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Why the Customs Union Has More
Chances Than Its Predecessors**

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Post-Soviet Integration Breakthrough

Why the Customs Union Has More Chances Than Its Predecessors

Resume In the medium term, the Common Economic Space will face the dilemma of either “enlargement” or “intensification,” which is well known to Europeans. One of the main reasons behind the Customs Union’s success is that it has focused on a clear and rather narrow objective.

The former Soviet republics have signed a great number of agreements, treaties and initiatives within a span of two decades since the breakup of the USSR. However, none of the “post-Soviet integration” bids proved capable of ensuring real cooperation among the states in the region. The fact was fairly obvious to everyone, above all to the states directly involved in the integration projects. Against this background, a fundamental change in the situation that occurred in the past three years came unexpected to analysts. The Customs Union of Russia, Belarus and Kazakhstan, launched in 2010, has become the first integration alliance where the partners meet their commitments notwithstanding the high costs it involves. The intention to set up a Eurasian Economic Union by 2015, announced last November, looks far more realistic than a majority of similar past resolutions. What changes have taken place in the post-Soviet space to make such projects realistic? Can we expect these initiatives to feature a steady growth? Are the objectives ambitious enough to meet the challenges facing the post-Soviet countries? And will their implementation help these countries take advantage of the opening economic development opportunities? Indeed, missing them would be inexcusable.

ON THE WAY TO REAL INTEGRATION

Let us first look back at the history of the emergence of the new generation of integration bodies in the post-Soviet space. The early 2000s saw the first calls for taking a more pragmatic approach to integration and abandoning idealistic rhetoric. Nevertheless, until quite recently the post-Soviet states have cooperated in but a few areas to handle issues of the common infrastructure created in Soviet times, specifically railways and electric power generation facilities. Attempts to breathe new life into existing organizations only worsened the contradictions. The two organizations set up in 2006 – the Eurasian Development Bank (EDB) and the CIS Interstate Humanitarian Cooperation Fund – can be viewed as the first portents of change. Unlike the previous initiatives, the objective of the new organizations was to support specific projects (banks handling the development of infrastructures and the economy, or foundations providing for culture and education projects), not general norms or policy coordination. The focus on specific cooperation objectives kept these two bodies from turning into new paper-pushing bodies.

But the genuine breakthrough was paradoxically brought about by the world economic crisis of 2007-2008. Instead of taking ever tougher protectionist measures (as often happens during global upheavals), post-Soviet states opted for establishing more effective cooperation. The establishment of the EurAsEc Anti-Crisis Fund in 2009 with a capital of 8.513 billion dollars was a landmark decision directly associated with the crisis. The fund has a dual function: first, it extends stabilization loans, performing the function of “a regional IMF.” It also compensates for balance of payment and budget deficits and supports the national currency. Second, it strengthens regional cooperation as a creditor of large investment projects. As of now, the Fund has extended loans to Tajikistan and Belarus. Post-Soviet integration has become financially attractive, at least for several countries.

The Customs Union was launched in 2010. It is the most impressive achievement of post-Soviet integration at present. Its key features are common duties with respect to third countries and a common Customs Code to regulate a majority of trade issues of the member-states. The Customs Union uses a proportional voting system, but all its decisions have been consensual up to date. The Customs Union members had to introduce major changes to foreign trade regulation. For example, Kazakhstan hiked 45 percent and cut 10 percent of customs duties. Aside from relations with third countries, the Customs Union has provided more opportunities for interaction between the member-states, and not just in trade; in border areas, a number of Russian companies consider moving to Kazakhstan's jurisdiction because of lower taxes there.

A still greater effect from the liberalization of investment flows is expected from a package of agreements on the Common Economic Space (CES), which came into effect on January 1, 2012. The CES already has 17 agreements and another 55 are in the works. The agreements spell out the freedom of movement of capital and labor, a common policy of competition (including natural monopolies, procurements and subsidies), coordination of macroeconomic policy, trade in services, technical standards, and access to gas and oil pipelines, energy transmission lines and railways. In February 2012, the Eurasian Economic Commission (EEC), a supranational body with broad powers, was set up to coordinate the CES. Interestingly, its "lower chamber" – the Board – is structured along the lines of the European Commission and comprises officials responsible for specific functional integration areas, so they are not merely representatives of their countries. Subsequent measures towards establishing a Eurasian Economic Union include a single railway cargo tariff starting from 2013, and national regimen of state procurements for all companies of the three member-states starting from 2014.

