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282

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CIS-7 Perspective on Trade with EU in the Context of EU Enlargement

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Contents

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Abstract

The paper analyses possible consequences of the EU enlargement on the EU – CIS-7 trade. It considers current situation in trade between two country groups, describes the factors limiting this trade, and discusses the opportunities for the trade associated with the EU accession of the Central and East European countries with strong historical ties to the CIS-7. The paper concludes that the EU enlargement creates some potential for expansion of trade and, importantly, exports from CIS-7 to Europe.

Introduction

The EU enlargement is an important event in the world economy and has consequences not only for the old fifteen and the new ten EU members, but also for many other countries. One of the country groups, which is expected to be seriously affected by the change in trade regime associated with the enlargement, is Commonwealth of Independent States including twelve former Soviet republics. The countries of this group have rather close economic and trade ties with Western Europe and especially with the new Central and East European EU members, majority of which just fifteen years ago were either parts of the same country, USSR, or members of the same economic and trade block – Council for Mutual Economic Assistance.

CIS countries are quite different in terms of territory, population, size of economy, policies, and institutional development. Aggregated CIS data reflect mainly situation in Russia, and also in Ukraine, Kazakhstan and Belarus. Other countries' contribution to the region totals is very small. Therefore, consideration of CIS countries as a single group may not provide appropriate picture for its smaller members. This is also applicable to the analysis of EU-CIS trade.

CIS-7 subgroup includes Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan, i.e., the countries which have lowest values of GDP per capita PPP among CIS countries. All these countries, but Uzbekistan, are small in terms of population; all countries, but Moldova, are remote from Europe or other developed regions/countries; all countries, but Georgia and Moldova[1], are landlocked[2]; all countries without any exemption have been affected by different military conflicts. Other common features are insufficient institutional development[3], large foreign aid inflow and relative openness of economy. These commonalities allow considering them together, while, of course, there are major differences between these countries, which are related to economic structure, geographical and commodity composition of exports and imports, macroeconomic and trade policies.

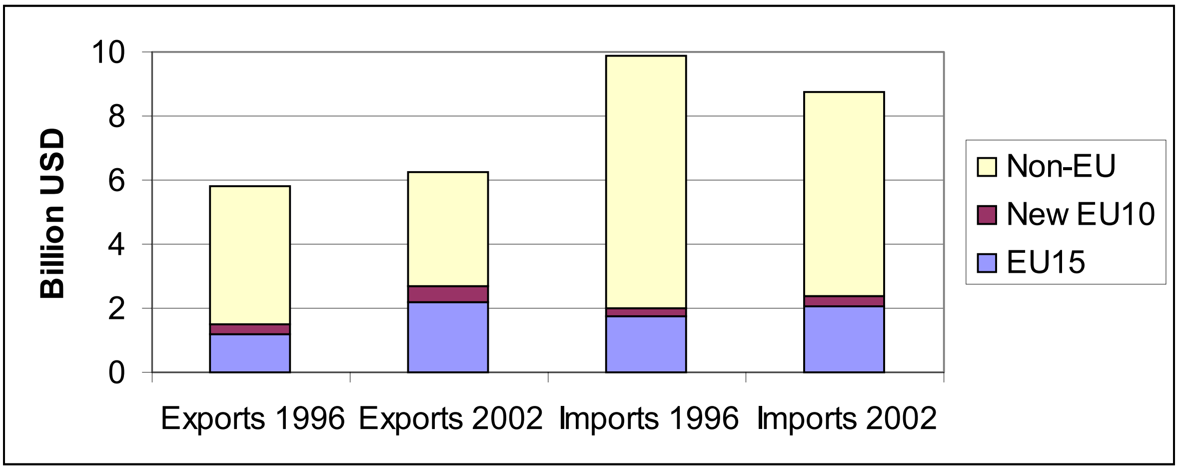
Because of all these specifics, the EU enlargement may have different consequences for CIS-7 countries, than for Russia and other bigger CIS partners.

