destabilising factors beyond the realm of the economy would embrace such issues as:

- International organised crime.
- Ecological threats.
- Mass emigration from countries with a destabilised economy, where transformation failed having being conducted in the wrong way.

Generally, the experience of the last half-century suggests that the development of democracy and of the economy are closely linked. A vicious circle linking political destabilisation and macrostabilisation are often seen in transition economies. Economic instability can be counted as a source of political instability and as a factor that hampers economic growth.

Links Within the Triad in Transition Economies

In the contemporary stage of international relations, the observed increase in the role of the economic dimension of security puts the East Central European states in a very specific, not to say difficult, situation. This is naturally caused by the fact that economics today can raise numerous threats to security. This problem was widely discussed in Polish literature by specialised political scientists (J. Kukulka, E. Haliżak, R. Zięba, R. Kuźniar). The first and most important danger in this area is linked with weakness in economic potential inherited from the former socialist period. The potential of those states is limited as they produce (excluding FSU states) only 3.1% of the global GDP. If we take into account the fact that this territory is inhabited by 2.3% of the world's population, one could say that this share is a fair one in comparison with developing countries. Nevertheless, this comparison appears less optimistic if matched

against the highly developed states of market democracies. The disproportion existing in this area was additionally deepened by the Cold War. This is well shown by J. Sachs in his three brilliant lectures on “Poland’s Jump to the Market Economy”, where he points out, *inter alia*, how such comparisons looked in the case of Poland and Portugal.⁹ Still in the early sixties, the two countries represented similar levels of development, but as time passed, Poland started to lag behind Portugal and a development gap started to grow. Recently, GDP in Poland was 30% lower than in Portugal.

Differences between separate groups of countries in transition are even greater. On the one hand, this is caused by the scale of isolation and lack of competition, while on the other, by errors (wrong decisions) made during the first phase of transition. It is clear that the closer countries are linked with the EU (and other international organisations) the better their results are with transition. There could be some arguments showing that those countries represented different levels of development and openness at the starting point of reform. That is true especially when we compare the Czech Republic, Estonia, Hungary, Slovenia and Poland as the most advanced, and Bulgaria, Lithuania, Latvia and Romania as countries that are following the leaders, with such countries as Russia, Ukraine, Belarus or Georgia which clearly lag behind. Although there are clear signs that they prepare their economies to be open for the foreign flow of goods, some of those countries such as Russia have opened for capital flows which indicates a reverse approach to opening than that applied in Poland or Hungary. This latter group is far behind in the institutionalisation process, resulting in economies that remain closed to external relations, as in the past. This results in macrostabilisation failure, leading to the erroneous argument that macrostabilisation policy cannot work or achieve equilibrium as it did in Poland, a success that is then ascribed to “national specifics”. The truth is that despite different national characteristics, allowing market forces free rein can achieve results anywhere. After ten years of transformation, our knowledge is now deeper and we also know that the institutional side of the reform process has to be prepared.¹⁰

Unfortunately, these lessons appear not to have been learnt. Moreover, fears that opening up the economy will kill weak and uncompetitive industry are also basically wrong, because although some pressure would be brought to bear upon state producers, it would increase supply and create income for those engaged in trade. All this in turn will stimulate demand, which would result in higher investment and job creation. This theory can be found in Domar’s readings in *History of Economy*.¹¹

In contemporary international relations, we are returning to theories based on classics, which generally advocate a reduction in the role of the state in the economy. This is also true regarding the reduction of state expenditure, which in turn reduces the pressure to raise taxes. This is not only a phenomenon in countries of transition but is also happening in developed market democracies.

In the EU, this process is stimulated by the single currency (the so-called convergence criteria). In the USA, this is fostered by budget debt reduction. Conversely, a national approach in which economies are isolated behind protective barriers acts against competition and market forces. Moreover, a closed economy with limited competition and with undue state intervention is not able to gain all, if any, of the advantages deriving from globalisation.

It is very clear that the new stage of international relations diminishes the role of the hard dimension of security and replaces it by a soft dimension. This is linked not only with changes to the new security system, but also with changes to the nature of threats, which are now located more often within the national borders of the state, rather than being external threats from elsewhere.

In trying to catch-up, each country has a choice between sustainable and cumulative growth. The former is based on Domar's theory in which he argues that an increase in investment should be matched by an increase in GDP, which in turn is matched by a higher level of savings. Savings in a transforming economy disappear if inflation is high, but national savings can be replaced by foreign savings, which requires the opening up of the economy for FDI. But opening the economy is not a sufficient precondition for attracting inflows of FDI. Investors are adverse to risk, which means that macrostabilisation is crucial in this context. Thus is the circle closed.

The latter (cumulative growth) is based on Keynes and post-Keynesian theories. An important role in this group was played by the Polish economist M. Kalecki, whose 100th birthday anniversary was celebrated in September 1999. According to this theory, the rate of growth can be accelerated by an increase in the rate of investment in annual terms. This can be done by adding FDI investment to national savings. All theories on FDI indicate that inflows are attracted to countries with low investment risks, in other words, those with a record of low inflation. Nevertheless, this is not the only precondition for inflows of FDI, as investors make their decisions taking into account the availability of skilled labour, a low cost base, size of the market, and so on. There is thus a close linkage between macrostabilisation, development and wealth. In other words, macrostabilisation is a precondition for growth, which in turn can result in economic and social stabilisation and the enhanced security of the state.

As we see, both theories are based on cooperation between states and the opening up of the economy, thus departing from protective models of development. The presented models show clearly that:

- There is a close linkage within the triad: economy, stability and security.
- That the hard dimension of security is losing weight as the soft dimension of security gains weight.
- There are several models showing how to catch-up in development, all based on the opening up of the economy and a cooperative model of international relations.

- Transition success, which has a direct impact upon stabilisation and security, is closely linked with the degree of economic openness. Countries which opened their economy are more advanced, those who hesitate are lagging behind. This hesitation hampers further changes not only internally but also externally.

Ten empirical years of systemic transition show that growth out of economic depression is closely linked with an increase in consumption on the internal market. There are two methods of stimulating consumption in the economy:

- **Budget expenditures**, which is synonymous with budget deficits, printing money and further economic destabilisation.
- **Self-financing of expenditure by consumers**, either by credits, which have to be returned, or by earned incomes.

Both methods are considered as sufficient to stabilise the economy in the short term and lift the economy out of depression. Nevertheless, their effectiveness is different and their evaluation in the long term varies. In the first case, when consumption is financed from the budget, the result is a growing budget deficit, which means that the short term effect of increased consumption vanishes as time passes. The budget deficit stimulates inflation and in turn destabilises the economy, undermining the stability of incomes. All this forces the state to withdraw from this type of strategy, replacing budget stimulation of incomes by other methods that stimulate self-financing of consumption. In the case of budget financing, an additional constraint would be the reaction of voters to the withdrawal of state financing, in other words, the replacement of “easy money” by “difficult money”. Self-financing of consumption, however, places all the constraints (“belt-tightening”) at the starting point of the reform process. But in time, incomes rise which boosts savings and stimulates investment. In this way, self-financing of consumption has an in-built stabilising anchor in both the short and long term.

In sum, systemic transition *per se* incorporates elements that can be considered as destabilising. Moreover, mistakes made in forming transition strategy can be considered as destabilising factors. Finally, errors made in implementing transition strategy can also be described as destabilising elements of an internal character. Generally, in transition economies, destabilisation can be closely linked with:

- Wealth of the society.
- Depth of the transition depression.
- The applied macrostabilisation strategy and its implementation.
- Strength of the democratic institutions.
- The ability to correct errors in transition policy.

Conclusions

At each new stage of international relations, an old order or disorder was replaced by a new order or disorder. The changes or evolution were caused by a process leading to a new balance of interests, relations and rules that define the new order. The main power behind this process is the evolution of and clashes between different interests, values and visions of the main actors on the international stage. A lack of mutual understanding among the actors usually caused a stiffening of the system, while their cooperation resulted in elastic solutions, which accelerate adjustments. It is very clear that the new system of international relations has been built in a similar way, according to models known from theory.