“INTEGRATION FROM BELOW” AND THE GLOBAL CRISIS

The success of the Customs Union and the CES looks all the more unexpected as it seemingly contradicts the logic of the development of the post-Soviet space. Two decades ago, the former Soviet republics had far closer economic ties, but their integration (including within the ruble zone) was a complete failure. The achievements of post-Soviet integration of the past few years may be explained by two circumstances: the growth of real integration “from below” in the 2000s and the global economic crisis.

First, it would be incorrect to describe the two decades after the breakup of the USSR solely as a period of growing fragmentation. Indeed, many Soviet-era ties were severed, but starting from the early 2000s they began to be replaced by new forms of interdependence. The economic growth of Russia and Kazakhstan from 1999-2000 whetted the appetites of the emerging transnational corporations of these countries, which began vigorously developing the post-Soviet space. Russian companies already dominate the mobile phone markets in a majority of CIS states and play an important role in many other sectors of CIS economies, while Kazakhstan had been leader in investments in the CIS banking sector until 2008. Labor migration is another form of new interdependence. Whereas in the 1990s CIS migration flows were largely the immigration of ethnic Russians from newly independent states, the past decade has seen an exponential growth of temporary migration based on economic factors. As a result, some CIS states have posted economic growth on the back of labor migrants' remittances. In Russia, labor migrants account for about 6 percent of the country's GDP, according to expert estimates.

Expecting a continuous growth of interdependence between the post-Soviet states would be a big oversimplification, though. Regionalization manifests itself in various fields of interaction (for example, it is far less expensive in mutual trade) and affects countries unevenly. According the EDB Eurasian Development Integration System review, which shows indicators of economic

interdependence of post-Soviet states in the past decade, Russia, Belarus and Kazakhstan formed the core of integration back in 2004-2005, and integration “from below” has been running at a fast rate since then. The establishment of the Customs Union was presumably a logical follow-up of the expanding mutual ties within the scope of this core.

Second, that the Customs Union and the CES emerged in the wake of the global crisis hitting the post-Soviet states is more than a coincidence. The logic of regionalism here differs in principle from the “classical” pattern. As a rule, the starting floor for integration is the existence of several economically separated countries for which integration implies considerable costs, at least in the short term. Regional integration requires changes in legislation and adaptation to new standards, and is accompanied by increased competition. Unsurprisingly, politicians tend to support regional integration during economically safe periods when the costs are less tangible, and are reluctant to launch integration projects during crises (the period of stagnation in European integration in the 1970s is a graphic example).

The situation in the post-Soviet space is the exact reverse. The countries have retained interdependence inherited from the Soviet era. Therefore, the choice of a disintegration course – which requires the development of new branches of industry and a search for new ways of integrating in the global system of division of labor – is often more costly. So, in the period of crises regional integration appears to be a more preferable option, while in affluent years countries can experiment with various options of autarchy or seek new partners. In other words, the shock caused by global instability (which dealt a painful blow to Kazakhstan back in 2007, and then to Belarus which had to implement a large-scale devaluation of its national currency two years later, and then to Russia) brought post-Soviet countries closer together.

PROBLEMS AND CONTRADICTIONS

The real situation is certainly not at all cloudless. The Common Economic Space and the Customs Union encounter serious problems whose solution will be crucial for their future. In the short term, the main difficulties will be technical. The Customs Code norms often contradict national legislations, though not critically, and there is no clearly set procedure for enforcing these norms. The CES is yet to create mechanisms to implement its basic agreements. Such problems are inevitable in implementing large projects, but they may prove fatal if handled by inefficient bureaucracy, making integration unattractive for business. In view of this, the Customs Union commission has taken a range of important measures to rectify the situation in this field.