[1] Moldova has the access to the Black Sea through the small Danube port Giurgulesti.
[2] While Azerbaijan has an access to Caspian Sea, this does not ease its trade with Europe and other developed regions.
[3] Even in comparison to larger CIS countries.

1. Current Situation in Trade between CIS-7 and Old and New EU members

At first look the trade of CIS-7 countries with EU15 and new EU10 countries is developing successfully, and one could register quite robust shift in trade from non-EU partners to the European markets (see figure 1).

Figure 1. Turnover of CIS-7 trade with its EU and non-EU partners



Source: IMF 2003.

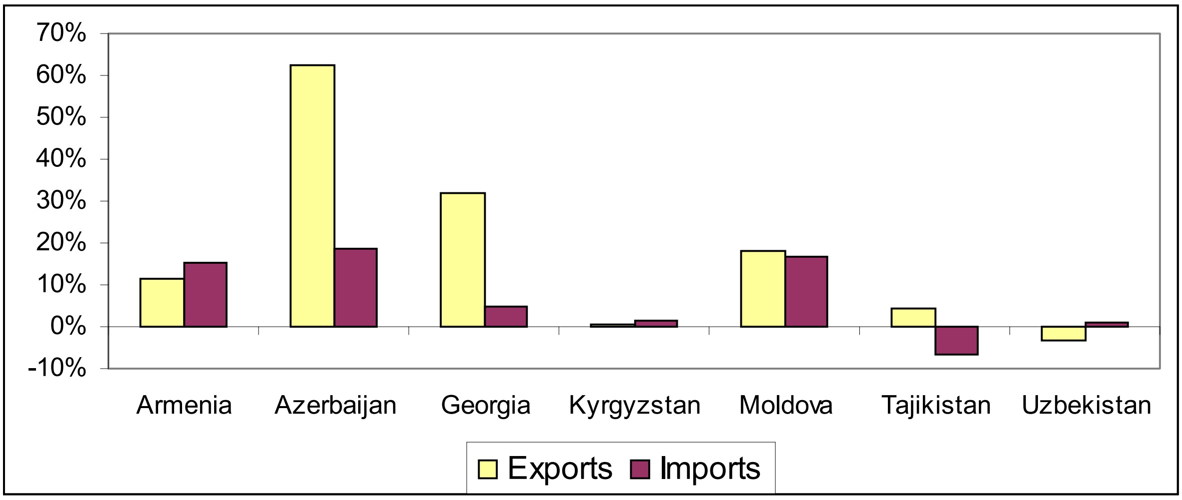
The share of exports to EU in total CIS-7 exports have increased from 21% in 1996 to 35% in 2002, for imports these shares are 18% in 1996 and 23% in 2002. While shares of new EU members are much smaller[4], they have grown as well. However, this trend is characteristic for the CIS-7 trade totals, individual country data demonstrate more diverse picture (see figure 2). For Transcaucasian countries and Moldova the increase in trade with EU is strong, while for Central Asian countries one can see much less progress. This fact suggests that the geography does matter, and more remote from Europe Central Asian countries made less progress in trade with EU.

Further analysis shows that dynamics of CIS-7 exports to EU is very much dependent on just one-two commodities for each country accounting for more than 50% of exports of the country to EU. These most important commodities are diamonds for Armenia, oil for Azerbaijan, gold for Kyrgyzstan, aluminum for Tajikistan, cotton and gold for Uzbekistan. Exports of these commodities are volatile in terms of prices, physical quantities and countries of destination[5], and their increase could not be treated as an evidence of sustainable strengthening trade links of CIS-7 with EU. If one considers exports to EU net of these commodities, the shares of exports to EU in total exports

[4] This is understandable taking into account the size of new EU10 economies in comparison to old EU15.
[5] For example, in 1997-2002 exports of Kyrgyz gold fluctuated in the range 160-230 mil. US dollars; during the same years exports of gold to EU countries varied from 0 to 190 mil. US dollars.

of these countries demonstrate no visible growth trend and become smaller (typically 10-15% of total exports, i.e., for these countries European market is not export destination of primary importance).