Clashes and/or confrontation between interests and visions can result in temporary instability both in the economy of a single state or in the region as a whole. Although the role of international organisations in reshaping the new economic reality of national markets helps to stimulate the process and increases stability, it is not able to fill all the gaps that occur in a transition economy, even assuming that we can utilise the experience of those advanced countries in transition to help those less advanced.

The evolving new security system is based on interdependence and cooperation, which decides that a new role is ascribed to the so-called soft dimension of security, while at the same time hard dimensions are losing weight and going through a deep change in their character.

Not all changes are linked with generally perceived issues such as the environment or organised crime. Certain destabilising factors can be found in the sphere of the social spending of citizens in the transition country as well as in living standards, health care, pensions and education. Smooth transition requires flexible changes to the budget on both sides, revenue and expenditure. Otherwise, politicians in power - despite their good intentions to change the economy for the better - will bring much social pressure and instability instead. If of sufficient scale, this could hamper further systemic changes. This requires specialists who are already experienced in making such adjustments. The countries more advanced in the process should help those which are less advanced, because they are able to identify errors and know how to avoid them. The interest here is mutual. On the one hand, it can build-up stability in the region, while on the other, it can accelerate transition. Another group of problems embraces such issues as the introduction of specific regulations enabling action against organised crime.

The main problem in looking closer at the links that occur within the triad: economy-stability-security is linked with the model of transition and the applied strategy of growth. All post-communist states are lagging behind the standards of living found in market democracies. Their catch-up strategies should be based on several assumptions:

- Macrostabilisation.

- Opening-up of the economy.
- Accelerated growth based on foreign trade and FDI inflows.
- Institutionalisation of external foreign relations.

The above-mentioned pillars - if wisely applied - are able to bring about wealth and stability to the transition economies. This approach is not an invention of current economic theorists in the service of international corporations, but reflect the ideas of classical economics.

Stabilisation in states going through systemic transformation is closely linked with the applied method of transformation, especially the complexity of the strategy applied and its application. The main role here is ascribed to the source of financing consumption, as each of the two options can bring about different results, both in the short and long term.

Notes

- 1 K. Knorr, The determinants of military power, in: H. Bienen (ed.), *Power, Economics and Security, the United States and Japan in Focus*, 1956.
- 2 B. Moller, *Security concepts*, Working Papers 18/1993, Centre for Peace and Conflict Research, Copenhagen, p. 10.
- 3 C. D. Goodwin, *National Security in classical political economy*, in: *Economics and National Security. A history of their interaction. Annual Supplement to Vol. 23. History of political economy* - Durham: Duke University press 1991, p. 23-35.
- 4 *Approaching the Northern Dimension of the CFSP: Challenges and opportunities for the EU in the Emerging European Security Order*. Helsinki, The Finish Institute for International Affairs, 1998.
- 5 J. Kukułka, *Bezpieczeństwo międzynarodowe w Europie Środkowej po zimnej wojnie*, Uniwersytet Warszawski, Instytut Stosunków Międzynarodowych, Warszawa 1994.
- 6 B. Russett, *Spoleczność pokoju: demokracja, współzależność i struktura międzynarodowa*, w: *Bezpieczeństwo narodowe i międzynarodowe u schyłku XX wieku*, red. D.B. Bobrow, E. Haliżak, R. Zięba, Instytut Stosunków Międzynarodowych, Warszawa 1997, p. 364.
- 7 K. Żukrowska, *International Organizations in New Conditions*, *The Polish Quarterly of International Affairs*, Volume 5, No.: 3-4/1996, p. 81-98.
- 8 Nonpolar model of security was introduced by A.D. Rotfeld (director of SIPRI) in one of his interviews given in a Post-Soviet states (reprinted in *Forum weekly in Poland*).
- 9 J. Sachs, *Poland's jump to the market economy*, The MIT Press, Cambridge, Massachusetts, London p. 16.
- 10 D. L. Barlett, *The Political Economy of Dual Transformations. Market Reform and Democratization in Hungary*, Ann Arbor, The University of Michigan Press 1997.
- 11 J. Górski, W. Sierpiński, *Historia powszechna myśli ekonomicznej 1870-1950*, PWN Warsaw 1972, p. 390-396.

DYNAMICS OF THE “ECONOMY-SECURITY” NEXUS IN TRANSITION STATES

Daniel Daianu

*Professor of Economics, Academy of Economic Studies, Bucharest
and former Finance Minister of Romania*

This year’s Colloquium takes place under special auspices. Firstly, we celebrate a decade since the fall of the Berlin Wall, which symbolises the demise of communism. Consequently, there is more than a need to take stock of events, of achievements and failures, as a way to scrutinise what lies ahead. Secondly, Europe witnessed another major military conflict this year, within Yugoslavia. This conflict reminded us vividly how much remains unfinished on the Continent in order to have lasting peace and realise economic prosperity for all. Thirdly, against the background of globalisation one can detect a mounting pressure to rethink the architecture of the international financial system, although some of the efforts subsided lately. The Bretton Woods arrangements are seen by many as inadequate for dealing with increasing volatility and spreading financial crises in the world economy.¹ Last but not least, this year signalled the official entry of two other big (populous) countries - India and Pakistan - into the “select” club of nuclear powers. This event indicates that the end of the Cold War is far away from taking the steam out of the arms race. I would even dare to say that the very special status of the USA now - as the only superpower left in the world - prompts other major countries to search for new vectors of power. This status has triggered a peculiar dynamic which, in my view, is going to reinforce tendencies for the creation of a multipolar world.

I have structured my brief intervention along three lines. On one hand, I try to deal with the nexus “economy-security” by originating the roots of crises in the economic field. An alternative perspective is to seek the origin of economic difficulties in the realm of security concerns of countries. And this approach will be used as well. At the end I try to sketch what I see as major features of the world context, which bear on the dynamic of this nexus. I should say from the beginning that my focus is on transition societies which try to construct market-based economies and pluralistic polities.

Economy and Security

That economic health conditions security is a trivial statement and one could question the suitability of mentioning it in front of knowledgeable persons.

What motivates me, however, to remind you of this obvious fact is the balance-sheet of post-communist transition in Europe and the CIS. After a decade of reforms the results are significantly different as compared to early expectations. Transformation has proved to be much more complicated and complex than initially thought. Institutional change, in particular, disproved the tenets of those who espoused a sort of hocus-pocus social science and practice. As against the euphoria at the start, nowadays, sobriety, cautiousness and more open-mindedness mark the conduct of research. Those who stressed the importance of initial conditions, of geography, of institutional change are vindicated by the sequence of events, and they can claim an intellectual victory.² There has been no major conference in the last few years which has not emphasised the importance of proper institutions for the success of transition. Policy is important, but policy itself depends on a propitious context, on preconditions. This is probably the most glaring lesson of transition, which explains why Slovenia and Hungary - which practiced gradualism - stay at the top of the league (of frontrunners) together with Poland, which championed fast reforms.

Let me get back to the nexus we are dealing with. The geography of transition results should give us plenty of food for thought and concern. This is because most of the transition economies are far away from what one considers to be a benchmark workable market economy (as exemplified in the Western world). There is a cluster of economies, in the vicinity of the EU, which score quite highly in many respects of transformation. At the same time, however, South East Europe and the CIS countries remain extremely shaky institutionally, with very depressed levels of output (even if correction is made for redundant output), low saving and investment ratios, and are crisis prone. In addition, most of these countries reveal steadily worsening social indicators (life expectancy, death rates, infant mortality, spread of new diseases, income inequality³, etc.), which is a bad omen for their ability to cope with future pressures. Moreover, weak public governance and a weak state is a constant trait of transition, which reinforces the thinking about unfavourable prospects for these countries.⁴

From this bleak description of transition there emerges an interesting question: is not this state of affairs unsurprising in view of the challenges of transformation, which had remained largely unheeded for many years? And if this is the case, what should be the nature and the order of concerns to policy-makers and analysts? In order to suggest an answer, I would side with those who stressed the unjustified high expectations at the start of transition. I would go further and submit that most transition economies reveal a striking combination of features pertaining to rich and poor countries. For example, the level of education (literacy) and skills, in general, vs. the degree of competitiveness of most of their industries. What is worrying for these countries is, in my view, the steady worsening of the “good” indicators, which may undermine what appear now as factors of strength. In this respect I submit that the experience of transition may lead to a resurrection of development economics along “classical” lines,

seen as a vehicle for helping countries escape the traps of poverty and underdevelopment. The intensity of debate on globalisation and the controversies surrounding the “Washington Consensus”⁵ provide a further argument to this end.

