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# **EURASIAN INTEGRATION**

## RUSSIA'S ATTEMPT AT THE ECONOMIC UNIFICATION OF THE POST-SOVIET AREA

Iwona Wiśniewska

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## THESES

- The post-Soviet countries, which used to be totally unified in legal and economic terms until 1990, have been drifting apart in the twenty years since the collapse of the USSR. Relations between them have been loosening despite the numerous integration attempts which have been made since the early 1990s. Declarations of integration have not been put into practice due to the great differences in the interests of individual countries. In 2009, Vladimir Putin, who was then the Russian prime minister, gave a successful impetus for establishing closer relations within a still narrow group of three countries: Russia, Kazakhstan and Belarus. With determination, Russia embarked upon implementing the principles of the Customs Union among these three states, and since 2012 within the Common Economic Space as well. This process of integration was intended to bring about the introduction of 'four freedoms' in this area: the free movement of goods, services, capital and labour.
- Despite the numerous limitations of the integration process, such as the small number of the participating states or limited progress in implementing the CES, this is still the most advanced integration programme in the region since the collapse of the USSR. Progress in putting the rules of the Customs Union into practice can be seen as a success for Moscow. In turn, the formation of the CES is still at an early stage, and it is difficult to determine at this point how deeply the three countries will harmonise their markets.
- The implementation of the principles of the Customs Union and the Common Economic Space has been strongly motivated by political factors. Regional integration has become a strategic goal in Russia's foreign policy over recent years. From Moscow's point of view, building up such integration structures is necessary especially to counteract the economic expansion of the European Union and China, as well as the loosening of the bonds between the CIS countries and Russia. At the same time, close co-operation is expected to guarantee Russia that the strong politico-economic influences in this area will be maintained. From the viewpoint of Kazakhstan or Belarus, integration with a partner whose economic, military and geographical domination is so strong raises the fear that they will become increasingly dependent on Russia. However, on the other hand, it guarantees access to the Russian market and counterbalances China's economic expansion in Kazakhstan. In the case of Belarus, it allows preferential conditions of economic co-operation with Russia to be maintained. It is worth noting that

regional integration barely contributes to the economic modernisation of this area. The CIS countries are searching for the new legal solutions, technologies, know-how and funds necessary to implement reforms and diversify their economies primarily outside the region, mainly in the West, and not in Russia.

- Russia, Kazakhstan and Belarus are becoming more and more integrated on conditions dictated by Russia, which are at times more protectionist than those which have so far obtained in these countries. This means the deterioration of the principles of third-country access to the market of this region, and a relative improvement in the competitiveness of Russian products in Belarus and Kazakhstan. The Custom Union is being implemented at the expense of these countries' relations with the European Union. Nevertheless, the integration process also offers some benefits to European countries. Lifting trade barriers broadens their sales markets, standardises the conditions of their operation on these markets (in compliance with the principles of the World Trade Organisation), and contributes to reducing the prospective exporters' and investors' expenses.

## **INTRODUCTION: THE UPS AND DOWNS OF EURASIAN INTEGRATION**

On 9 June 2009, the Russian prime minister, Vladimir Putin, after his meeting in Moscow with the leaders of Belarus and Kazakhstan, announced that these three states had embarked upon the creation of a Customs Union. At that time, his announcement sounded like a repetition of a slogan which had been heard many times before. After all, as early as September 1993, a group of countries belonging to the Commonwealth of Independent States (which had been formed on the ruins of the collapsing Soviet Union just a year and a half previously) had signed an agreement which envisaged the creation of a free trade zone, to be followed by a customs union and later an economic union. This was expected to be a gradual process of a new (re)integration of this area. In January 1995, a customs union agreement was signed by Russia and Belarus, soon to be joined by Kazakhstan, and then in 1996 by Kyrgyzstan and in 1999 by Tajikistan.

However, too many factors were working against the integration process. It was initiated by Russia, which had from the very beginning aspired to play the role of hegemon in the post-Soviet area. The process was formally supported by such countries as Belarus, Kazakhstan and the remaining Central Asian countries, which were strongly connected to Russia (and some of which were even economically dependent on it), to whom the ongoing disintegration of economic bonds meant the greatest losses. However, even they had a different vision for integration than did Russia, and were using this process for their own needs, as a means to solve their current problems. Many of these countries, like Ukraine, saw these agreements more as a way to arrange a 'velvet divorce' from the former USSR rather than a transition to a new kind of community. They were focused on turning themselves into independent states, also in economic terms.

However, paradoxically, Russia itself was the main cause of the failure of integration efforts at that time. It had to deal with an economic crisis and carry out painful reforms; so it really did not want to bear the costs of what effectively was subsidising the economies of the other CIS countries, most of which had chosen other economic policy models based even less on free market principles. Nor could it really afford this. For this reason, the rouble zone collapsed in summer 1993, when the monetary reform in Russia forced other CIS countries to introduce their own national currencies, even though some of them had not planned to do so. It was also Russia which in fact blocked the implementation of the free-trade zone agreement signed in 1994 by most of the CIS countries.

Furthermore, a number of Russian initiatives – including the customs union project in 1995, and especially the subsequent agreements with Belarus (1996, 1997, 1999) envisaging the creation of a kind of a union state – were in fact superficial political and propaganda actions aimed at rescuing the reputation of President Boris Yeltsin, whose popularity in Russia had been weakening.

These factors, along with the deepening differences in interests and development levels, the lack of basic trust, the use of protectionism to cushion the weak economies, which were unprepared to face competition, meant that despite the numerous agreements signed, the 1990s were in fact a period of accelerated disintegration of what had been a uniform economic area in the Soviet period.

A breakthrough was expected when a new, vigorous leader, Vladimir Putin, took power in Russia at the beginning of 2000. Indeed, his coming to power coincided with new initiatives – the countries participating in the customs union signed an agreement in October 2000 setting up the Eurasian Economic Community (EAEC). However, the implementation of the agreements signed and the construction of the new community's structures (some of which were by definition supranational) again met with great impediments. The states involved had different interests, and they lacked strong economic and political motivation.

Russia became the source of economic motivation in response to the launch of a new European Union initiative in 2003, which a year later became known as the European Neighbourhood Policy. Moscow saw this as a challenge to its hegemony in the CIS area, which was especially dangerous in the case of Ukraine, a country it sees as strategically significant for many reasons. This was the primary origin of another Russian initiative, the Common Economic Space (CES) of Russia, Ukraine, Belarus and Kazakhstan. The March 2003 declaration and the CES agreement of September that same year, which were signed under political pressure from Moscow, were primarily aimed at pulling Ukraine into the integration orbit. However, this plan was thwarted when political forces reluctant to join the CES took power in Ukraine in 2004 as a consequence of the Orange Revolution. The process of creating the CES entered a phase of stagnation which lasted until 2009. Then a new economic factor emerged: the economic crisis (from autumn 2008), which dealt a heavy blow to Russia, and an even heavier one to Ukraine. The other countries from the CIS area were also affected, albeit to a lesser extent. It could thus have appeared that establishing closer economic co-operation, trade liberalisation and opening up the borders between the key CIS countries would definitely help their economies and accelerate their exit from the crisis. Political stimuli were also present.



In 2009, the EU initiated the Eastern Partnership programme (upon a motion from Poland and Sweden), which envisaged the negotiation of EU Association Agreements and Deep and Comprehensive Trade Area agreements (DCFTA) with those eastern partners who had made the most progress in their reform processes (Ukraine and Moldova were the first to start this process). Russia saw this as a new challenge, and wanted to respond to it in a decisive manner. Moscow was also anxious about China's increasing economic expansion in Central Asia, which was undermining Russian influence in the region, including in Kazakhstan, a country of strategic significance for Russia.

This was the essential background for Vladimir Putin's initiative to rapidly build up the Customs Union of Russia, Belarus and Kazakhstan. Another important fact was that Putin was the prime minister at that time, whose formal key prerogative was the economic policy of Russia. The idea of the CU became Putin's flagship project after that time. It was so important that in an attempt to force the EU and the USA to recognise the Customs Union as a partner, he delayed the negotiations concerning Russia's accession to the WTO by over a year.

Yet on the other hand, it seemed that Putin had learnt some lessons from the failures of the previous integration processes in the CIS area. The new initiative differed from the previous ones in several important elements.

Firstly, the draft agreements were prepared much more carefully. They were significantly more specific and covered a broader scope of issues. Russia's political determination to implement them was also greater.

Secondly, Russia made clear concessions to its partners in its effort to make them genuinely interested in implementing the agreements. Moscow used the conditionality principle in this case as well, but it also used the principle of greater symmetry of benefits. The impression could have been gained that Russia was ready to incur significant but temporary economic costs to gain long-term political benefits.

Thirdly, unlike before, efforts were made to ensure that the CU agreements were based to a greater extent on international standards. In particular, Moscow forced its partners *de facto* to accept that the provisions of the Customs Code complied with the negotiated protocols setting the conditions for Russia's accession to the WTO. Another characteristic feature was the similarity (at least on a formal level) of the names and institutional solutions of the initiatives originating from Russia and the European Union.