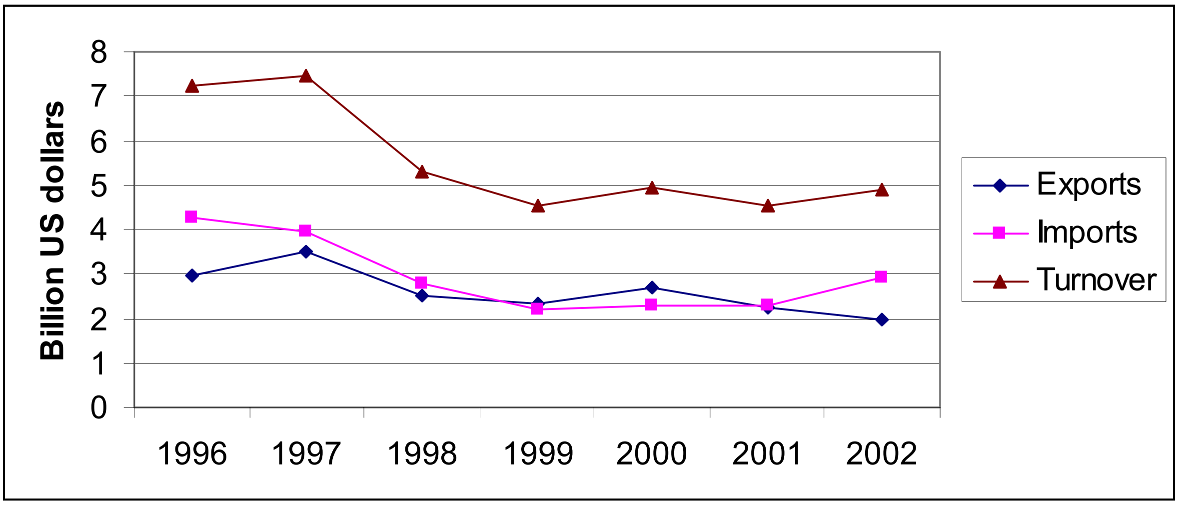
Figure 2. Increase in share of trade with EU for 1996-2002



Source: IMF 2003.

Another source of formal increase in EU shares in foreign trade turnover of CIS-7 countries is the reduction in trade with traditional partners, which are basically neighboring countries[6] plus Russia (figure 3). Well-known problems with regional economic cooperation typical for every part of CIS resulted in reduction in regional trade turnover of CIS-7 countries by one-third.

Figure 3. CIS-7 trade with neighboring countries and Russia



Source: IMF 2003.

[6] In this context a neighbor is a country, with which given country has common surface border. According to this definition Russia is a neighbor only for Georgia.

Theoretically, the WTO accession of some of CIS-7 countries[7] could improve their opportunities in trade with the EU. While it may be too early to comment on the impact of the WTO membership on Armenian, Georgian, and Moldavian trade, Kyrgyzstan's five-year experience suggests that the membership in this organization has neutral effect on both exports to and imports from WTO member countries including EU15 and new EU10 countries (see (Mogilevsky 2004)). For example, annual average value of non-gold exports of Kyrgyzstan to the EU in 1996-1998 (pre-accession period) was 20 mil. US dollars; in 1999-2002 (post-accession period) this average value has slightly decreased to 18 mil. US dollars.

Thus, the real progress in CIS-7–EU trade is not very impressive despite of clearly spelled-out policies of all governments in the group in favor of export expansion, openness of these economies[8] and the attractiveness of the European market. Therefore, there should some factors preventing CIS-7–EU trade from expanding.