The difficulties largely stem from the imbalance of advantages and costs in the CES member-states. For Kazakhstan and Belarus, the Customs Union implies a considerable increase in import duties and, consequently, price hikes and a distorted pattern of trade ties. For Russia, it remains unclear, for example, how national phytosanitary standards of the three countries will be implemented and monitored within the Customs Union. According to the available studies (major assessments of the Customs Union and CES perspectives have been published by the World Bank and the EDB Integration Studies Center), these integration bodies can contribute to the growth of their members’ economies due to a larger capacity of their domestic markets and intensive competition. However, this will be possible under certain conditions, above all if non-tariff barriers are eliminated. Thus far, the introduction of common technical and phytosanitary norms in the Customs Union area has been slow.

In the medium term, the CES will face the dilemma of either “enlargement” or “intensification,” which is well known to Europeans. One of the main reasons behind the Customs Union’s success

is that, unlike previous regional integration projects with unrealistic ambitious programs, the Customs Union has focused on a clear and rather narrow objective. Its membership is far more homogenous than in many other regional agreements in the former Soviet Union, and the signatories are well-chosen (unlike in other projects). Will the “troika” union be able to go beyond its initial agenda? The package of the CES agreements that has come into force shows that it can. However, another question arises: Does this rapid process (the transfer within just two years from the Customs Union format to the CES notwithstanding unresolved technical problems) pose a considerable risk to prospects for more intensive integration?

Failures may undermine the trust of society and business in the CES, and the governments may find themselves unable to keep with the present development rate. However, the peculiarity of the post-Soviet space (in contrast to Europe) is that interrelations between countries concerning the movement of production factors (capital that is relevant for interaction of the Customs Union members, and labor force for interaction between other CIS countries and Customs Union states) develop at a faster rate than those in trade. From this point of view, it would be expedient to go beyond the Customs Union format, as it only marginally affects interaction in fields where “integration from below” is proceeding vigorously. Paradoxically, only a fairly intensive form of integration can score a real success in the post-Soviet world (and, perhaps, in other unions of developing countries).

The possibility of the Customs Union’s enlargement is currently being discussed with Ukraine and Kyrgyzstan. Ukraine’s membership in the CES is problematic, despite the “troika’s” best efforts (and Russia’s efforts in particular) and close economic ties. Experts estimate that Ukraine’s joining the CES, with subsequent technological rapprochement, will secure a 6-percent increase of its GDP in the long term (according to the findings of the EDB’s joint study with the Institute of Economic Forecasting under the Russian Academy of Sciences and the Economic Policy Institute, NANU). But political factors interfering with integration are too strong. Even Ukraine’s becoming an EDB shareholder – a neutral issue which does not involve crucial decisions – has been stalled despite obvious advantages for Kiev.

As for Kyrgyzstan, its ascension to the CES and the Customs Union is quite possible, considering the country’s vulnerable economic position. In the recent years, the Kyrgyz economy has been growing mainly due to its role as a transshipment point for re-export of Chinese consumer goods to CIS and Central Asian countries, made possible by a very liberal foreign-trade regime. Having found itself outside of the boundaries of the Customs Union, Bishkek can no longer play this role because of stronger customs barriers on the border with Kazakhstan. By joining the Customs Union, Kyrgyzstan will have to toughen its foreign trade regime, which will partially close “the window” for trade with China. Analyses by the EDB Integration Studies center and Kyrgyzstan’s National Institute of Strategic Studies show that the pros of joining the Customs Union outweigh the cons. Kyrgyzstan’s WTO membership is another problem: the country will have to hike tariffs if it joins the Customs Union, in some cases to a level that would contradict WTO rules, which will require negotiations within the WTO framework. Of course, the expected WTO membership of Russia and Kazakhstan will make the solution of the problem easier.

In the long term, the development of integration in the post-Soviet space may be held back by factors which the Eurasian Economic Union will have to face sooner or later. This is, first of all, the prevalence of the resource sector in the economies of two of the three CES states, which diminishes the integration effect. Moreover, the key oil and gas sectors of Russia and Kazakhstan are oriented towards foreign markets. Deeper integration requires diversifying the economy and reducing its dependence on raw materials, a task whose successful solution can hardly be found in international practice. Second, the progress of post-Soviet integration also

depends on successful modernization of institutions and societies in the post-Soviet countries, which is yet another difficult task.