Let me pass to a special category of transition economies, those which I call *distress economies*. The latter can be found in the Balkans, where a decade of massive destruction and human suffering (caused by wars and inter-ethnic strife) complicated exceedingly the tasks of reforms, of transformation. Most of the Balkans is made up of disaster areas, which suffer from huge unemployment, aid-addiction, very depressed levels of output, export stagnation, and rising criminal activity. I should say that disaster areas can be found elsewhere as well; let us think about the Caucasian space of the former Soviet Union, which is also ravaged by military conflicts and very precarious public governance. Nonetheless, nowhere else there does seem to be so much destruction linked with the process of one entity dissolution. The bad news is that the political map of the Balkans is still fuzzy and the current “silence” of the arms is due, to a large extent, to the presence of outsiders, to the functioning of hard and soft protectorates. It goes without saying that sensible economic policies are very difficult to pursue under such circumstances and that economic fragility will continue to mark the life of these countries.

On this line of reasoning, I would highlight the *high vulnerability* of most transition economies. It is noteworthy that this vulnerability is not linked necessarily with financial markets;⁶ it derives from large disequilibria, from very intense strain, which sooner or later comes into the open as high inflation or banking crises, etc. Vulnerability should be judged in a narrow and a broad sense. In a narrow sense it refers to its economic dimension, to the inability to cope with domestic and external shocks. In a broad sense, it points to failures of society (state) to deliver public goods and provide a liveable and empowering environment to its citizens; it signals a high probability for the existence of considerable internal strife, for fragmentation and the upper-hand of centrifugal forces, which can be viewed as real threats to national security. Thence arise temptations to impose authoritarian political solutions as a substitutes for weak state structures.

Security and Economy

One can go the other way around and see how security failures and concerns interfere with and strangle economic advance.

When borders are questioned, or when the process of state-formation is the overriding task of policy-makers, the economy serves an ancillary function. Consequently, and as I mentioned above, sensible economic policies - evaluated from the rationality of market-oriented institutional reforms - are hard to formulate and implement. This combines with the intrinsic pains of implementing reforms when *strain* is overwhelming. For this can be propounded the rationale for and

emergence of the policy propensity to apply *kriegswirtschaft* (*war economy*) - specific means - such as a wide range of direct controls in the economy. Sometimes such controls function in conjunction with quasi- or simulated democratic procedures. Can the economy progress under such circumstances? This is highly unlikely.⁷ For it is one thing to apply public policy (state intervention) as a means to forward reforms and a development agenda⁸, and it is a different thing if controls become ubiquitous and entrenched, and are a means to exert centralised and abusing power.

Very shaky institutional foundations and a weak state are fertile ground for the expansion of underground, parallel, structures. As a matter of fact, in many transition economies parallel structures are so powerful that they determine social and economic dynamics. What has been happening in several Balkan countries, in Russia, Ukraine, etc., is quite relevant in this respect. A big threat to society is that parallel structures, which are non-transparent by definition, are driven frequently and mainly by criminal organisations (networks). Would such organisations (networks) become transparent and submit themselves to the rules of well functioning market economy and democratic polity? I would argue that the victory of the good over the evil cannot be taken for granted, even in the very long run. *Path-dependency* plays a critical role in history. For historical breakthroughs to occur there is a need to combine the action of domestic factors with external anchors, with the “gravitational power” of clubs like the EU and NATO. However, for big countries, like Russia and Ukraine, the efficacy of such clubs can be questioned. In their case internal factors are of paramount importance.

Let me end this section by referring to an issue which was touched upon by Martin Spechler as well. It is about the allocation of resources between different purposes. Transformation is supposed to raise both productive and allocative efficiency, and arguably, to alleviate an old policy dilemma: guns vs. butter (security vs. consumption). However this reasoning may not hold when time is neglected, or when the provision of public goods is impaired by the pains of transformation and the “Big Trade-Off” (between efficiency and equity)⁹ shows its limits.

The World Context

My subsequent glossing over the world context may be viewed by some as unbalanced, and I would not dispute such a judgement. As a matter of fact it is not my intention to deal herein with the “new economy” or as it is said by some pundits, the “new paradigm”. It is not my purpose to analyse the impact of the new information technologies which, some claim, seem to have revolutionised the American economy and ushered in the longest business cycle growth phase after the Second World War. Neither is my intention to look at the process of EU integration, at mega-mergers which seem to have gripped Western economies

in the last two years. All these processes have consequences for the relationship between economy and security, for they mean new technological and economic edges for some, growing divides, and intensified non-co-operative behaviour as well.

Instead I will highlight what I view as security challenges which are rooted in world-wide dynamics.

Globalisation was mentioned several times in my intervention. Usually this process is meant to cover financial and trade-related matters. But there is another space of globalisation, less visible but highly threatening. Let us think of arms and drug trafficking, money-laundering, illegal immigration, etc. Criminal activity is getting a global thrust and it uses increasingly sophisticated means in order to outsmart state authorities. Many transition economies have become “congenial” environments for such activities.

Globalisation is linked also with growing gaps both inside countries and among them. A recent UNDP report speaks eloquently about the dangers posed by a rapidly rising income inequality which, arguably, is enhanced by the new information technologies. Increasing discrepancies between so called knowledge have and have-nots are very likely to strain social structures and create tensions; high inequalities would also impede economic growth, as World Bank studies emphasise.¹⁰ The late backlash against globalisation, which can be detected both in rich and poor countries, mirrors intense social strain which could lead to policy reversals and serious clashes.¹¹ Let us not forget that the period preceding the First World War was one of extreme openness of trade relations and labour movement, but was followed by rising protectionism.¹²

Globalisation can lead to major trade clashes, which, sometimes, can be viewed through the lenses of Huntington’s “Clash of Civilisations”. For example, one should not underestimate the feelings of Asians following the financial crisis which engulfed South East Asia in late 1997 and 1998. Mahathir Mohamad, the Prime Minister of Malaysia, expressed publicly in a very blunt way what other Asian statesmen voiced very softly (diplomatically), or behind closed doors. One strongly held perception was that Westerners use the plight of Asian countries to “colonise” them again economically, that the pressure put by USA and the IMF for financial liberalisation serves only the interests of the American (Western) financial industry.¹³ It can be said that the refusal of major South Korean chaebols to submit to the requirements of Western creditors indicates such a thinking. And the economic recovery in Malaysia and the remarkable rebound of industrial output in South Korea strengthened their leaders’ determination to find a way out of difficulties by not giving in to pressure.

Globalisation effects social psychology, and it can increase fears of and resentment towards neighbours or “those who are not like us”; xenophobia is rising in many parts of the world, including Western Europe. The rise of right wing extremist parties in Austria, Switzerland and Denmark is very telling in this respect.

The comments made above lead us to the issue of fragmentation, be it social or among ethnic groups. There are many revealing examples in today's world about economic strain leading to fragmentation, social and inter-ethnic upheavals. Indonesia is a conspicuous example in South East Asia. But one can argue that in the Balkans, too, economic strains have fuelled the dynamics of fragmentation.¹⁴ Russia, too, feels the heat of this tension; other examples can easily be provided.

If one combines the social tensions and upheavals, which are induced by economic strains, with moral and value-related uncertainties the result can be pretty disturbing. Fukuyama, in a recent book in which he looks at the Western world in the main, talks about the "Great Disruption"¹⁵; he is confident nonetheless that, in the end, human society will reorder itself owing to intrinsic virtues and a natural proclivity for order and self-organisation. I would espouse this optimism were I not so worried about possible long detours and bad path-dependencies. In addition, I would say that the world is so multicoloured and diverse that opinions need to be differentiated according to local circumstances.