2. Factors limiting trade of CIS-7 countries with EU

First possible inhibitor of CIS-7-EU trade coming to one's mind is a limited market access, which is understood as high import tariffs existing in EU and "non-market economy" designation for CIS countries. However, as it is shown in (Michalopoulos 2003), for commodities, which create a core of CIS-7 exports to EU, the tariffs are low, and anti-dumping measures almost have not been applied to CIS-7 exports. At the same time, tariffs for the commodities originating from CIS-7 are somewhat higher than for their potential competitors from Balkan countries and LDCs (see (Aslund, Warner 2003)), and this may affect adversely exports of CIS-7 to EU.

Still, the competition in price on the EU market could not be considered as a main impediment for CIS-7 exports. Consideration of exchange rate dynamics allows proving this. Significant changes in national currencies' exchange rates of CIS-7 currencies with regards to Euro have been characteristic for the period 1996-2002; especially strong was the impact of Russian financial crisis in 1998. As a result, in 1998-1999 currencies of several CIS-7 countries[9] depreciated against Euro in nominal and real terms. Despite of this fact, CIS-7 exports demonstrated little sensitivity to this positive price shock. At the same time, the exchange rate shock did cause 20% drop of imports from EU in 1999.

[7] The Kyrgyz Republic joined WTO in 1998, Georgia – in 2000, Moldova – in 2001, and Armenia – in 2003.
[8] With the only exception of Uzbekistan.
[9] Georgia, Kyrgyzstan, Moldova, and Tajikistan.

One of additional explanations for reduction in imports from EU is related to the foreign aid flows. All CIS-7 countries receive considerable aid from international financial organizations and bilateral donors. Together with USA and Japan, the EU is a major source of this aid. Obviously, part of this aid is tied up directly or indirectly with imports from these countries. The large inflows of aid in 1990s led many of these countries very quickly to a foreign debt accumulation, which became unsustainable after the currency devaluation in 1998-1999. It has become necessary to limit further aid flows to the indebted countries, and, among other things, the policy of aid containment had a consequence of contraction of imports including imports from EU. Fluctuations of real exchange rate and aid flows explain well dynamics of imports from EU to these countries. For example, for the Kyrgyz Republic the following relationship holds for the period 1996-2001:

$$\mathbf{log}(\mathbf{M_{EU}}) = 5.70 - 1.08\,\mathbf{log}(\mathbf{RER}) + 0.72\,\mathbf{log}(\mathbf{AID})$$ [10], $R^2 = 0.86$,

where $\mathbf{M_{EU}}$ – imports from EU countries (mil. US dollars), **RER** – real exchange rate of the Kyrgyz currency som with respect to Euro/ECU (1997 = 100), **AID** – annual amount of foreign aid inflow to the country (mil. US dollars).

Returning to the reasons of poor performance of CIS-7 exports to EU, it is important to consider trade related capacity and institutions (see (Michalopoulos 2003)) in these countries. These institutions are generally weak, but in this context underdeveloped marketing institutions seem to have especially adverse impact on expanding of the CIS-7 exports. These countries have very short history of direct trade with the EU concentrated in just few sectors of economy, businessmen on both sides often do not know situation and market opportunities in Europe and CIS countries, trade rules and practices. Small size of markets and lack of regional cooperation make unprofitable or risky FDI inflow from EU countries and corresponding investments into market research. In many cases the transaction costs of overcoming the so-called technical barriers to trade (EU standard requirements, certification, etc.) are too high in comparison with the potential value of export operations: relatively small CIS-7 enterprises supply too small quantities of export products to make these transaction costs (including marketing research) affordable.