What the new initiative and the previous ones had in common was the assumption that it would be implemented stage by stage, as well as the great ambitions of the project, which from the Customs Union would soon lead to the creation of the Common Economic Space and later the Eurasian Economic Union. It was also clear from the very beginning that one of Russia's key political goals was to make Ukraine part of the new structure.

This text is an attempt to sum up the progress which has so far been made in implementing the integration initiative announced by Vladimir Putin in 2009. The chapters of this work provide an outline of the following elements: assumptions of the initiatives and progress in implementing its subsequent stages (chapter one); brief characteristics of the national interests, primarily Russia's, but also those of Russia's present and potential partners (chapter two); and finally, the economic consequences of the integration process and its outlook for the future (chapter three).

# I. THE ASSUMPTIONS OF THE INTEGRATION INITIATIVE OF NOVEMBER 2009

## 1. The documents setting up the Customs Union and the Common Economic Space

Vladimir Putin's declarations on integration forced Russian officials to activate negotiations with their partners in Kazakhstan and Belarus. Part of the formal and legal framework for the structures being implemented was based on agreements concluded as part of the Eurasian Economic Community. They served as reference for the documents signed by Russia, Belarus and Kazakhstan on 27 November 2009 and allowed the Customs Union between these countries to be established in 2010. As a consequence, a single customs tariff started to apply in the three countries on 1 January 2010 (for the first time since 1991). The Common Customs Code became binding on Russia and Kazakhstan on 1 July 2010, and on Belarus on 6 July 2010. An agreement setting the rules for the distribution of incomes from import duty (as well as taxes and other duties) between the member states of the Customs Union became effective on 1 September 2010. Furthermore, the Custom Union member states entered into an agreement regulating the operation of the Customs Union within the framework of the multilateral trade system on 19 May 2011. This agreement *de facto* meant that Russia's obligations with regard to the World Trade Organisation (at that time Russia was about to close its accession negotiations<sup>1</sup>) would also become binding upon the entire Customs Union.

**The Customs Union was just the first stage in the process of these countries' integration. In 2010, the parties agreed to form the Common Economic Space between 1 January 2012 and the end of 2015, and signed seventeen general agreements<sup>2</sup> concerning its operation on 9 December 2010. The three countries' presidents also signed the following three documents on 18 November 2011 in Moscow: an agreement on the Eurasian Economic Commission, setting up a body in charge of integration coordination; the Eurasian Economic Commission Regulation; and the Declaration on Eurasian Economic**

<sup>1</sup> Russia officially joined the WTO on 22 August 2012. Kazakhstan is also in the final stage of its negotiations and hopes to close them in 2013. Belarus's accession process is frozen.

<sup>2</sup> These documents were developed by the Customs Union Commission. The member states ratified them at express pace just a few days before the end of 2010; [http://www.economy.gov.by/ru/f\\_economic/foreign-policy/foreign-affair-integrity/foreign-affair-integrity-formirovanie-edinogo-ekonomicheskogo-prostranstva](http://www.economy.gov.by/ru/f_economic/foreign-policy/foreign-affair-integrity/foreign-affair-integrity-formirovanie-edinogo-ekonomicheskogo-prostranstva)

Integration which envisaged the creation of the **Eurasian Economic Union** in 2015. This structure was to signify the close politico-economic co-operation between the three states.

The *acquis* of the integration process initiated by Russia has been supplemented by executive acts and agreements containing more precise regulations in addition to these quite general documents.

## **2. The principles of the integration process of Belarus, Kazakhstan and Russia**

### **2.1. Integration as part of the Customs Union**

As the principles of the Customs Union were being introduced, barriers were also being lifted (with some exceptions, mainly concerning oil trade) in internal trade between these countries within the free trade zone. Furthermore, a **single customs tariff (SCT)** was introduced, which was to a great extent based on that which had previously applied in Russia. 80% of the common customs rates were the same as the rates used by Russia. According to the Customs Union Commission's estimates, before the SCT was introduced, import duties in terms of the number of items had been 90% harmonised between Russia and Belarus, but only 38% between Russia and Kazakhstan<sup>3</sup>. It should also be noted that the Russian trade policy was less liberal than those adopted by Kazakhstan or Belarus. The weighted average import duty rate in Russia in 2009 stood at 10%, which meant that the other two member states of the Customs Union had to raise their respective import duty rates. As a consequence of these changes, Kazakhstan's weighted average import duty rate rose from 6.2% to 10.6%. In the case of Belarus, the increase in the customs duties was significantly smaller and covered only certain goods, primarily cars, electric engines and leather products. In the next few years, the import duties applicable in the Customs Union are bound to fall, considering Russia's commitments to the World Trade Organisation (its weighted average import duty rate should be reduced to 7.8%). The first changes in the single tariff, with the customs conditions negotiated by Russia taken into account, were made as early as 23 August 2012<sup>4</sup> (when Russia

<sup>3</sup> Sergei Glazev, Secretary of the Customs Union Commission, <http://www.customs-union.com/зачем-нам-нужен-таможенный-союз>

<sup>4</sup> The decision concerning this matter was passed on 16 July 2012 by the Eurasian Economic Commission; [http://www.tsouz.ru/eek/RSEEK/RSEEK/7z/Pages/R\\_54.aspx](http://www.tsouz.ru/eek/RSEEK/RSEEK/7z/Pages/R_54.aspx); [http://www.tsouz.ru/eek/RSEEK/RSEEK/7z/Pages/R\\_55.aspx](http://www.tsouz.ru/eek/RSEEK/RSEEK/7z/Pages/R_55.aspx)

officially joined the WTO). The duty rates were reduced primarily for food (especially pork), clothes, steel products and transport vehicles. In general, the weighted average import duty rate should fall from the previous level of 9.6% to approximately 7.5% in 2018.

To limit the negative consequences of the SCT introduction, Kazakhstan and Belarus had negotiated a list of goods (over 400 items) which would not be covered by the single tariff in the transitional period<sup>5</sup>. For example, until the middle of 2011 citizens of these two countries were allowed to buy cars on the conditions which applied before (a 10% customs duty rate, while the SCT was 25%). Kazakhstan and Belarus were also given preferential conditions until 2013 for importing means of transport (railway carriages, including cisterns) and furniture. The Single Customs Tariff will also not apply to medical diagnostic equipment until 2014, or pharmaceuticals and aircraft until 2015. At the same time, the duty-free import of aircraft spare parts was not restricted by any timeframe. When the Single Customs Tariff was adjusted to Russia's commitments to the WTO, approximately 120 groups of goods were still excluded from the SCT, for instance cars and pharmaceuticals. Another exception from the SCT was the ten-year transitional period granted for Kazakh sugar factories, which received consent for duty-free import of raw material for the production of cane sugar. It was also agreed that the import of technological machinery and equipment for investment purposes (used for the modernisation of the top priority sectors) would also be exempted from customs duty.

Pursuant to the agreement setting the rules for the distribution of incomes from import duties (taxes and other levies) between the member states of the Customs Union, 87.97% of the incomes will go to the Russian budget, 7.33% to the budget of Kazakhstan and 4.7% to the budget of Belarus.

Although the exceptions which are not covered by the single customs tariff form a rather limited number of product groups (120 in 2012 and 400 in 2010, out of a total number of several thousand), they concern products which are important for each given country. Usually, these countries are dependent on imports of such goods, because they manufacture them either not at all or in insufficient quantities. However, a decidedly more important limitation for the common trade policy between the three states is the fact that the single customs tariff does not apply in the case of **export duties**, which are usually

<sup>5</sup> <http://tsouz.ru/db/ettr/Pages/Perehodny.aspx>

imposed on mineral resources – the key export products of these countries<sup>6</sup>. Export duty is most frequently used by Russia. It is also worth noting that export duty poses a barrier to internal trade between the three member states of the Customs Union as well. For instance, Moscow imposes it on those crude oil supplies to Belarus which are not intended for the needs of this country. Since 2012, only oil supplied via pipelines to the Customs Union member states is duty-free (customs duty should be imposed on oil transported by railway cisterns). Furthermore, Russia has promised to impose customs duty on all oil sent to Kazakhstan starting from 2014.

The entry into force of the **Common Customs Code** (CCC) in all three member states has been of key significance for the operation of the Customs Union. This document set the same rules for the member states regarding the imposition of customs duty, extra-tariff regulations, customs inspection and all procedures linked to import, export and transport of goods. The CCC was based on the International Convention on the Simplification and Harmonisation of Customs Procedures (signed in Kyoto in 1973) and the WTO's requirements. This document introduced facilitations in customs clearance of goods supplied from outside the Customs Union, reduced the clearance time and the number of required documents. When the CCC started to apply in internal trade inside the Customs Union, customs clearance was lifted in the case of goods originating from CU member states, or third countries if the goods were cleared by the customs services of any of the CU member states. Furthermore, customs inspection points were withdrawn from the internal borders of the CU. They were liquidated on the Russia/Belarus border on 1 January 2011<sup>7</sup>, and half a year later (on 1 July 2011) on the Kazakhstan/Russia border.