I come to the close of my remarks by reiterating nuclear weapons proliferation, for it is one of the new facets of the arms race. The latter is no longer an exclusive affair of governments; groups inside countries can drive it, whether they vie to take over state power, or are engaged in international illegal activities. This dynamic blurs images and hinders the capacity to deal effectively with threats

The plethora of new security threats (including diseases, spreading epidemics)¹⁶ induces governments to seek more co-operation arrangements with partners who share common values and interests. This, too, sounds very much a trivial statement. The big question is what this natural policy reaction means for the dynamic of alliances in the future. Will we see more of the formation of major blocks, whether in trade or going beyond trade. Will the EU develop its own defence capability and what would this mean for the North Atlantic military alliance? If the Euro validates itself as a strong currency, will it join the US dollar as a major reserve currency and how would this affect world financial flows? Will Asian countries reinforce their efforts to develop intra-area trade, or even create an Asian Monetary Authority? These are all questions which imply dealing with the nexus "economy-security".

Notes

- 1 See also Stanley Fischer, "Reforming the international Monetary System", *The Economic Journal*, vol.109, no.459, pp.557-557.
- 2 Since the early 90s the UN/ECE reports have constantly emphasised the time-consuming nature of institutional change and the inherent difficulties of transformation. See also Kozul-Wright, Richard and Paul Rayment, "The institutional hiatus in transition economies and its policy consequences", *Cambridge Journal of Economics*, 1997, 21, pp.641-661.
- 3 Russia, where the Gini coefficient is now above 60%(like in Brazil), underwent this phenomenon in a few years time, which is quite unique in modern history. See in this respect Branko Milanovic, "Income, Inequality and Poverty during the Transition from Planned to Market Economy", *Regional and Sectoral Studies*, The World Bank, Washington DC, 1998.
- 4 I tried to make quite an extensive analysis of transition trends in my keynote speech, "Institutional Change in a Post-Communist Setting", presented at the 1998 NATO Economics Colloquium, in Ljubljana. See the proceedings of the Colloquium.
- 5 See Joseph Stiglitz, "Whither Reform", Speech at the ABCDE Conference, World Bank, Washington DC, 1999. Stiglitz also criticizes sharply traditional aid policies in his "The World Bank at the Millenium", *The Economic Journal*, vol.109, no.459, pp. 577-597.
- 6 Deep financial markets are dangerous whenever macroeconomic policy is not sound and institutions are shaky.
- 7 The case of China merits discussion in this context. In China direct controls are used according to the logic of a functionally dual economy, and they have been used along the trend of gradual economic liberalisation.
- 8 Several Asian states (Japan, and, later, South Korea and Taiwan, Singapore, etc.) are famous for their ability to formulate developmental industrial policies, which proved highly successful.
- 9 Arthur Okun, "The Big Trade-off: Equality vs. Efficiency", The Brookings Institution, Washington DC, 1975.
- 10 The Comprehensive Development Framework (CDF) promoted by the President of the World Bank, Jim Wolfensohn reflects this vision, which contrasts with Simon Kusnets, the economics Nobel Prize laureate's argument, namely that growth assumes and is accompanied by rising income inequality.
- 11 See also Edward Luttwak's book, "Turbo-capitalism. Winners and losers in the world economy", New York, 1999.
- 12 Jeffrey Williamson makes an illuminating analysis of that period and warns that one should not consider globalisation as an inexorable process. See his "Globalisation and the labour market: using history to inform policy" in Ph. Aghion and J.Williamson: "Growth, Inequality and Globalisation", Cambridge, Cambridge University Press, 1998, pp.103-201.
- 13 On this aspect is relevant a New York Times article of 14 February, 1999, which quotes Laura Tyson, the now dean of the Haas School of Business at Berkeley and a former Chairman of the Clinton Administration's Council of Economic Advisers. In her cited remarks she highlights the role of American financial institutions in shaping USA external economic policy, the pressure put on Asian economies to liberalise their financial markets prematurely.
- 14 See Susan Woodward, "Balkan Tragedy. Chaos and Dissolution after the Cold War", Washington DC, The Brookings Institution, 1995.
- 15 Fukuyama asserts that "One of the greatest challenges modern information age democracies face today is whether they can maintain social order in the face of technological and economic change...the tendency of contemporary liberal democracies to fall prey to excessive individualism is perhaps their greatest long-term vulnerability"(Francis Fukuyama, "The Great Disruption.", New York, Free Press, pp.10).
- 16 Think only about AIDS in Africa and elsewhere.

A GEOPOLITICAL ANALYSIS OF ECONOMIC TRANSITION AND ITS IMPACT UPON SECURITY IN EUROPE

Peter Sutcliffe

NATO Economics Directorate

This paper reflects the personal views of the author and should not be interpreted as official NATO policy. In parts, the analysis may come across as negative and/or over-critical, even conceited - if so, this is not intended. There is much that is positive going on in the transition economies of C&EE, indeed, a look into the “rear-view mirror” to see where many of them were just a decade ago reveals the progress made to be little short of miraculous. But ultimate success is not guaranteed. This paper attempts (in Part 1) to explain the nature of economic transition in relation to concepts such as power, security, democracy, hegemony, culture, history and sovereignty in order to better understand (in Part 2) the security risk for the West that continuing economic weakness in some Partner countries undergoing transition represents, and, conversely, the security concerns felt elsewhere as Western values of market capitalism and individual liberty go global.

PART 1: GEOPOLITICAL ISSUES WHICH MOULD TRANSITION

The End of History?

Is the end of the Cold War really the end of history, as Francis Fukuyama¹ has famously expounded? On the face of it, democracy has in the 20th Century defeated its greatest foes in succession, first fascism and now communism. No significant state - many suppose - will ever choose to follow those paths again, in particular, the state-controlled command plan economics of the latter. Although the form may vary, every state will - according to this thesis - soon be democratic and by extension market-oriented because the free movement of ideas and money made possible by new technologies are removing whatever physical barriers that states might construct over how much of both is sent and to whom. Indeed, information technology is the conduit by which democratisation trends are growing. Democracy is even beginning to chip away at the fringes of the Arab world as well because absolute rulers there are unable to completely stem

the flow. Because it is the West that, by and large, is the progenitor and master of the new technologies, it is Western ideology, or at least its most seductive parts such as consumerism and individual freedom, which are gaining wider currency and support. As a Dalek might say to Doctor Who, “Resistance Is Futile”. Whether they like it or not, states are becoming more similar to one another and so will have little or no need to go to war. As Fukuyama still opined in 1999, “liberal democracy and a market-oriented economic order are the only viable options for modern society”.² After all, where is the competition?

But taken to extremes, such a “democracy guarantees peace” argument could be considered crude. Just holding a free election does not in itself turn a country into a stable, peace-loving and tolerant society. Take Algeria and Pakistan for example, or Fujimori’s Peru. Democracy has to grow up. It needs to be nurtured by things such as a stable economy, impartial judges, an uncorrupted civil administration, independent political parties and a free press. Above all, it needs self-discipline amongst would-be leaders and governments - and amongst minorities that might be systemically denied full representation. Creating all of these things takes time and it would be truly remarkable should all the new recruits to democracy acquire them all straight away. Clearly they have not and it is likely to be many decades before the World achieves Fukuyama’s dream of political and economic homogeneity, or anything approximate to it. During this period, instability the like of which has disfigured the last century will likely continue to be a feature of the next. But despite the growing pains, no one has come up with an empirically better way for humans to coexist with one another and democracies have not gone to war against each other since 1914. Moreover, the richer and more sophisticated that the people living in Western democracies become, the less acceptable that war and its attendant horrors likewise become. As one observer recently put it, “a whole new body of states is emerging that seriously want not to fight each other”.³

What is the West?