FROM POST-SOVIET TO EURASIAN INTEGRATION

There are problems not only in interaction among post-Soviet countries but also in their relations with the rest of the world. For many of them, including Russia, the EU is a more important trade partner than their immediate neighbors. The recent years have seen a growing role of China as a source of investments and loans in Central Asia, as well as in Belarus and Ukraine. International actors and analysts alike seem to share the view that the post-Soviet and European integration vectors are incompatible in principle, and that Post-Soviet countries of Eastern Europe, in particular Ukraine, Belarus and Moldova, should decide once and for all where their loyalties lie. This is hardly a true-to-fact view, yet it prevails at present and has a very negative influence on integration dynamics in northern Eurasia. Therefore, it is important to underscore once again that integration projects can fully realize their potential in the post-Soviet space if implemented as part of a broader, transcontinental integration involving external players.

In the first place, it concerns infrastructure networks. The geographic position of post-Soviet states between Europe and Asia enables the CIS states to derive considerable benefit from their transport potential – but only if it is linked with cross-border transport projects implemented in other parts of Eurasia, for example, by the European Union or the Asian Development Bank.

In the electric power sphere, the common market of the former Soviet Union, mostly inherited from the USSR unified energy systems, would be more effective if it were linked to the energy markets of other countries, such as the EU, Turkey, Iran, Pakistan, Afghanistan and China. In the same manner, there are advantages of open borders with external players in trade and investments where such “open regionalism” helps avoid conflicts between integration projects. In general, new integration projects do not have to be confined to the borders of the former USSR; on the contrary, it is quite natural to look for new partners outside of these borders, especially in Europe and East Asia.

Ways to organize interaction with external players differ in the east and the west of the post-Soviet space. In the west, priority may be given to structuring the Eurasian Economic Union in such a way that participation in it would be combined with cooperation with the EU. It may involve, for example, harmonization of the parties’ standards and technical and phytosanitary norms. Of course, it cannot be accomplished by a single-step decision, as harmonization requires considerable costs, yet the best option would be to look for solutions compatible with European ones. In trade, cooperation suggests the establishment of a Deep and Comprehensive Free Trade Area (DCFTA) between the Customs Union and the EU, which would provide for the solution of issues of trade proper, as well as of uniform standards, protection of investments, migration and the visa regime. Such a scenario can and should be discussed, even if it seems hard to implement at present. In the conditions of the EU unification crisis, the EU may become more autarkic, and it will take time to resolve its fiscal integration problems.

In Asia, the situation seems somewhat simpler: the integration is more flexible there and it involves a limited range of issues. Consequently, there is no competition between integration initiatives, while interaction with the post-Soviet integration group involves fewer institutional difficulties. Yet there exist quite a few problems there as well.

First, it is important to avoid post-Soviet agreements turning into huge structures comprising too many incompatible players. It would be useful to analyze the negative experience of APEC

falling victim to its own success: consistent use of the open regionalism principle increased the organization's membership and heterogeneity, and eventually reduced its capability. Secondly, the deficit of trust is present in Asia, too: China, for example, causes serious apprehensions in the elites and populations of post-Soviet countries (although these fears are caused by myths rather than real risks). Ideally, interaction between the Eurasian Economic Union and Asian countries could lean on a range of complex bilateral free trade areas (preferably backed by additional agreements on visa-free movement and labor migration), as well as on "functional" projects to effectively pool transport, energy and telecommunication infrastructures.

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Within a span of several years, post-Soviet integration has evolved from a largely paper project and rhetoric construct – which certain countries exploited to suit their domestic policies – into an important factor influencing economic development. However, its further prospects are unclear. On the one hand, it is the current format of a small group of countries with a clear objective (trade and economic rapprochement) that made the Customs Union a success. On the other hand, a truly big success can only be achieved by crossing the present-day borders – both geographic (for example, by stepping up interaction with China and the European Union) and functional – by handling the movement of production factors, ensuring uniform rules of the game (technical regulation, and access to monopolies' services) and guaranteeing the coordination of macroeconomic policy. Finally, post-Soviet regionalism is by no means an alternative to global integration, for example within the framework of the World Trade Organization (as is sometimes claimed). The advantages of WTO membership for the CES states are considerable, so the regional project should be viewed as a process parallel to global economic integration.