The CCC also introduced a single customs declaration used by all three states, a customs value declaration, and instructions for completing these documents. Since the CCC was being developed at a fast pace, it was impossible to negotiate all the necessary details. As a result, the document includes many references

<sup>6</sup> The share of incomes from sale of mineral resources (oil and petroleum products, natural gas, metal and metal products, and fertilisers) is approximately 80% of Russian exports, over 85% in Kazakh exports and less than 65% in Belarusian exports.

<sup>7</sup> However, according to Belarusian press reports, Russian customs officers returned to the Russian-Belarusian border checkpoint in Smolensk oblast at the beginning of 2012. The Russian side claims that the customs officers are not working at the border checkpoint but only in the customs inspection zone, which is located at the border. For more, see: <http://belaruspartisan.org/economic/215904/>

to the national regulations of the countries involved in the integration process. The parties also failed to develop all the necessary executive acts. As a result, differences in some customs procedures used by each of the three states have remained. One example may be the rules of functioning and the procedure for granting Authorised Economic Operator (AEO) status. Such entities had already been present on the Belarusian and Kazakh markets, but Russia needed to develop a new law, which was enacted as late as November 2010, and took the form of the Customs Regulations Act (four months after the introduction of the Customs Code).

The integrative actions taken by Russia, Kazakhstan and Belarus enabled them to set up the Customs Union. However, its operation is restricted to import policy. Energy resources, which are of key significance for these countries' trade (with export shares of 80% in Kazakhstan, 70% in Russia and 30% in Belarus), have been excluded from the integration process. It was Russia's decision to relinquish the harmonisation of export duties; this revealed its lack of readiness to share (at least formally) its competences, which guarantee around 30% of its budget intakes.

Additionally, the co-operation rules dictated by Moscow (especially the single import tariff), which strengthened the protectionist policy applied towards third countries, proved to be unfavourable for Kazakhstan and Belarus, caused an increase in the prices of third-party goods, and thus contributed to improving the price competitiveness of goods from Russia, despite their poor quality.

The efficient operation of the Customs Union was furthermore impaired by the inconsistent and ambiguous Common Customs Code, which leaves room for free interpretation of its provisions to each of the customs services. The amendments made to this document only partly improved its effectiveness. As a consequence, work commenced on a new document which would be more precise and reduce to a minimum the possibility of introducing any national solutions<sup>8</sup>.

Nevertheless, the adjustment of the Customs Union's rules to those applicable in the WTO, which Russia undertook to adhere to as a member of this organisation, has been a positive factor. As a consequence, both Kazakhstan and Belarus, which are formally outside the WTO structures, have been forced to adopt the terminology and the customs procedures which apply in the WTO member states.

<sup>8</sup> Министр таможенного сотрудничества ЕЭК Владимир Гошин: „Кто виноват? Таможня“, 11 July 2012, *РБК daily*.

## 2.2. The formation of the Common Economic Space

Although the Common Economic Space formally began to operate on 1 January 2012, most of the executive acts necessary for the structure to meet its assumptions have not yet been agreed on. Work on the required documents and the implementation thereof have been divided into stages according to the schedule<sup>9</sup> for implementing the agreements setting up the CES which was adopted in April 2012. The greater part of the work is expected to have been finalised by 2015<sup>10</sup>, although in some cases the transition periods could even be extended to 2020. Pursuant to the agreements on the CES adopted and the executive acts already developed to some of them, the parties have set the rules of integration in several areas<sup>11</sup>.

**Economic policy**, including:

- **macroeconomic policy guidelines**, partly by determining the convergence criteria (modelled on the EU's Maastricht criteria): the budget deficit of the CES member states may not exceed 3% of GDP, the public debt may not be higher than 50% of GDP, and the inflation rate may not be more than 5 percentage points above the price level in the member state where the inflation is lowest. Officially, these parameters becomes binding in 2013, although all three countries had already met these conditions in 2011;
- **the operation and access to the services provided by selected natural monopolies**, albeit with the exception of the gas market, which will be regulated under a separate agreement. The parties announced they would adjust their terminology and legislation in order to create the principles for common monopoly regulation, while maintaining the national regulators; and grant entities from the CES non-discriminatory access to the services provided by monopoly firms. The schedule for the step-by-step development of common rules regulating the operation of natural monopolies is expected to be ready by March 2014<sup>12</sup>;

<sup>9</sup> <http://www.tks.ru/news/law/2012/05/04/0001>

<sup>10</sup> 'YEP udstasa sformirovat v blizhaishiye polgoda, zayavil Lukashenko', *RIA Novosti*, 9 December 2010.

<sup>11</sup> Presentation by the Ministry of Economic Development of the Russian Federation.

<sup>12</sup> Решение Коллегии Евразийской экономической комиссии от 5 февраля 2013 г. N 14 „О реализации Соглашения о единых принципах и правилах регулирования деятельности субъектов естественных монополий от 9 декабря 2010 года”, [http://www.alt.ru/show\\_orders.php?action=view&filename=13kr0014#ANCHOR\\_Ao1](http://www.alt.ru/show_orders.php?action=view&filename=13kr0014#ANCHOR_Ao1)



- **competition policy:** the parties have promised to harmonise their legislation and to transfer the management and audit (including punishments in case of breach) to a supranational anti-trust agency. The documents which determine such issues as the methodology of evaluation of market competition, considering breach reports, assessing the penalties and the manner of enforcement thereof, were adopted in November 2012;
- **government subsidies for industry and agriculture:** the parties have divided the industrial subsidies into three types: specific (these are admissible, unless they are prejudicial to any partners from the CES), forbidden (the introduction of which enables the partners to use compensation mechanisms) and admissible (horizontal, for instance concerning support for small- and medium-sized businesses or very poor regions). The common criteria for granting the right to subsidies and evaluation of their use will be agreed by 2015. The supranational agency will receive the right to decide whether these can be used by that time, as well. As regards support for agriculture, for example, the parties have agreed that export subsidies will be forbidden, while any support which does not affect trade can be offered without any limitations. The value of subsidies affecting trade has been restricted to 10% of the net value of agricultural production. The decision on how to report on the subsidies used was passed in November 2011. The participating states thus undertook to adjust their national laws to the community rules (a transitional period until 2016 was introduced for Belarus; it will gradually reduce the value of its subsidies from 16% in 2011 to the agreed level of 10%);
- **public procurement at local level:** it has been agreed that entities from all CES member states will be given equal access, and that the procurement rules, the way information on purchase plans is presented, and the requirements for procurement in electronic form will be harmonised. The parties have agreed that in exceptional situations it will be possible to derogate from these rules for a period not longer than 2 years. National rules are expected to apply to entities from other CES countries (operation on the same conditions as domestic companies) from 1 January 2014;
- **the service sale and investment policy rules:** the CES member states have agreed that they will aim to offer their partners access to the services market according to the national rules; the exceptions will be audiovisual services, air transport, banking services, postal services, inland water and

maritime transport, and pipeline transport<sup>13</sup>. Foreign investors' share in the telecommunication services and air transport sectors has been restricted to 49% of the market, and their share in the mass media to 20%. Nor will the market for lawyer or notary services be subject to integration (those who offer such services must be citizens of a given country). Furthermore, each of the states can also lengthen the list of exceptions individually;

- **the rules of intellectual property protection:** the rules being introduced must comply with the international commitments of the states involved in the integration process. The parties have also set general rules for the standardisation of copyright, trademarks, names of the places of origin of goods, and patent rights. It is planned to create a common system for the protection of intellectual property rights, and to establish a coordinating authority on the CES level. It was agreed that the acts enabling the use of these rules would be developed by the end of 2012, but this deadline was not met.

### **The free movement of capital and the common currency policy**

The parties have promised to harmonise their laws, requirements, market management regulations and the protection of consumer rights on the banking, insurance and securities markets. They have also declared their support for guaranteeing the transparency of their markets' operation. The harmonisation is expected to be completed by the end of 2013. As regards the common currency policy, the parties have undertaken to coordinate the exchange rate policy and currency repatriation requirements, to introduce standardised terminology, to unify the import and export of currency, to harmonise the standards and rules of currency adjustment, and to coordinate currency control. The regulations for the export and import of currency were unified on 1 July 2010. Furthermore, in November 2011, the central banks made arrangements concerning currency policy coordination, and an agreement on the co-operation of agencies in charge of currency audits was signed. Although the documents include no declaration on the introduction of a single currency, the Russian side has recently been fostering this idea<sup>14</sup>.

<sup>13</sup> <http://www.wto.kz/index.php?r=2&p=264>

<sup>14</sup> At the Saint Petersburg economic forum on 15 June 2012, Prime Minister Dmitri Medvedev suggested that a single currency could be introduced in the Eurasian Economic Union. This idea was also backed by the Russian Parliamentary Commission for the CES.