So the World appears to have a growing hegemonic order comprising democracy and market capitalism as its principle ingredients and loosely grouped under the label “the West”. But how real a concept is the West? Its chief components are the United States and Western Europe, with other outlying appendages such as Canada, Australia, New Zealand and Japan, some of which are clearly not western in any geographical sense. In an economic and/or cultural sense, states as diverse as South Africa, Singapore, Hong Kong, Taiwan, Turkey, Israel and maybe Mexico might also count, even though many people in these countries might not consider themselves “Western”. The United States is clearly the leader of the pack and it is American popular culture that the others follow, as indeed do the populations of outside countries that aspire to join the West. But America is a self-sufficient continent, even psychologically, and is less interested than

Europe in other cultures. In the words of Dominique Moisi, “America is more imperial than imperialist”.⁴

One result from this is that Europe is becoming more aware of the limitations that part-dependence upon America entails, something the Kosovo war has advanced. Whilst Europe remained divided, this did not seem to matter. But now that Europe is regaining its geographical unity, it is becoming more aware of its separate identity, and, in military terms, its second-class status. Indeed it is mildly ironic that just as the Central European nations are eagerly embracing the West which for them not only exists but forms a central part of their new identity, the West may be becoming two different “West” with each preserving their cultural differences or essence. Nevertheless, what unites Europe and America remains far more fundamental than what divides them. With modesty and care, the more sensitive and ability-to-compromise qualities of the former combined with the raw dynamism of the latter can be offered to the World. In short, a way of organising society that has served both so well. One hundred years ago, the “West” **was** Europe and ruled much of the World. Today, the West is less hegemonic in geopolitical terms but perhaps more influential than ever before as a model for others to follow.

The Choice on Offer

But exactly what is the “model” on offer. There are several different variants on the market capitalism theme. The “social-market” of Germany or Scandinavia; the “mercantilist” market of France; the “bureaucratised” market of Japan; or the “laissez-faire” market capitalism of the Anglo/Americans. Which is best has not been settled and probably never can be settled, for each has its advantages and disadvantages. The choice depends to some extent upon a nation’s culture or “sense of being”. What people feel comfortable with. Elections may lead to alternate governments of “left” and “right”, but the policies each pursue merely push at the boundaries of each chosen model without ever seeming to violate them. A nominally right-wing government in Germany never in a whole decade made any serious dent in the post-war social contract. A nominally left-wing government in Britain is proving to be more pro-business than its right-wing predecessor.

The point here is that despite a commonality of interest and culture, a largely shared history, the building of an ever-closer economic union and the imminence of a common currency, the states of Europe still maintain significant differences and a fair latitude for independent action. In particular, states - either alone or as allies - are still the predominant wielders of armed force. This is not about to change soon. States in the West are still sovereign entities and if this sovereignty has become a little diluted as money, information, ideas and increasingly people have become highly mobile, it is because a conscious decision has been made to pool it.

Sovereignty under Threat?

To some extent, choosing to undertake transition - as most states in Central and Eastern Europe (C&EE) have - involves a conscious decision to give up some sovereignty, which is more difficult for a country such as Russia to accept because it has a large historical stock of sovereignty to lose. Russia has its own sense of being and still sees sovereignty and security as indivisible. But in reality, at least in the West, it is pooled sovereignty which provides security - something quite different. Despite the fact that say Italy and Germany have pooled their sovereignty in that both are members of the EU and of NATO and will soon be sharing the same currency, Italy remains definitively Italian and Germany remains definitively German. The citizens of both countries would not have it any other way, but for them, sovereignty is defined more by their distinctive cuisines, by their musical or architectural heritage and the colour of their trains than by who precisely controls interest rate policy.

Russia and other states undergoing painful transition may not be ready yet to understand this, let alone compromise on it. The “crony capitalism” often prevalent in these states is sometimes justified on the grounds that it is at least domestic rather than foreign bandits that are to blame. But the only solution might be to leave the macro-management of money - something that Russians in particular have always been useless at⁵ - to someone else. Such a solution has been advocated by several commentators⁶ and would involve the imposition of a currency board or even making use of the US dollar (already the *de facto* currency of private trade) or the Euro official. Good money would soon drive out bad. Existing central banks would also need to be overhauled or abolished and commercial banking sectors would need to be freely open to foreign competition. Good banks would soon drive out bad.

Such a policy cocktail would of course seriously impinge upon conceptions of national sovereignty, but the ability to actually use sovereignty, to act unilaterally and influence the behaviour of others, is also compromised by a poorly functioning economy. This takes time because political capital takes much longer to dissipate than economic capital, which can flee across borders in an afternoon. Russia - as Britain before it - will continue to punch above its (economic) weight in World affairs for several more years, but the poorer the country becomes - relative to elsewhere - the less able Russia will be to act upon its pronouncements, and the less inclined others will be to listen. Russia's burgeoning debt to Western creditors is also increasing its obligations and reducing its ability to act independently in a subtle way. Indeed, NATO's recent action in Kosovo - accompanied throughout by shrill denunciations from Moscow - suggest that this process has already begun. Maybe Russia joining the West - once it understands that its sovereignty would be enhanced rather than diminished - could be compared with Britain joining the EU. All knew

the marriage to be ultimately inevitable, but what a struggle to get the bride to the altar.

Not All Quiet on the Western Front

But maybe it simply will not be the case that once all the significant states in the World are democratic, have working market economies of varying efficiency, and have come to terms with the loss of raw sovereignty involved, the West can sit back in the twilight of history, relax, and contemplate on a job well done. Suppose that by 2010 China has evolved into an aggressive export-orientated, bureaucratic-capitalist yet democratic state (not dissimilar to Japan). Russia, meanwhile, has at last addressed issues of fundamental economic reform to become a less efficient and evolved (than say Germany) version of the social-market model, whereas India has embraced Anglo-American laissez-faire. To suggest that such a situation would not result in conflict would be panglossian in the extreme. America and Europe are continually engaged in trade disputes of one sort or another, which can on occasion turn quite bitter. But these are mature democracies and wiser councils (or WTO arbitration) usually prevail. Put another way, inhabitants of a young or immature democracy might be more willing to answer the call of national honour than the people of Liverpool, Los Angeles or Liege. More specifically, China, India and Russia will be among the chief contestants in the race to secure hegemony over the rich oil and gas reserves of Central Asia. Whether they are all democracies or not when battle commences is unlikely to either temper their as yet unsubdued nationalism or influence the intensity of the conflict.

Samuel Huntington⁷ expressed this idea in another way. For him, politics (whether democratic or autocratic) and economics (whether market or directed) are merely the super-structure of a state, not its foundations. The latter are blood, faith, instinct and cultural kinship. On this basis, the World could be divided into super-blocs based on the West, Islam, Confucius, Hinduism, and Slavic-Orthodox. Not all the World fits into this neat pattern of course, with Latin America and Africa being too diverse within themselves to be categorised. This World of “super-blocs” or “culture-areas” could be described as the competition that Fukuyama suggests will soon no longer exist. A new balance of power to replace the Cold War - but for two essential differences. First, these culture areas are a massive distance away from becoming political unions, let alone are the states within them equal or alike economically. Indeed, conflicts within them are far more numerous than between them. Second, the West is now predominant and sets the politico-economic agenda that it invites others to join. In other words, it is in a position to widen the security paradigm of the Cold War that was based upon defensive passivity into something altogether more pro-active.

West on the Offensive

Kosovo was a turning point. This short and for NATO casualty-free war said to the rest of the World that the Western democracies were no longer content to restrict themselves to self-defence and the pursuit of self-interest, leaving other “culture areas” to their own devices. On the contrary, it stated very clearly that the West is in the business of exporting its liberal market, democratic culture elsewhere, by force if necessary, to those regions that have the potential to destabilise or at least inconvenience either itself or converts to the cause. With virtually the whole of Europe democratising and marketising (albeit at varying pace and with differing degrees of success), the West (through NATO) showed with its air campaign against Serbia that it was no longer prepared to tolerate, in its own backyard, someone going the other way. The conclusion reached - certainly in Moscow and Beijing - is that the Western democracies are now prepared to fight a war to protect their political and economic interests, both in Europe (Kosovo) and near to Europe (Kuwait). The message to other culture areas is clear - confront us at your peril.