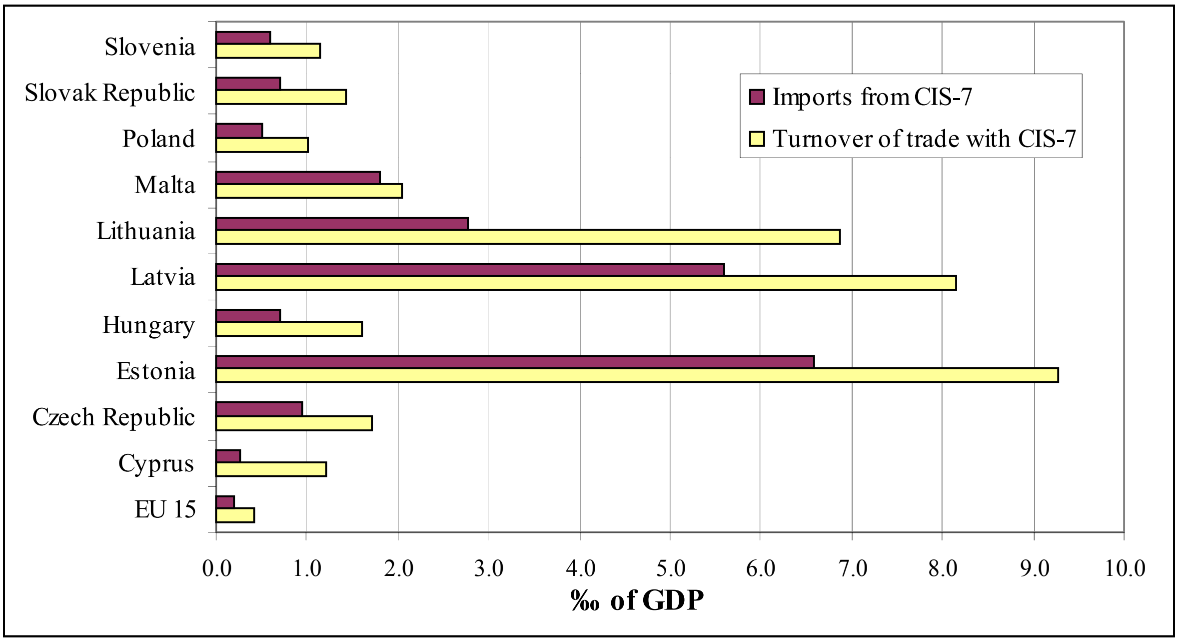
3. Role for new EU member countries in expanding trade with CIS-7

As soon as the mutual knowledge of markets is concerned, the new EU entrants have some advantages in trade with CIS countries. Eight of ten new EU members are former socialist

[10] All coefficients are significant at 10% significance level.

countries (or their parts), which had extensive trade relations with the former Soviet Union and its republics. Therefore, trade linkages between these economies have much longer history than in case of old EU countries[11], and less language, business practice and mentality barriers exist. This results in better performance in CIS-7 trade with new EU members measured by shares of trade turnover and CIS-7 exports in partner countries' GDP (figure 4). These shares are the biggest for Estonia, Latvia and Lithuania, i.e., three former Soviet republics, which together with CIS countries were parts of a single economic system before 1991.

Figure 4. Trade turnover with CIS-7 and imports from CIS-7 for new EU member countries and EU 15