## Energy and transport policy

These arrangements were to result in free trade in oil and petroleum products, the non-imposition of export duties inside the CES (this rule started to apply when Russia signed bilateral agreements with Belarus and Kazakhstan on settling their accounts regarding the mutual re-export of oil<sup>15</sup>). Equal non-discriminatory access to the transport system for entities from all CES member states, common conditions for setting transport tariffs, and the unification of the standards and norms concerning petroleum products have been promised by the parties. A decision of August 2011 imposed the obligation upon the parties to inform each other of the export and import of petroleum products. The parties also agreed that petrol and diesel oil requirements and standards will be implemented as of 2013<sup>16</sup>. As regards co-operation in the railway sector, they have agreed to harmonise the rules for setting railway tariffs, which is expected to be done in 2013. Unrestricted access to services is to be ensured for entities from all CES member states in 2015. However, the common access and service provision rules need to be agreed first, originally planned by the end of 2012. The parties' arrangements concerning the gas sector signify that only the procedure for determining the gas price will be established. Access to the transport network is expected to be ensured only upon meeting numerous conditions, or bringing the gas prices on the CES market closer to the free market levels (i.e. a price level comparable to that offered to Europe, minus transport costs and export duty). It is assumed that this will take place in 2015.

## The free movement of labour

The parties have decided to join efforts to counteract illegal migration of workers from third countries and to determine the legal status of expatriate workers

<sup>15</sup> For example, the Russian export duty rate is imposed on Russian oil re-exported by Kazakhstan, and is then transferred to the Russian budget. If oil from Kazakhstan is re-exported by Russia, the customs duties go to Kazakhstan's budget.

<sup>16</sup> A three-year transition period was introduced in the case of the adopted technical regulation on the requirements concerning petrol and diesel oil, which will take effect in 2013. Regulations introducing the Euro-4 and Euro-5 emission reduction standards, which are new in this region, are expected to take effect in Russia and Belarus in January 2015, and in Kazakhstan one year later. Fuels supplied as part of orders from the defence sector, exported outside the CU, those used as reserves and those used in the oil industry have been excluded from these regulations. For Belarus, whose refineries have already been modernised, meeting these standards will be the easiest task. However Kazakhstan, which is just planning to modernise its oil refining sector, will find it most difficult to implement these standards.

and members of their families. In December 2010, CES member states reached an agreement on the legal status of expatriate workers and on counteracting illegal immigration. Owing to this citizens of the three states can be employed within CES, regardless of their origin, without any restrictions or the need to apply for special permits<sup>17</sup>. The labour market protection mechanisms do not apply to workers from CES. For example, workers from Belarus and Kazakhstan are not included in the quotas of foreigners who can be employed on the basis of a permit.

## Technical standards

As agreed between the CU's parties at the end of 2010, the community's technical standards<sup>18</sup> based on international standards, including those applicable in the WTO, should be the only binding standards for these countries as of 1 January 2012 (the national requirements should be lifted). Common sanitary and epidemiological requirements were already adopted for goods subject to this kind of supervision as part of the Customs Union in mid-2010<sup>19</sup>. These standards were also harmonised with Russia's commitments to the WTO. A common list of production types subject to technical regulations was adopted in January 2011. The present version of the list, which was supplemented under a decision by the Eurasian Economic Commission Council of 22 November 2012, consists of 66 items<sup>20</sup>, including machinery and equipment, grain, children's toys and food. In April 2011, the parties further agreed on the procedures to confirm compliance with the requirements. Additionally, agencies from individual countries were put in charge of the technical regulation issues<sup>21</sup>. A register of laboratories authorised to certify goods and admit them to trade in all three countries was also approved at the beginning of 2011. Standardised certificate and declaration registration forms were introduced within the CU in mid-2011. 31 technical regulations (out of the 66 needed) took effect by April 2013. The effective dates of the remaining ones have been postponed until as late

<sup>17</sup> W. Ioncew..., Yedyniy rynek truda YeEP: ekonomicheskyyi efekt soglashenyi v oblasti trudovoi migratsii. Eurasian Development Bank, *Евразийская экономическая интеграция*, no. 2 (15) 2012.

<sup>18</sup> Exceptions to the community standards could only be made for geographical or climatic reasons. For example, Russia has not decided to impose a ban on using cars with the steering wheel on the right-hand side.

<sup>19</sup> [http://tsouz.ru/KTS/KTS17/Pages/P2\\_299.aspx](http://tsouz.ru/KTS/KTS17/Pages/P2_299.aspx)

<sup>20</sup> <http://www.tsouz.ru/db/techreglam/Documents/Ed%20operech%20new.pdf>

<sup>21</sup> <http://www.tsouz.ru/db/techregulation/techbars/Pages/default.aspx#>

as 1 January 2015<sup>22</sup>. The regulations which have already been developed cover railway transport safety (in force), food production (as of 1 January 2013), machinery and equipment (as of 15 February 2012) and petrol & diesel oil requirements (1 January 2013), among others<sup>23</sup>. In the case of goods for which common standards have not been developed, the national standards in force hitherto still apply.

As a result of the changes which have been taking place within the CES, the process of introducing the free movement of labour between Russia, Kazakhstan and Belarus is the most advanced. Even before the present integration structures were created, these countries had offered numerous mutual travel facilitations to their citizens, such as visa-free movement for citizens holding both internal passports (identity cards) and foreign passports. The integration process has also offered citizens of Kazakhstan<sup>24</sup> **access to the labour market** in the CES. At present, citizens of all three countries need not apply for special work permits, and workers from CES member states should be treated as the domestic workforce is. Furthermore, the registration obligation has been lifted from both expatriate workers and members of their families, if their stay is shorter than 30 days<sup>25</sup>.

However, it has been impossible so far to introduce the **free movement of goods**. Although most tariff barriers have been lifted, many other barriers are still restricting trade. The most serious restrictions include the continuing differences in technical requirements and the failure to comply with the agreed rules<sup>26</sup>.

Progress in introducing the **free movement of capital** has also been rather modest. The main stage of harmonising laws regulating the banking, currency, securities and insurance markets, including requirements for licensing operation in these sectors, is to begin by the end of 2013. The entire process is expected to be completed by as late as 2020. It is also likely that further restrictions

<sup>22</sup> For a complete list of regulations see: <http://www.tsouz.ru/db/techreglam/Pages/technical-reglament.aspx>

<sup>23</sup> See footnote 16.

<sup>24</sup> The free movement of labour also existed before, as part of the Union State of Russia and Belarus.

<sup>25</sup> W. Ioncew..., *Yedinyi rynok truda YeEP: ekonomicheskyyi efekt soglashenyi v oblasti trudovoi migratsii, op.cit.*

<sup>26</sup> Epidemiological and sanitary standards which did not fully meet the community requirements still applied in Russia in the first half of 2012. For more, see: <http://www.a4consulting.ru/articles/1728-edinye-sanitarnye-trebovaniya-tamozhennogo-soyuza.html>

will be imposed on foreign investors' access to the financial markets in individual CES member states. As part of its negotiations with the WTO, Russia has been given guarantees that the share of foreign capital in the banking and insurance sectors will not exceed 50%. Belarus also strictly regulates the presence of foreign entities on its market. Only Kazakhstan has no such restrictions; however, its government has begun to consider the possibility of imposing some of them.

Limited progress can also be observed in the introduction of the **free movement of services**. The national regulations of the state in which the service is provided still apply<sup>27</sup>. The services sector became part of the integration process only within the framework of the CES. Before that, this market segment had been developing autonomously in each of the countries.

However, it turns out that the introduction of the 'four freedoms', especially the free movement of labour and goods, could also have negative consequences for Kazakhstan's plans for developing its local economy. Kazakhstan's government insists that local workforce and goods must be used to the broadest possible extent as part of investment, energy and infrastructural projects. Meanwhile, investors in an increasing number of cases are also including Russian workers and goods in the pool of orders reserved for Kazakh businesses and employees.

### **2.3. The authorities in charge of operation of the integration structures**

It has been agreed that the responsibility for the integration process rests with the newly established authorities of the Customs Union and the Common Economic Space. Their tasks include administering and supervising the integration process (including monitoring the implementation of the decisions adopted, and developing legal acts to enable deeper integration). It is worth noting that some of these authorities were established after the Eurasian Economic Community had been formed, which raises doubts about the distribution of competences.

<sup>27</sup> When the Customs Union was being formed, service sale issues were not raised, and no special regulations in this sector were introduced. The lack of a common policy regarding the services sector in the CU was one of the impediments which prevented Russia, Kazakhstan and Belarus from jointly embarking upon accession negotiations with the World Trade Organisation in 2009. Regulations concerning the services sector are an essential part of the WTO's *acquis*.

The most important political body of the integrating structures is the **Supreme Eurasian Economic Council**, which meets annually at the presidential level and at least twice a year at the government heads' level. The council meets in the format of five states: Russia, Kazakhstan, Belarus, Kyrgyzstan and Tajikistan. However, decisions regarding the CU and the CES are taken only by the three countries involved in the integration process. The council decides on strategic co-operation directions by consensus. Individual states may appeal to the council if they do not agree with the conditions or methods of integration.