But is the West now acting out of **altruism** or **self-interest**? Viewed from Moscow or Beijing, the spread of democracy is also the spread of Western values, many or all of which they do not share. But these are not and need not be the same thing. The man or woman who invented the wheel was not accused, when passing on the discovery, of imposing upon others the gift of mobility. Spreading democracy and economic freedom is not imperialistic in that one country is taking over the government of another. Quite the opposite. It is allowing the people of that “another” country to govern themselves, freeing them from whatever dictatorship had previously denied their political and economic freedom, even their existence.

But as explained earlier, there is more to democracy than simply holding an election and more to creating a market economy than abolishing *Gosplan*. Some states exposed to democratic values and free-market forces have collapsed rather than reformed. Much of Africa is a case in point. In the former Soviet Union, some would argue that transition failure is inevitable because “reform programmes have ignored the realities of political power and are indifferent to human behaviour that does not conform to the liberal, market paradigm.”⁸ Lieven reserves particular scorn for the optimists who assumed that simply changing the ownership pattern of the economy would induce restructuring, wealth creation, and, in time, wealth distribution and philanthropy. He quotes Anatoly Chubais talking about Russia’s robber barons “...who steal and steal. They are stealing absolutely everything and it is impossible to stop them. But let them steal and take their property. They will then become owners and decent administrators of this property.”⁹

Such optimism has so far proved to be unjustified. Theft and now capital flight have become defining features of the post-Soviet Russian economy, indeed,

with people like Potanin, Berezhevsky and Chernomyrdin as role models, how on earth can you tell an ordinary, often unpaid official that it is morally wrong to steal from the state? Andrei Piontkovsky¹⁰ has expressed this sentiment better than most. He has compared the lists of Russia's leading politicians, its leading businessmen and its richest people only to find them practically identical. The oligarchs themselves - not one of whom according to Piontkovsky is a self-made man - openly admit that the only profitable business in Russia is politics. Having won the Presidency for Yeltsin, they expected and largely got their reward. With their chief protector and benefactor Yeltsin now gone, many oligarchs - cheque-books in hand - are seeking protection under new acting President Putin's banner whilst others have secured immunity by buying seats in parliament instead. Politics has thus become a top-down structure devoid of parties, ideology or grass roots support, which form the bedrock of politics in a Western sense. The question now becomes one of whether Russia and other former Soviet republics in a similar mess have already failed the transition test. Maybe they will never make it to the altar. Piontkovsky is in no doubt; "The future is cancelled. There will be only an eternal present in which the country (Russia) is doomed to poverty."¹¹

The Price of Failure

The failure of democracy and liberal capitalism in Central and Eastern Europe, especially in Russia, would be a bitter blow to the West. The clear implication would be that the Western system does not and cannot work well across the globe. Such a failure in Europe, in the heartlands of liberal democracy, would re-ignite issues of isolation, physical security and fear. But if failure is as inevitable as Lieven suggests then the economic and security organisations of the West may as well all pack up and go home - or revert to a former role. Such a move would be a dismal prospect indeed, but might be welcomed by those who see no future role for the institutions of the Cold War. Keith Hartley accepts that NATO's new roles of crisis management, peace-keeping, peace-enforcing, rendering humanitarian assistance and aiding transition - sometimes out-of-area - are likely to attract public support for continued defence funding, but sees all of these activities as "...a further example of the efforts by bureaucracies and interest groups to affect favourably the demand for their services whilst under-estimating or ignoring the costs of these policies".¹²

If intervention in Kosovo and Kuwait had been a failure, if Bosnia had erupted once more into full-scale war (it still might of course), if NATO's humble efforts to assist Partner countries within the PfP, PJC and NUC frameworks were not appreciated, and if on a wider scale there were no transition success stories to point to, then Hartley would be right. It **would** be time for the West to retreat into its Cold War shell. But so far, pro-active engagement has been a (qualified) success. Future plans to create a sort of "Marshall Plan II" for the

Balkans have every chance of aiding economic restructuring and promoting social and political stability in this turbulent region, just as its predecessor did in Western Europe. And whilst the governments and people of Poland, Hungary and the Czech Republic deserve the lion's share of credit for their remarkable transition success, it was the example of the West and a strong desire to belong that provided the stimulus. But even in these three new NATO members and especially further east, transition is work-in-progress. By continuing with this work, the altruistic - and indeed practical - aim is to improve living standards across the continent, which is the essence of economic security in a European context (*see Part 2 of this paper for details*).¹³ The self-interest lies in avoiding the negative, in that dealing with failure might compromise the West's own unprecedented period of security, personal freedom and prosperity. Altruism is self-interest.

PART 2: VIEWS OF AND THREATS TO EUROPEAN ECONOMIC SECURITY

Economic Security

In the Cold War era, economics and security were linked only to the extent that a strong economy provided the wherewithall to fund a strong military, which in turn provided physical security - behind **closed** borders - against invasion or subjugation by a foreign power. If the two words "economics" and "security" were ever used in tandem, it was in relation to **security of supply**, especially of energy and raw materials. The oil price shocks of the 1970s led directly to recession throughout the developed World, but price rises of a similar magnitude over the past year have had no noticeable effect of growth at all, largely because most economies, especially in the West, have become more open, adaptable and diverse. Put simply, they run on information not oil. Nevertheless, the Western democracies were still prepared to oust Saddam Hussein from Kuwait and remain concerned that energy egress routes from the Caspian should head west rather than anywhere else. Individual G7 states such as Germany still have a strategic interest in maintaining stability in individual energy producing states (in Germany's case, Russia) because supply disruption would be irritating and potentially expensive albeit not a direct threat to security. But in overall strategic terms, Western power does not accrue from producing oil and gas, indeed, no major exporter of energy or raw materials in the World today is also a major political player on the global stage, and none has a higher standard of living than the G7.

So although security of supply is still relevant, more consequential economic threats to security of a non-state nature have now emerged. The new liberal, some would say capitalist, paradigm of **open** borders has brought forth the

globalisation of information and markets, and prosperity for those prepared to embrace them. In turn, wealth promotes the creation of a large and politically powerful middle class and, for want of a better term, a “civil society”. But open borders have also aided the proliferation of WMD, the growth in international crime and corruption, and drug trafficking. Environmental pollution is also now very much an international issue, and threat.

Perhaps the biggest threat of all to states that have created a civil society is the envy and resentment of those who have not. In other words, improving living standards equals improving security, or conversely, low or declining standards of living compromise internal security by fomenting social unrest, which may be containable within the nation state or could spill over into neighbouring regions or states (Chechnya and the Caucasus come to mind, as do Yugoslavia, North Korea and Afghanistan). But the process is self-reinforcing, in that unemployment and poverty provoke strikes or other forms of social unrest which lead to less trade, less investment and less growth which in turn leads to worsening unemployment and so on. The poorer people are, the less they have to lose by challenging - perhaps violently - the status quo. But poverty need not be absolute to cause instability. People in the Soviet Union did not become demonstrably less well off in the Brezhnev era of stagnation, they simply became aware of their growing relative poverty *vis-à-vis* the West. The Soviet Union was not therefore a victim of major economic disruption, but, *inter alia*, of a growing discontent that rotted the system from within.