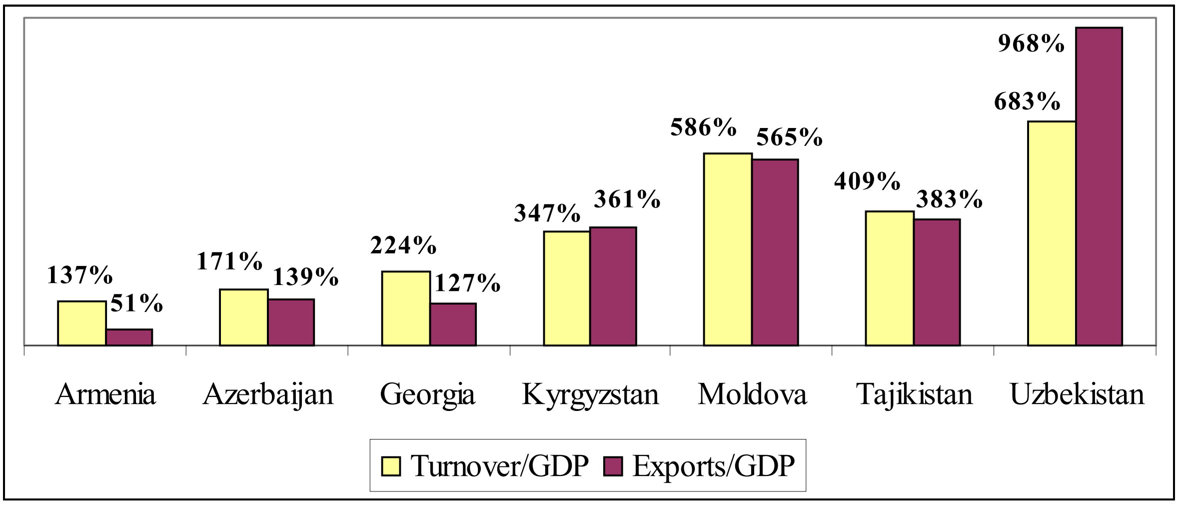


Sources: IMF 2003; IMF's World Economic Outlook database.

Analysis of shares of individual CIS-7 countries on the new EU member markets (measured by turnover/GDP and export/GDP ratios) in comparison to their shares on EU15 markets also confirms stronger CIS-7 links with the new EU entrants (figure 5).

[11] EU15 countries also had rather big trade with Soviet Union; but because of USSR's high centralization of economic and especially foreign trade management all these trade links were concentrated in Moscow.

Figure 5. Shares of CIS-7 countries on new EU10 markets as percentage of these shares on EU15 markets



Sources: IMF 2003; IMF's World Economic Outlook database.

Finally, detailed trade data available for the Kyrgyz Republic for 1996-2002 allow estimating the following gravity-type regression linking exports from Kyrgyzstan[12] to every country of enlarged EU (**X**, mil. US dollars) with GDP's of these countries (**GDP_EU**, bil. US dollars), the distance between capitals (**Dist**, thousand km) and a dummy for former socialist countries – new EU entrants (**FS**):

$$\mathbf{X} = 0.30 + 0.0016^{*}\mathbf{GDP\_EU} - 0.00840\mathbf{Dist} + 1.60^{*}\mathbf{FS}$$ [13].

The significance of the **FS** dummy indicates that exports from Kyrgyzstan to the eight transitional EU countries are larger, than could be explained by the distance to and capacity of their markets only.

As these countries have some "historical" advantages in trade with CIS countries, which are quite measurable in case of CIS-7, their EU membership provides them with additional chances to become facilitators in trade of smaller CIS countries with the European Union. Taking into account the slow progress in regional economic integration in CIS, which undermines European business's interest in CIS-7 markets, and large structural and institutional problems, which are experienced by CIS-7 economies and prevent them from attempts of aggressive penetration into EU market, the facilitator/intermediary role will probably remain with the new EU members in the mid-term and, maybe, in the long-term period.

[12] Without gold exports, which are exogenous (see discussion above).
[13] * means coefficient significance at 1% level.

Conclusions

The progress of CIS-7 countries in expanding trade with and exports to the only practically accessible developed market of the European Union is very slow so far. The CIS-7 exports to the EU are dominated by products of extracting industry, CIS-7 imports from the EU are aid-dependent; all these make the CIS-7–EU trade flows insufficiently sustainable. While trade policies on both sides are partially responsible for this situation, there are much bigger impediments to trade related to incomplete structural reforms, underdeveloped institutions in CIS-7 countries and, importantly, combination of small size of CIS-7 domestic markets and lack of regional cooperation in CIS. In these conditions established business connections between the new EU members and CIS-7 countries become a factor facilitating CIS-7–EU trade expansion.

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