The **Eurasian Economic Commission** (EEC) operating in Moscow is a permanent regulatory body of the Customs Union and the emerging Common Economic Space<sup>28</sup>. This commission replaced the previously operating Customs Union Commission and took over its competences at the beginning of 2012. The EEC consists of the Council and the Board. The **Council**, a political body, is formed by three deputy prime ministers (one from each state)<sup>29</sup>, who supervise the Commission's work and decide on the general directions of its operation. The Council of the Commission passes decisions which are within the prerogatives of the EEC (currently predominantly concerning the tariff and customs policy and standardisation) by consensus. If the parties are unable to reach the consensus, the issue is passed, to be resolved later by the Supreme Eurasian Economic Commission.

In turn, the **Board** is the Commission's executive body (it has been modelled on the EU's European Commission), and consists of nine members: three representatives (commissioners) from each state, who are appointed for four years. The Board's tasks include direct management of operation of the bureaucracy of the Customs Union and the Common Economic Space, which is divided into 23 departments. Since 2012, the EEC's competences are primarily as follows: administering and adjusting the tariff & customs policy, developing and supervising compliance with technical, sanitary & phytosanitary regulations, distribution of the income from customs duty, and setting the rules of trade co-operation with third countries (all these functions had previously been performed by the Customs Union Commission). As integration of the three states deepens, the Commission's competences will be gradually expanded, to

<sup>28</sup> Agreement of the Eurasian Economic Commission of 18 November 2011; [http://www.tsouz.ru/Docs/IntAgrmnts/Pages/Perechen\\_MDTs.aspx](http://www.tsouz.ru/Docs/IntAgrmnts/Pages/Perechen_MDTs.aspx), regulations of its operation; <http://www.tks.ru/files/other/reglament-ek.pdf>

<sup>29</sup> In 2012, the Council consisted of Igor Shuvalov from Russia, Kairad Kalimbetov from Kazakhstan and Siarhey Rumas from Belarus.

include for example co-deciding on the anti-trust, currency, macroeconomic, energy and competition policies; regulations concerning government subsidies for industry and agriculture; public procurement, transport and migration. The scope of the Commission's competences will depend on the degree of these states' real integration. The Commission has the right to represent the member states of the Customs Union and to hold international negotiations.

Pursuant to the regulations, the Board passes decisions by a qualified majority of two-thirds of the votes. Each state and the Council of the Commission can contest the Board's decisions at the Supreme Eurasian Economic Commission. Decisions which have been finally accepted by the Commission (the Council and the Board)<sup>30</sup> directly become part of the legal base of the CU and the CES, and do not have to be ratified. The national state authorities are in charge of implementing these decisions<sup>31</sup>.

The number of officials employed by the Commission is constantly growing. One thousand people have been working there since January 2013. 84% of them are citizens of Russia, 10% are citizens of Kazakhstan and 6% are citizens of Belarus. The members of the Commission (both the Council and the Board) have also been granted immunity and federal minister status<sup>32</sup>. The Commission's budget will be formulated by the states in proportion to their respective shares in incomes from import duties in the CU (Russia accounts for 87.97%).

Officially, the Eurasian Economic Commission was formed on 1 January 2012, but it started *de facto* operation on 2 February 2012, when Viktor Khristenko was appointed head of the Board (so-far deputy prime minister in the Russian Federation). The predecessor of the EEC, the Customs Union Commission, finally ceased formal operation as late as 1 July 2012.

<sup>30</sup> To become effective, decisions of the Eurasian Economic Commission must be published on the Commission's website. However, the site was only created on 1 July 2012; before then, decisions were published on the Customs Union Commission's website.

<sup>31</sup> The Agreement on the Customs Union Commission of 7 October 2010 ceased to be binding on 2 February 2012. The Agreement on the Eurasian Economic Commission of 18 November 2011 came into force on 2 February 2012. [http://www.tsouz.ru/Docs/IntAgrmnts/Pages/Perechen\\_MDTS.aspx](http://www.tsouz.ru/Docs/IntAgrmnts/Pages/Perechen_MDTS.aspx)

<sup>32</sup> The immunity granted can be rescinded by the Commission itself. Other privileges include a 45-day holiday leave, coverage of social, accommodation and medical costs, and wages at ministerial level. The Commission's work will be financed from the budgets of the states involved in the integration process: 87.97% by Russia, 7.33% by Kazakhstan and 4.7% by Belarus. In 2011, the Customs Union Commission's budget was worth 437 million roubles; in 2012, the budget of the Eurasian Economic Commission rose to approximately 4.8 billion roubles.



The **Court of the Eurasian Economic Community** (operating in Minsk) is in charge of resolving economic disputes and handling the issues of the parties' compliance with the agreements signed. This body has been in operation since January 2012. It consists of ten judges: two representatives of each of the states. Disputes within the Customs Union and the CES are resolved by the judges representing the member states of these organisations. The first instance is formed by a board of three judges; appeals can be addressed to the remaining three judges. The court's verdicts are binding upon the member states.

The establishment of a supranational body, and granting it the competences of making laws which are directly binding upon all the states involved in the integration process, can be recognised as serious achievements by these states. At present this commission effectively administers tariff & customs issues as well as the process of harmonising the technical requirements. However, on the other hand, the fact that Russian officials predominate in the Commission gives rise to the risk that the integration process will be subordinated exclusively to Russian interests. Furthermore, the Commission's effectiveness has been hampered due to its limited competences and the need to compete with the national ministries and services, which are only reluctantly relinquishing their previous rights.

## II. THE BASIC INTERESTS OF THE PRESENT AND POTENTIAL PARTICIPANTS IN THE INTEGRATION PROCESS

The countries in the region have an ambivalent attitude to Vladimir Putin's integrationist ideas. On one hand, closer economic bonds offer opportunities for growing trade and economic development; but on the other, the political project being pushed through by Moscow and rapidly implemented is giving rise to fears that the CES region could become totally dominated by Russia.

### 1. Regional integration: Russian interests vs. those of selected countries in the region

#### 1.1. Russian interests

**Russia's** decision to embark upon regional integration has been motivated primarily by political factors, and not by its economic needs.

Regional integration had been one of the **strategic interests** in Russian foreign policy since the collapse of the USSR. However, it was only in 2009 that the Russian administration, closely supervised by Vladimir Putin, embarked upon real formation of the community structures. Closer co-operation was intended to enable the achievement of both regional and global goals. Regional integration became an area of competition between Moscow and the European Union for influence in Ukraine, Belarus, Moldova, Armenia, Azerbaijan and Georgia. Over the past few years these countries have been co-operating increasingly closely with Brussels<sup>33</sup> in an attempt to modernise their economies and reduce their dependence on Russia. From Moscow's point of view, regional integration was intended to counteract the economic expansion of the third countries and the loosening of the bonds between CIS countries and Russia, while at the same time guaranteeing that Russia maintained its strong politico-economic influence in this area, especially in the energy sector, which is a decisive factor in the region's importance for the global economy. This is why Russia, by making use of all the instruments available to it, has been making efforts to convince selected CIS countries – especially Ukraine, the region's second largest

<sup>33</sup> For example by negotiating Association Agreements with the EU, one element of which is the Deep and Comprehensive Free Trade Area agreement with the EU. Ukraine already initialled such an agreement in 2012. Furthermore, negotiations with Moldova, Georgia, Armenia and Azerbaijan have been set on track.

economy – to join the regional integration structures. For example, during the summit of the leaders of the Eurasian Economic Community (March 2012), President Dmitri Medvedev warned non-member states (his words were mainly addressed to Ukraine, Armenia and Moldova) that their remaining outside this structure could mean a great deal of difficulties for them, although he did not give any precise examples.

Russia's determination to push through the integration process is partly a result of the fact that Moscow sees strengthening its position in the region as a way of increasing its importance on the international arena as well. In Putin's opinion<sup>34</sup>, the combined potential of the CIS countries (raw materials, capital and human resources) should improve the area's competitiveness and attractiveness, and thus also its role in the global economy. In the future, the integrated CIS area could establish closer co-operation with the European Union, thus forming a common economic space extending from Lisbon to Vladivostok. A partnership between these two integration structures would create real conditions for geopolitical and economic changes on the continent, the effects of which would also have global significance.

Regional integration has also been important for Russia as an image builder. It has been Moscow's desire to use the success of this process to demonstrate that it still is the centre of attraction for CIS countries, and is capable of carrying out successful initiatives in the post-Soviet area. Russia has also wanted to show that it is an independent player on the international arena, and that it is able to build its own regional groupings, similar to those existing in other parts of the globe (the EU, NAFTA, ASEAN and MERCOSUR).

In economic terms, establishing closer co-operation with Belarus and Kazakhstan has been of limited significance for Russia. Integration on Russian terms, including the need for Minsk and Astana to raise import duty rates, has undoubtedly brought about a relative improvement in the competitiveness of Russian goods on this market. Ensuring an outlet (even if a relatively small one, consisting of approximately 26 million people) for domestic production has been very important, especially considering the continuing global crisis. Integration could in particular be beneficial to the Russian automobile industry (given the high customs duties imposed on vehicles imported from third

<sup>34</sup> Vladimir Putin, *Rossiya i Yevropa: ot otmysleniya urokov krizisa – k novoi povestke partnerstva*, *Süddeutsche Zeitung*, 25 November 2010; Vladimir Putin, *Novy Integratsionny proyekt dla Yevrazii – budushcheye, kotoroye rozhdayetsya segodnya*, *Izvestia*, 2 November 2011.

countries), the food industry (given the lifting of the non-tariff barriers) and the oil refining sector, which could compete in quality with Belarusian products, and above all with the poorly developed oil refining sector in Kazakhstan. However, Russian manufacturers are gradually losing their advantage as Russian commitments to the WTO are being fulfilled by restricting the protectionist policy.