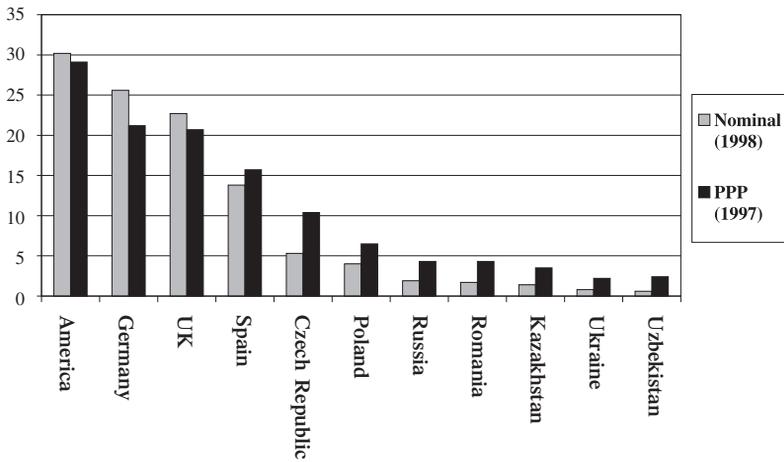
China is an interesting case. Perhaps because it is not a democracy, rapidly growing economic strength is not being fully channelled into rising prosperity for all, but more into both domestic repression and the establishment of a vigorous and expansionist foreign policy that now represents a security risk for most of Asia and a potential security threat elsewhere. Each case is to some extent *sui generis*, but the general, underlying rationale still holds. If in doubt, ask yourself whether the tragic events of the past decade in Yugoslavia would have occurred had that country been as rich as Switzerland?

Economic Weakness

Figure 1 below presents selected World Bank international per capita GDP figures for 1997/98 expressed in a common currency, the US\$, and calculated both at nominal and Purchasing Power Parity (PPP)¹⁴ exchange rates. Even using the latter which account for the greater internal purchasing power of undervalued currencies, the figures reveal just how poor most economies in C&EE and Central Asia are when compared with the West. For example, Russian per capita GDP (PPP) in 1997 was about 7-times smaller than in the US and nearly 4-times less than in Spain. Even just over 10 years ago when this author first started work in this field as a junior research analyst looking at Soviet agriculture, no-one knew for sure exactly how large the Soviet economy

was. But it was practically taken as read that it was the World's second largest after the US. That assessment has now proved to be wildly incorrect and the Russian economy today - expressed in dollars at the prevailing market exchange rate - would not come in the top 30 despite its huge geographical spread, its massive resource wealth and still large population. Even using PPPs, the Russian economy would rank about fifteenth in the World and in per capita terms no higher than about fiftieth.

Figure 1 - Per Capita GDP Comparisons (in '000 US\$)



Values: America - 30.2/29.1; Germany - 25.6/21.2; UK - 22.7/20.7; Spain - 13.8/15.7; Czech Republic - 5.3/10.4; Poland - 4.0/6.5; Russia - 1.9/4.3; Romania - 1.7/4.3; Kazakhstan - 1.4/3.5; Ukraine - 0.8/2.2; Uzbekistan 0.6/2.4.

Source: World Bank

Why Economic Weakness is a Security Risk

Some people might look at this graphic and say; “So what? Is it not a **good** thing that former foes are now impoverished and cannot properly fund their armed forces? Surely this makes them less of a threat.” Were economically strong states either within or adjacent to Europe under the control of autocratic, nationalist despots (a most unlikely combination), then it would be possible to have some sympathy with such sentiments. But otherwise, the security risks for the West that neighbouring states with perpetually enfeebled economies pose are several and significant:

- First, because the whole of society can become frustrated by the sheer complexity and unending nature of change. Widening income differentials

could become socially explosive, as has occurred in parts of Latin America, whilst even the ruling elites feel increasingly impotent in the face of globalising forces over which they have no control. Catch-up with the prosperous West becomes an ever more distant prospect. Under such conditions, the whole rationale of transition becomes discredited, perhaps fatally. “Reform” could be written-off as a failure before it has had a chance to succeed. The result could be a turning away from the “quasi-democratic, half-reformed economy” state that states such as Russia are now at and have gone through so much pain to reach, and, the **emergence of more aggressive, nationalist leaders that would be instinctively anti-West**. Countering such a development would be expensive and eliminate whatever peace-dividend the end of the Cold War has brought. A potentially devastating clash between “culture areas” would then become more likely.

- Second, the danger that people within these failing economies will seek to **emigrate** in greater numbers. An influx of highly qualified young people would of course benefit the West, and this has to some extent already happened. Many thousands of Chinese, Indians and, to a lesser extent, Russians, already staff the top science, technical and computing research centres of America and Europe. Good for the recipient but bad for the donor, merely re-inforcing the cycle of relative economic decline. Should this decline degenerate into meltdown, mass migration could result which would be costly and destabilising for the recipient countries, at least in the short- and medium-term.
- Third, is the export of **crime**. Corruption and organised crime thrive in weak or undemocratic states with transitional legal systems. It also flourishes where there is a residue of overt state intervention in the economy such as export quotas and licensing. Such criminal economic activity has a cross-border security dimension with regard to money laundering and drug trafficking. It also distorts competition and undermines the legitimacy of the state, which may lose its ability to maintain public order and enforce the law as a result. In Indonesia, the state became a family business - with cataclysmic results. In Russia, the “crony capitalism” highlighted by Anatol Lieven has at best distorted, at worst taken over, the economic potential of the state. A by-product is **capital flight** that further stunts investment and growth.
- Fourth, because wealthier, more self-confident states in transition would be economically more diverse, selling consumer and engineering goods rather than just raw materials, energy and heavy industrial goods as tends to be the case at present. For example, oil and gas represent about half of total Russian exports by value, and around one third of all government tax revenues. The West would benefit greatly from the **increased commercial potential** that successful transition would represent.
- Fifth, because a poor state’s greed for cash means that it turns a blind eye to its own arms exporters as they sell advanced weapons and associated

technology to rogue regimes thereby boosting **proliferation**, which is rightly regarded as one of the most critical security problems that the West now faces. Indeed, vendor states in transitional Europe ought to have as great a security interest in keeping WMD out of the Middle East and North Africa as does the West, but advanced military goods represent one of the few saleable items that some states have - short-term economic expediency means that they cannot afford not to sell them.

- Sixth, is the danger that growing **regional autonomy** could get out of hand. When a state fails to provide economic stability, regions within that state - especially those with resource wealth - start to consider secession as a means to escape the mess. Ethnic differences within the same state can also provide the stimulus for secession, as happened peacefully with the “velvet divorce” between the Czech and Slovak Republics. This divorce was unencumbered by an atmosphere of economic failure or collapse. But when ethnic tension is combined with economic turmoil within the same state, the result can be something like former Yugoslavia, most of which has become a costly security nightmare for all for Europe. Trying to put out the fires after they have started is - as we are witnessing in Bosnia and Kosovo - a thankless, difficult and expensive task. And there is a military angle to this as well. The increasing inability of federal governments to fund the defence budget means that regional military commanders must and are seeking support at the regional level. Remember the old adage; “Whoever pays the piper calls the tune.”
- Seventh, and linked, is the fact that economic weakness leads to a **degraded military**. The main related security risks are that internal conflicts might be uncontrollable within a state’s borders and spill over into neighbouring states. This in turn heightens the risk of non-European powers such as China and Iran intervening to safeguard their interests or security. In such a scenario, the degraded conventional force serves to **reduce the nuclear threshold**.
- Eighth, and finally, because rich states can afford - indeed their people insist that the money be spent - to protect the **environment**. Of course, the West is responsible for far more carbon emissions than any other “culture-area”, but its cities are significantly cleaner whilst trans-national catastrophes on the scale of the Aral Sea and Chernobyl could only occur in a politico-economic environment characterised by autocracy and distortion. (*Or am I being complacent here?*)

But just as the economic weakness of many transition states raises security concerns in Western Europe and further afield - to the extent that they justify pro-active intervention by the West in defence of its own interests - the overwhelming economic might of the West, America in particular, is perhaps seen as a threat in other “culture-areas” where the hegemonic power of “Western” ideology in an increasingly unipolar world is not welcome. The West, as global hegemon, is seen to be imposing a common yardstick, a set of value judgements - capitalism, democracy, individual responsibility, unfettered markets, etc. - that

some other states may feel uncomfortable with and which threaten other more statist, nationalist and socialist value-judgements which they - or at least their ruling elites - may not wish to abandon, even though this means abandoning the gift of mobility provided by the inventor of the wheel. If one is at the wrong end of a bar chart like **Figure 1** - a perceived victim rather than beneficiary of the hegemonic world order - a decision needs to be made whether to join. Let us review the evidence from a different perspective.