Nevertheless, the economic impact of Belarus and Kazakhstan on the Russian economy is quite limited. These two countries in aggregate account for approximately 7% of trade and approximately 5% of investments in Russia. In principle, neither of them is able to offer the Russian economy any raw materials or technologies which Moscow does not have. At the same time, these countries are competing with each other on global markets (being primarily exporters of raw materials and low-processed goods).

Russia has been interested in introducing the 'four freedoms' slowly and selectively. This has allowed it to reduce the threat posed to its economy by the possibility that Belarus or Kazakhstan could be used as an access window to the Russian market. This has also allowed it to relocate production to these countries, since each of them has been conducting a less protectionist policy and offered a more favourable investing climate.

Furthermore, the price Russia had to pay for Belarus's participation in the integration process was maintaining the latter's existing economic privileges offered by the Russian budget. Minsk has retained its gas price privileges and, partly, its privileges in oil supplies. It also continues to receive massive loans, which allow the present Belarusian economic model to keep operating.

## **1.2. The interests of selected countries in the region**

Integration with Russia, a partner which dominates the rest of the countries in numerous areas, such as politics, economy, military and geography, gives rise to both hopes and fears of the consequences of such co-operation in each state. The calculation of the profits and losses, in the context of economic and political interests alike, is of key significance for each country's attitude to the Russian initiative.

**Kazakhstan** sees regional integration in political terms. Co-operation with Russia is a strategic issue for Astana. Kazakhstan cannot, and has never allowed itself, to openly oppose Russian policy. Moscow has also been playing

a key role in the country's political and economic (in)stability partly due to Kazakhstan's heavy reliance on Russian transit routes, especially oil transport infrastructure.

Kazakhstan, which borders on two powerful partners, Russia and China, has been trying to keep a balance between the two by not allowing either of them to dominate its economy, while at the same time maximising the benefits of co-operation with each of them for its economic development. China's increased economic engagement in Central Asia, including Kazakhstan, has been notable over the past decade. Considering this, Astana could use deeper economic integration with Russia as a means to protect itself from Beijing's economic and political expansion and to balance it with co-operation with Russia. In this context, the Customs Union can be seen as a tool which could help to restrict co-operation with China and give it a form as desired by Kazakhstan (partly thanks to the introduction of the single customs tariff and the Customs Code, it will be able to protect itself from being flooded with cheap Chinese products and strengthen its position in energy negotiations).

It is also vital for Astana to gain facilitated access to the Russian market (approximately 8% of Kazakhstan's exports went to Russia in 2012). Lifting barriers to trade with Russia is expected to boost exports from Kazakhstan (this primarily concerns the metallurgical, coal, chemical and agricultural sectors) and to increase the influx of foreign direct investments to this country. Kazakhstan, where the investment climate is much more attractive than in Russia and Belarus<sup>35</sup> (less bureaucracy, lower fiscal levies and better protection for investors), expects that business will want to take advantage of emerging opportunities and relocate production there. However, on the other hand, integration on the conditions dictated by Russia brings about the need to raise import duties on goods from third countries, which will result in raising their prices. Strong competition from Russian manufacturers may adversely affect plans to diversify Kazakhstan's economy and develop those sectors of the economy which are not involved in raw material production – all the more so because Russia has a similar

<sup>35</sup> In the World Bank's Doing Business 2012 rating, which evaluates the conditions of doing business in a given country, Kazakhstan was ranked 47<sup>th</sup> and Belarus 67<sup>th</sup>, while Russia's position was as low as 120<sup>th</sup>. For example, to start a business, it takes 19 days in Kazakhstan, 5 days in Belarus and 30 days in Russia; to get an electricity connection it takes 88 days in Kazakhstan, 254 days in Belarus and 281 days in Russia (the slowest of all the countries covered by the survey); in terms of investor protection mechanisms, Kazakhstan is ranked 10<sup>th</sup> out of the 183 states, Belarus 79<sup>th</sup> and Russia 111<sup>th</sup>; <http://www.doingbusiness.org/~media/FDPKM/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport.pdf>

problem, as its economy relies heavily on exports of raw materials, and is not interested in sharing technologies with Kazakhstan.

Integration as part of the Customs Union and the CES has had little impact on the intensification of economic relations between Kazakhstan and Belarus. The reasons for this include the geographical distance between the two economies, infrastructural limitations, the unattractive trade offer, and strong competition from Russian manufacturers. Belarus's share of Kazakhstan's trade has been well below 1%; co-operation with Kazakhstan has been of minor significance for Minsk, as well.

**Belarus**, which is in conflict with the European Union and is politically and economically dependent on Moscow, effectively has no other alternative but to join the integration process initiated by Russia. On the one hand, Moscow has many instruments for putting pressure on Minsk, which it has used on numerous occasions to force President Lukashenka to pass decisions which are beneficial to it. It has also done this on numerous occasions in the integration process (see section 2.2 below). On the other hand, Moscow is one of the few allies of the Lukashenka regime, and by backing the Belarusian economic model based on government orders and distribution, it guarantees the continued existence of this regime. As a consequence of joining the integration process, Belarus has received Russian loans and subsidies which are vital for its economy, such as preferential prices of energy raw materials, including duty-free supplies of Russian oil and low gas prices<sup>36</sup>. As more and more barriers are being lifted, such as control at internal customs borders and the introduction of common technical and sanitary requirements (many such barriers had been lifted earlier, as part of the Union State), Belarusian goods have gained facilitated access to the Russian market (35% of Belarusian exports went to Russia in 2012). This has had a fundamental impact on some sectors (over 90% of Belarusian food exports, and on average 41% of its exports of machinery, equipment and transport, go to Russia). Minsk, like Astana, also hopes that lifting the trade barriers will make Belarus more attractive to investors. Foreign exporters and investors could use Belarus, where the conditions of doing business are better than in Russia, as a doorway to the Russian market. Minsk also strongly appreciates the fact that the regional integration structures are based on WTO rules, which brings it closer to membership of this organisation. The WTO accession negotiations are currently blocked for Belarus, but thanks to

<sup>36</sup> In 2012, Belarus paid US\$165 for 1000 m<sup>3</sup> of gas, while the price for Ukraine was US\$430.

the Customs Union Minsk has been partially implementing the international standards, which may facilitate its accession process in the future and open up access for Belarus to global markets. Yet on the other hand, the Belarusian market's totally openness to Russian imports poses a threat to some sectors of Belarusian industry, whose market share has been taken by the more competitive Russian products. This especially concerns the oil refining and automobile sectors. From the point of view of importers, raising duties on goods bought from third countries has meant an increase in the prices of such goods and derived products, and so switching to supplies from Russia, thus becoming even more dependent on its market.

**Kyrgyzstan and Tajikistan** are not involved in the integration process as yet. These countries, whose economies are weak, have declared their readiness to join the Customs Union on the one hand, but on the other, they fear being dominated by the stronger partners, Russia and Kazakhstan. Bishkek hopes that the gains will outweigh the losses. Since stricter control has been introduced on the Kazakhstan/Kyrgyzstan border (which has become the Customs Union's external border), the possibilities of re-exporting Chinese goods to other CIS countries have been dramatically reduced. This used to generate significant incomes for small- and medium-sized businesses (Central Asia's largest wholesale markets are located in Kyrgyzstan). As a result, in connection with its accession to the CU, Bishkek wants to be granted preferential rates, for example for its light industry, which could at least partly replace Chinese production. At the same time, Bishkek fears that membership in the CU could give rise to problems in its relations with the WTO (which Kyrgyzstan has been a member of since 1998). If customs rates in Kyrgyzstan were changed, the country would have to offer expensive compensations to its WTO partners, since the conditions of their access to the Kyrgyz market would deteriorate. Tajikistan (which joined the WTO on 2 March 2013) has stated that it could only join the Customs Union when it has a direct border with the other CU member states, i.e. when Kyrgyzstan joins this structure. Dushanbe fears that at present its accession to the Customs Union would not offer any tangible benefits, but would restrict its economic relations with other partners, especially China, and cause price rises (according to Tajikistan's estimates, its accession would cost between US\$400 and US\$500 million). In turn, better conditions for expatriate workers and labour market liberalisation are less important for Tajikistan, since these issues have been regulated in bilateral Russian-Tajik agreements, which were signed in autumn 2012. Although these two countries are of marginal importance for the effectiveness of the integration process, Russia has been consistently persuading Bishkek and Dushanbe to join in (although in the case of Kyrgyzstan

it fears an uncontrolled influx of cheap Chinese goods). Moscow sees Kyrgyzstan's and Tajikistan's membership in the Customs Union as confirmation of its influence in post-Soviet Central Asia, and as yet another barrier to drugs being smuggled on a mass scale from Afghanistan (as the Afghanistan/Tajikistan border would become the CU's external border).

**Ukraine** has, under pressure from Moscow, declared its readiness to become an observer in the CU, although Russia has made it clear that it is interested in Ukraine's full membership. In March 2013 Ukraine's Council of Ministers decided to create a working group for deepening co-operation with the CU and the CES for further growth in trade, expanding co-operation and attracting investments to Ukraine.

On 31 May 2013 in Minsk, the Prime Minister of Ukraine Mykola Azarov signed a memorandum of deepening cooperation between Ukraine and the Eurasian Economic Commission. The memorandum provides the establishment of a permanent Ukrainian representative in the CU, access for Ukraine to copies of the CU's public documents, and the right to submit its own proposals to the EuEC. Kyiv also received the opportunity to participate in open meetings of the CU's highest bodies, albeit only upon an official invitation. In Section 4 of the memorandum, Ukraine declared its "intention to abide by the rules" enshrined in the legal documents underlying the CU, and to "abstain from any actions and statements" which would affect the interests of the CU. The document is declarative in nature, and does not constitute a legal obligation to integrate with the CU.

Ukraine sees economic co-operation with the Customs Union member states as very important. In 2011 these countries accounted for approximately 38% of its exports (Russia had a 29% share in its exports) and 45% of its imports (Russia had a 35% share in its imports). It is difficult for a significant part of Ukrainian production to find an alternative to its eastern neighbours' markets. Russia is also a very important investor in Ukraine. In 2011, it accounted for approximately 10% of direct foreign investments (its share is certainly much larger, since a large portion of investments from tax havens, including Cyprus, were *de facto* Russian investments).

Ukraine primarily exports machinery and transport vehicles to Russia, products which are basically uncompetitive on the EU market. Therefore, Ukrainian manufacturers depend on their eastern, predominantly Russian, buyers. Manufacturers of food and agricultural products have a similar problem; the need to meet the high sanitary and phytosanitary standards makes the EU



market practically inaccessible to a significant part of Ukrainian products. The Russian market is also of fundamental importance for many metallurgical products (for example, large-diameter pipes). However, as regards the metallurgical sector, Ukrainian and Russian manufacturers are above all competitors to each other on global markets.

In the case of a large part of Ukrainian imports, Kyiv is also finding it difficult at this moment to find an alternative to Russian suppliers; above all, this concerns oil and gas. Given the fact that the Ukrainian economy is extremely energy-intensive, this is vital for Ukraine's relations with Moscow.

This dependence on the Russian market is causing many Ukrainian manufacturers to become especially interested in good relations with Russia, which guarantees access to its market. However, those sectors which are oriented towards the EU market, including part of the metallurgical, chemical and services sectors, are interested in modernisation and Western technologies, and are principally aiming to improve the conditions for co-operation with the EU.

As a consequence, the Ukrainian government is making efforts to reach a balance between Brussels and Moscow, and thus be able to derive economic benefits from co-operation with both its most important economic partners. Although Kyiv had granted high priority to entering into the Deep and Comprehensive Free Trade Area agreement with Brussels<sup>37</sup> until recently, it has also decided to sign a free-trade area agreement with Russia. These two agreements do not collide with one another, and at the same time guarantee facilitated access to the markets of both partners. However, deepening integration as part of the Customs Union would mean the need to declare close co-operation with Russia, as well as a loss of the opportunity to receive favourable terms of trade from the EU, which is what the Ukrainian government is trying to avoid<sup>38</sup>. Nevertheless, maintaining access to the Russian market and getting a lower price for gas bought from Russia is vital for Kyiv (in 2012, the gas price set for Ukraine was higher than that paid by Slovakia or Germany). The Kremlin has

<sup>37</sup> Resolution from the Verkhovna Rada of Ukraine of 19 May 2011.

<sup>38</sup> President Viktor Yanukovich, in his address to the Verkhovna Rada on 7 April 2011, suggested that the Customs Union could co-operate with Ukraine in the 3+1 format (three member states of the Customs Union plus Ukraine). However, he did not explain what this co-operation would look like. During 2013 Ukraine has also made suggestions that it could participate in the CU without being a full member, for example as an observer state. However, all such proposals have been rejected by Russia. Compare, for example: <http://www.unian.net/news/559808-medvedev-o-chlenstve-ukrainyi-v-ts-ili-vse-ili-nichego.html>

hinted on numerous occasions that it is making both of these issues dependent on Ukraine's membership in the Customs Union<sup>39</sup>.

## 2. The negotiation disputes

The differences in the interests as described above, the disproportions in the potentials (see the table below) and the time limitations have all made the process of negotiating the integration conditions, even within the narrow group of three states, a very difficult and tense process. Disputes emerged both during the establishment of the Customs Union and the Common Economic Space alike. Confrontations mainly arose between Moscow and Minsk, although Astana was also trying to protect its interests.

Belarus and Kazakhstan, for instance, both protested against Moscow's proposal to significantly raise import duties imposed on goods bought from third countries. They both feared an increase in prices on their markets, as well as growing public dissatisfaction. The Kremlin agreed to make only partial concessions by introducing transitional periods for some goods (used cars and pharmaceuticals) and allowing individual persons to bring up to 50 kg of goods for their private needs<sup>40</sup>.

Another dispute between Russia, Belarus and Kazakhstan concerned the distribution of import duty income. Russia initially insisted that 93% of the income should go to its budget. After several months of tough negotiations, Moscow finally accepted a share of 87.97% in May 2010 (which took effect on 1 September).

However, the conflict between Russia and Belarus reached its peak when the Common Customs Code was to be introduced. The code, which Belarus refused

<sup>39</sup> For instance, in March 2011, Prime Minister Putin threatened that barriers could appear in trade with Ukraine, if Kyiv chose to continue its economic integration with the EU (see Russian Federation: Prime Minister Putin threatens Ukraine, *EastWeek*, OSW, 16 March 2011). In turn, on 18 May 2011, Dmitri Medvedev warned the Ukrainian government that it must make a clear declaration of whether it wants to integrate with Russia or the EU. He recalled that Russia, which was not a WTO member, could reintroduce barriers to trade with Ukraine without any restrictions. In turn, the link between the gas prices and Ukraine's membership of the Customs Union has been mentioned, as in Medvedev's statement of 24 August 2011 (see: Medvedev posovetoval Ukraine poprosit u Moskvyy skidku na gaz, *Lenta.ru*, 24 August 2011).

<sup>40</sup> Before the Customs Union was set up, residents of Kazakhstan benefited from imports of numerous cheap consumer goods from China, which were supplied either from China directly or via Kyrgyzstan.

to sign, became nothing more than a tool in the hands of Alyaksandr Lukashenka, who insisted that the Kremlin should lift the customs duty off oil and petroleum products supplied to Belarus (which had been imposed on 1 January 2007). In response, Russia provoked a gas conflict with Minsk, cutting off gas supplies<sup>41</sup> and threatening to impose export duty on the gas it supplied<sup>42</sup>. As a consequence, the Belarusian president, who wanted to maintain the previous preferential conditions of co-operation with Russia, was forced to accept the code. However, he only did so after a five-day delay, which was symbolically significant and demonstrated the continuing distrust between the partners. As regards export duty on the oil and petroleum products supplied to Belarus, Moscow agreed to supply only the part of duty-free oil allocated for Belarus's own needs<sup>43</sup> (according to Russian estimates, these preferences are worth approximately US\$2 billion). However, in return, President Lukashenka had to sign a package of agreements setting up the Common Economic Space in December 2010.

Export duty on oil and petroleum products also triggered a dispute in Russian-Kazakh relations. In an attempt to withdraw from duty-free oil supplies to Kazakhstan, which in its opinion were too heavy a burden for the Russian budget<sup>44</sup>, Russia started demanding compensation from Kazakhstan. After a period of negotiations, during which Russia also reduced its supplies to Kazakhstan<sup>45</sup>, Astana agreed in June 2012 to supply Russia with 2 million tonnes of oil as compensation for the duty-free supplies from Russia. However, the Kremlin announced that the existing preferences would only continue for two years, and export duty would be imposed on oil supplied to Kazakhstan starting from 1 January 2014.

<sup>41</sup> Kamil Kłysiński and Wojciech Konończuk, Russia provokes a new gas conflict in Belarus, *EastWeek*, OSW, 23 June 2010.

<sup>42</sup> Elena Mazneva, Strakhovka ot Batki, *Vedomosti*, 5 July 2010.

<sup>43</sup> Belarus imports approximately 22 million tonnes of oil annually. 6 million tonnes are used for its own needs, and the rest, processed in refineries, is exported.

<sup>44</sup> Until 2012, Astana imported approximately 7 million tonnes of oil duty-free from Russia. This primarily concerns northern Kazakhstan, where connection to the Kazakh resources via the transport network is lacking. Above all, this concerns the Pavlodar refinery, to which oil from Russia was supplied via the pipeline, as well as many small refineries to which Russian oil was transported by railway. According to the Kremlin's estimates, duty-free supplies of oil to Kazakhstan deplete the Russian budget by approximately US\$2.5 billion annually; Astana has calculated that this sum does not exceed US\$1 billion.