A Reverse View of Transition

Maintaining an autocratic-style government and state control over the economy has some attractions, in that a state is able to control its own destiny, it can ensure that basic needs are catered for (so long as the state has something to export that the rest of the World wants), it can hide inflation and unemployment and can give an outward impression of stability. But at a cost. Such a system leads to massive inefficiency and waste, satisfying consumer preferences becomes a largely arbitrary process, the economy becomes brittle and society immobile with neither being able to adjust to changing global conditions, unaccountable and corrupt elites asset-strip the wealth of the state, and living standards for the majority stagnate and decline relative to the hegemonic West.

On this basis, making the transition to an open, democratic and market system would seem to be an obvious choice. But transition can be traumatic. Many old, inefficient industries need to close down thereby increasing unemployment and poverty for an extended period. In a new competitive environment, many are unable or unready to compete so income differentials can widen greatly. The economy also becomes subject to sudden fluctuations in capital flows, the stock market, exchange and interest rates over which the government has little or no control. And finally, new institutions necessary to manage the market and give it a sound legal basis take time to develop, with crime and corruption filling the void. Thus transition can, and in the former Soviet Union has, given an overall outward impression of extreme instability which is why so many now wish to reverse or in some way alter the process and why the historical inevitability of transition success expressed by Fukuyama and others could be wide of the mark.

But it would also be wrong to give up hope as Lieven and Piontkovsky appear to have done. In Russia, the security risks inherent in any prolonged period of economic weakness are well understood, indeed, the new draft Russian Military Doctrine - despite its more confrontational and anti-West bias¹⁵ - identifies **significant threats to national security as being internal**, emerging from, *inter alia*, acute economic and social problems. Both in the earlier document and to my knowledge in the new draft as well, the internal economic problems were/are further specified as being the increasing numbers living below the poverty line, the stratification of society and widening wage differentials,

mounting wage arrears, and the escalation of social tension. This is the “civil society” dimension to economic security that was alluded to at the beginning of this part of the paper. And if Russia’s leaders are prepared to compromise on (largely false) sovereignty by legalising the US dollar and allowing foreign banks free rein - as advocated by Hanke, Schuler and Selgin (*see footnote 6*) - there might be a way to create this “civil society” in Russia after all.

Moreover, many within the Russian leadership are also now aware that military spending should for the first time be driven by the economic possibilities and/or limitations of the state and be what Russia can reasonably afford rather than what the military leadership think they need. The fall in the Soviet/Russian military burden from a ludicrous 20% or so of GDP in the late 1980s to less than 5% of GDP in 1998 has been one, maybe the only one, success of the Yeltsin regime. This has indeed been a radical departure from the past when military demands ran the Soviet economy to the extent that a war economy was maintained even in peacetime. The problem is that this debate remains unresolved with most of the military and many in parliament still insisting that spending should be whatever it needs to be to counter all threats to Russia’s security, which, in the light of an expanding NATO, the rise of Islamic fundamentalism and a resurgent China, they naturally believe to be external as well as internal. Russian military spending probably hit rock bottom in 1998 and is now, because of war in the Caucasus and other factors, beginning to rise again in real terms.

Final Thoughts

To conclude, I think it would be wrong for the West to abandon Russia or any other transition state in difficulty until fundamental internal debates such as the one outlined above are resolved, and this will not happen overnight. Transition cannot occur let alone succeed unless and until they are, with the desire to be materially better off acting as the main stimulus. States undergoing transition thus require a consensus and a commitment to real economic reform across the political and social spectrum that some have not, so far, acquired. In this respect, economic transition is to some extent a **state of mind**. To succeed, a state must want to succeed and in some transition economies it may be a generation or two before the national mind-set is made up. In Russia and some other parts of the former Soviet Union, it is not only crooks who have prospered. Many thousands of young people have enjoyed a decade of unprecedented freedom to shape their own lives. As Fred Hiatt reminded his readers in the *Washington Post*: “Only when (this) generation comes to power will we know for sure whether or not Russia is lost”.¹⁶

But in some societies, individual wealth (and especially individual freedom to acquire wealth) is not considered to be important, indeed, in religiously fundamental societies, such behaviour would be considered immoral or even

evil. Maybe Huntington has a point - blood, faith and cultural kinship are more important than economics and politics in defining societies and/or the state structures in which they are given form. Even in culturally unique societies such as Confucian China that also happen to want to grow rich, some everyday features of the West - such as drug abuse, juvenile crime and the pervasive influence of big business in all walks of life - are not seen as mere unattractive spots on an otherwise beautiful face, but as defining features of Western society. Moreover, in the short period of American-led Western global hegemony (post-1945), the better-off have prospered mightily whilst the very poor have both multiplied in number and become worse off in both absolute and relative terms.¹⁷ The West may be more influential than ever before as a model to follow, but some would view Western society as existing in a “moral vacuum” which they may abhor and might even like to fill.

At present, no other culture-area is close to challenging Western hegemony, but that does not necessarily make other non-western cultures unviable, as Fukuyama suggested (*see again paragraph 1*). Who knows, in 50 years time, the World may be looking at a very different set of hegemonic value-judgements (imposed by China perhaps) and it will be the West that is faced with the sort of agonising choices now facing economies in transition. Indeed, there are very few certainties in this rapidly changing World. As democracy spreads, it would be rash to assume that it will cover the entire globe and ridiculous to suppose that all will agree on all matters. Disagreements between existing and future democracies will occur and some might even lead to war. Nevertheless, at this moment in time, the security and prosperity of the Western democracies would be greatly enhanced by successful economic transition in those parts of Europe that still lag behind, the Balkans and the former Soviet Union in particular. On balance, the West is right to force the pace of change - so long as this is done more through example than coercion and so long as no one assumes that history is dead.

Notes

- 1 "The End of History"; *National Interest*, 1989.
- 2 As quoted in *The Economist*, 31.07.99.
- 3 "The new Geopolitics". *The Economist*, 31.07.99.
- 4 *Financial Times*; 26.07.99.
- 5 See "Russians and Money : The cash don't work"; *The Economist*, 19.12.98.
- 6 George Soros in his famous letter to the *Financial Times*; 13.08.98.
Kurt Schuler and George Selgin. "Replacing Potemkin Capitalism", *Policy Analysis*, 07.06.99.
Steve Hanke. "Only the Dollar Can Rescue Russia". *Wall Street Journal*, 24.08.98.
- 7 "The Clash of Civilisations". *Foreign Affairs*, 1993.
- 8 Anatol Lieven. "History is not bunk"; *Prospect*, October 1998.
- 9 Quote reportedly by Anatoly Chubais who was responsible for Russia's privatisation programme, including the notorious "shares for loans" scheme by which the business elite acquired, at prices untested by the market, much of the resource wealth of Russia. *Source as above*.
- 11 Andrei Piontkovsky. "What went wrong - Asian Flu or Russian Pneumonia?" *PRISM*, published by Jamestown Foundation. 18.06.99.
- 11 Source of quote as above.
- 12 Keith Hartley. "State Budget in a Changing Economic and Security Environment". 1998 NATO Economics Colloquium. "*Economic Developments and Reforms in Cooperation Partner Countries : The Role of the State with Particular Focus on Security and Defence Issues*." Published by NATO Economics Directorate and NATO Office of Information and Press. ISBN: 92-845-0108-3. (An example of NATO upholding the democratic principle of free speech!)
- 13 One could argue that if the West were **really** serious about aiding transition, it would remove its import tariffs on agricultural produce and heavy industrial goods. This would do more to spur economic growth in C&EE than any amount of development aid or structural loans advanced through the international institutions.
- 14 The exchange rate at which a basket of (near-) identical goods costs the same in two different countries.
- 15 Than the previous 1993 draft.
- 16 "Only Time Will Tell if Russia's Great Experiment has Failed." Article re-printed in *International Herald Tribune*, 30.08.99.
- 17 See Jeffery Sachs. "Helping the World's Poorest", *The Economist*, 14.08.99.