<sup>45</sup> In May 2012, Russia even cut supplies to the Pavlodar refinery in Kazakhstan, which could be interpreted as an act of retaliation as Kazakhstan had not signed an agreement setting the rules for calculation of export duties within the CU. *Razvedka i dobycha SNG, Rus-energy*, 5 March 2012.

## The economic ratios of Belarus, Kazakhstan and Russia in 2012

	<b>Russia</b>	<b>Kazakhstan</b>	<b>Belarus</b>
GDP (PPP), US\$ billions	2513.3	231.8	146.7
GDP (PPP) <i>per capita</i> , US\$ thousands	17.7	13.9	15.6
Inflation, % as of year end	6.6	6	21.8
Total economic investments, % of GDP	24.5	22.8	38.9
Budget surplus/deficit, % of GDP	0.0	3.7	-1.1
Budget deficit, % of GDP, except for the oil and gas sector	-10.6	-9.3	-
Current account balance, % of GDP	4.0	4.6	-2.9
Imports (of goods and services) in US\$ billions	312.6	44.5	50.1
Including share of: Russia, Kazakhstan & Belarus	- 6.1%	40% -	approx. 50% -
Exports (of goods and services), US\$ billions	524.7	92.3	52.3
Including share of: Russia, Kazakhstan & Belarus	- 7.4%	7.4% -	37.1% -
Reserve funds (December 2012), US\$ billions	150.7	59.5	-
Currency reserves (December 2012), US\$ billions	537.1	28.3	8.0
Foreign direct investments, US\$ billions	18.7	14	1.4

**Source:** Statistical offices and central banks of Belarus, Kazakhstan and Russia, the IMF

The concept for establishing the Eurasian Economic Union in 2015 also stirred up dispute. It turned out that the countries involved in the integration process had different visions for the ultimate co-operation model. According to original Russian declarations, the document setting up the Eurasian Economic Union in 2015 was to have been signed in March 2012; however, the parties were unable to reach a compromise. Belarus and Kazakhstan chose to postpone a decision regarding this issue for several years. It was finally agreed that the draft agreement would have to be submitted for signing by 1 May 2014.

### III. THE ECONOMIC CONSEQUENCES AND POSSIBLE FUTURE DEVELOPMENTS OF THE INTEGRATION PROCESS

#### 1. Economic effects of integration

##### 1.1. For its participants

Lifting trade barriers usually contributes to boosting trade. Trade volumes have increased in the past three years, also within the Customs Union; they rose 25% in 2010, over 30% in 2011<sup>46</sup>, and 8.7% in 2012. However, it is difficult to estimate to what extent this growth affected the integration process. The tariff barriers between Russia, Kazakhstan and Belarus were already low before the CU was established, because these countries were bound by a free trade agreement (with numerous exceptions, it operated in a similar way to the CU). Meanwhile the non-tariff barriers, which are of key significance for intensifying trade, have been being removed at a quite slow rate. Furthermore, a natural process of trade volume reconstruction has been taking place over the past few years, since the drop in trade volumes during the crisis in 2009.

An intensified influx of Russian entities to Kazakhstan has been observed since the establishment of the Customs Union. The number of firms with Russian capital in 2012 increased by 80%, exceeding 9000<sup>47</sup>. These are usually firms from Russian frontier regions, for example from the agricultural, food and machine-building sectors, which take advantage of less bureaucracy, lower electricity prices (by approximately 30%) and lower fiscal levies in Kazakhstan. Some Russian firms have even attempted to use Kazakhstan as a tax haven within the Customs Union. However, for the time being, relocation of Russian firms to Kazakhstan is not a mass movement, and has caused only marginal losses to the Russian budget (approximately 0.01% of the income)<sup>48</sup>.

##### 1.2. For third-party countries

The creation of the Customs Union between Russia, Kazakhstan and Belarus has raised the customs duties on some goods from third-party countries. The access conditions for exporters from the European Union, including Poland,

<sup>46</sup> Statistical data from the Eurasian Economic Commission, <http://www.tsouz.ru/db/stat> 2012

<sup>47</sup> <http://tengrinews.kz/money/rossiyskih-biznesmenov-privlekayut-v-kazahstane-nizkie-nalogi-i-loyalnyie-vlasti-230025/>

<sup>48</sup> Natalia Telegina, Dobežhat do kazakhskoi granitsi, *Magazine.rbc.ru*, July 2012.

have deteriorated as a result of the establishment of the CU, primarily in Kazakhstan and to a lesser extent in Belarus. However, despite these unfavourable changes, trade between the Customs Union member states and third countries grew by almost 4% in 2012. In 2012, an increase was observed in Poland's exports to Belarus (18%), Russia (25.2%) and Kazakhstan (24%). The Customs Union's most important trade partner is the European Union, which accounts for over 55% of its exports and 44% of imports. The second most important partner is China, with a 9% share in exports and 17% in imports<sup>49</sup>.

Despite the increase in customs duties, the establishment of the Customs Union and the implementation of the single market rules in Russia, Kazakhstan and Belarus will bring a number of benefits to foreign partners. The standardisation of market access rules should reduce the costs linked to handling the formalities and obtaining certificates. For example, meat plants from the European Union are controlled by the Customs Union's inspectors, and following their approval, can export products to all three CU member states. However, on the other hand, EU exports could be much more severely affected should any reservations against European products be made. In such cases exports can be withheld to all three states. In the past, when Russia imposed embargos on (for example) Polish meat, exports of such products to Belarus would increase.

One more positive consequence of the establishment of the Customs Union was the adjustment of the rules applicable in this structure to the World Trade Organisation Standards. This also forced Belarus and Kazakhstan, which do not belong to the WTO, to apply these standards.

Furthermore, lifting barriers in internal trade between Russia, Belarus and Kazakhstan offers opportunities for exporters and investors from the European Union to operate on the markets of all three countries from out of that country which offers the best conditions for business development (Kazakhstan is the leader in this aspect).

## **2. Prospects for regional integration**

The establishment of the Customs Union and of the Common Economic Space is unlikely to significantly improve the economic attractiveness of the countries engaged in the integration process and thus contribute to an increase in the

<sup>49</sup> Data from the Eurasian Economic Commission.

influx of investments and rapid economic development. The conditions for integration existing so far, and the manner in which they have been implemented (poor quality of law, the lack of executive acts and the fact that no information policy has been launched), do not presage any major liberalisation in trade or improvement in the investment climate. The integration has primarily been aimed at restricting access for entities from third countries, and has not been focused on improving the competitiveness of the market itself.

The integration process will continue, but delays can be expected in its implementation. It is also doubtful whether it will be possible (and if so, in what form) to fully implement the documents signed as part of the Common Economic Space. Belarus and Kazakhstan fear the possibility of becoming completely economically dependent on Russia. As a consequence, they are reluctant to transfer the competences which set the rules of operation of their economies to a supranational authority dominated by Russia. Restricting the competences of the national institutions is likely to cause increasing resistance in these countries. Russia has sufficient instruments (for example, oil and gas supplies, partial control of the transit routes and political dependence) to force its partners to implement more and more integration documents. However, if these countries are forced into the integration, they may make attempts to disregard those legal solutions which are unfavourable to them. Resistance can especially be expected from Minsk, since a total implementation of the CES principles would mean a deconstruction of the present model of the Belarusian economy as controlled by President Lukashenka by making it open to the competition from Russia.

More countries, first of all Kyrgyzstan and Tajikistan, are likely to join the Customs Union and the Common Economic Space. This enlargement will be primarily an effect of Russian pressure on the leaders of these countries. It is also unlikely that Russia will offer them all the privileges that the implementation of the Common Economic Space entails; this in particular applies to the free movement of labour. Russia has already taken steps to reduce the number of expatriate workers from Kyrgyzstan and Tajikistan.

It also appears that Russia has sufficient instruments (for example, controlling gas prices and restricting access to its market for Ukrainian exporters) to force Kyiv to join the integration structures. Kyiv's participation in the integration process would certainly mean a political success for Moscow, as this would negate the achievements Ukraine has so far made in moving closer to the European Union. Nevertheless, Ukraine's forced membership is unlikely



to improve the economic performance of the integration process. Kyiv will certainly be more determined than Belarus and Kazakhstan to insist on integration solutions that are beneficial for itself and in blocking those which are unfavourable. It will also extend the process of negotiating and implementing the agreed principles.

**It can already be observed that the Kremlin's political will to implement the integration process, which arose in 2009 partly because Russia had been very severely affected by the economic crisis, is gradually weakening. Russia is not ready to make compromises and concessions on the issues which are vital for it, such as those concerning the energy sector. In effect, the integration is proving to be fragmentary, and covers only selected sectors of the economies involved in the process. Additionally, more and more negative consequences of establishing closer co-operation as part of the CU and CES are being revealed, especially for Kazakhstan. Furthermore, when the integration process is expanded to include issues which go beyond trade and economy, like the anti-trust policy or setting the domestic prices of energy carriers, the leaders of Kazakhstan and Belarus tend to distance themselves. As a result, the integration has lost its initial momentum over the past few months.**

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