

# 3 Opportunities and Obstacles to EurAsEC Integration\*

MICHAÏL  
GOLOVNIN

## ANALYSIS OF THE INTEGRATION PROCESS IN THE EURASEC

The Eurasian Economic Community (EurAsEC) integration organisation is now the largest formal integration association in the post-Soviet space in terms of number of participants. It brings together countries which have made a concerted choice in favour of creating supranational bodies, paving the way for a customs union and single economic area. The group has evolved at some length from the Customs Union Treaty signed by Russia, Belarus and Kazakhstan in Moscow on 20 January 1995 (and which was later joined by Kyrgyzstan and Tajikistan). The Eurasian Economic Community was formally created in October 2000, and its most recent expansion came when Uzbekistan's decision to join was ratified at an Interstate Council meeting in St Petersburg on 25 January 2006. The path to EurAsEC integration has not always been smooth. Although most customs duties had been harmonised by the mid-1990s, the consequences of the Russian financial crisis in 1998 led to the deterioration of trade relations and unilateral modification of import duties by Russia, Belarus and Kazakhstan. More recent examples of tension between EurAsEC member countries include the oil and gas conflict in early 2007, involving Russia and Belarus, and trade wars affecting agricultural products (notably, Kazakhstan's restriction on sugar imports in February 2008).

Nevertheless, the Russian authorities have been showing a keen interest in integration. This was illustrated at a summit of CIS and EurAsEC heads of state held in Dushanbe on 5-6 October 2007, which adopted the Concept for Further Development of the CIS and other documents to create a customs union between Russia, Belarus and Kazakhstan and set up supranational bodies. Another nine international agreements relating to the customs union and the Concept on Formation of the Single Transport Space in the EurAsEC were adopted at a EurAsEC Interstate Council meeting in Moscow on 25 January 2008<sup>1</sup>.

We believe that there are several reasons for Russia's renewed interest in integration. Firstly, Russia is striving to increase its political power in the international arena, for which it will require a group of countries prepared to align their foreign policies with Russia's. At present, this group, albeit with certain reservations, comprises countries which are members of the EurAsEC. It should be noted that the EurAsEC had

---

\* Material prepared in cooperation with specialists of the Centre for Problems of Globalisation and Integration of the Economics Institute of the Russian Academy of Sciences, Ushkalova D. and Dr. Libman A.

<sup>1</sup> <http://www.evrases.org/ru/main/messagepage/723/>, as of July 2008.

drafted mechanisms to coordinate the interests of member countries and had adopted the principle of "weighted" voting, which is based on the pro-rata contribution of each country to the Community's budget: Russia controls 40 per cent, Belarus, Kazakhstan and Uzbekistan 15 per cent each and Kyrgyzstan and Tajikistan 7.5 per cent each. Apart from Russia, this distribution of voting share by budget contribution gives more rights to each country than if other indicators had been used (for example, population, size of economy or industrial output<sup>2</sup>). In practice, of course, Russia has the strongest voice in the adoption of EurAsEC decisions, and Russia's greatest weight is a problem in any association in the post-Soviet space.

Secondly, objective economic interest in integration is linked to the synergistic effect resulting from the joint resolution of shared economic problems and the expansion of markets for goods produced in EurAsEC member countries, especially those with high value added.

The main economic problem which the EurAsEC must resolve is the structure of its member countries' economies. It has to be improved in order to increase the competitiveness of these individual countries and that of the whole Community within the global economy. The existing structure of the EurAsEC economies, among which only Russia and Belarus can boast substantial manufacturing sectors, is an obstacle rather than an asset to integration.

In 2006, for example, the mining and metallurgy and metal products sectors accounted for 23 per cent and 15 per cent respectively of Russian industrial output; the fuel and energy sector accounted for 29 per cent of Belarus's industrial output; the mining and metallurgy and metal products sectors accounted for 57 per cent and 17 per cent respectively of Kazakhstan's industrial output. The fuel and energy and metallurgy sectors accounted for 27 per cent and 21 per cent of Uzbekistan's industrial output; metallurgy and metal products and power, gas and water production and distribution accounted for 33 per cent and 21 per cent respectively in Kyrgyzstan; metallurgy accounted for 46 per cent of Tajikistan's industrial output. Moreover, agriculture, forestry and fishery accounted for 33 per cent of Kyrgyzstan's GDP, 28 per cent of Uzbekistan's GDP<sup>3</sup> and 23.9 per cent of Tajikistan's GDP<sup>4</sup> in 2006. As a result, these countries compete in low-value-added sectors which are the economic foundations of many EurAsEC member countries.

These shared problems relate not just to the deterioration of the inherited structure of the economy but also to the need to create new and efficient sectors, for example, the financial sector. Banking systems and financial markets in EurAsEC countries, except for Russia and Kazakhstan, remain underdeveloped. Russia and Kazakhstan face large-

---

<sup>2</sup> In 2006, according to the Interstate Statistical Committee of the CIS, Russia accounted for 69% of the EAEC's population, 87.7% of GDP and 85.2% of industrial output ([www.cisstat.com](http://www.cisstat.com)).

<sup>3</sup> In 2005.

<sup>4</sup> Source: Interstate Statistical Committee of the CIS ([www.cisstat.com](http://www.cisstat.com)).

scale outflow of capital, which is preventing their domestic financial markets from developing properly. The joint resolution of these problems may inform the new “agenda” of integration.

Defining the objectives of integration is one of the major problems of the present day. Until recently, the approach has been to adapt the European integration model to the post-Soviet space and formulate long-term goals. The long delay in the process of achieving these goals, and countries’ unwillingness to surrender even part of their newly won sovereignty, have blighted the integration process.

EurAsEC does have, de facto, a free trade area and relative freedom of movement of people (the absence of visa controls between most member countries). The creation of a customs union is also a near-term ambition, and this issue is attracting particular attention at present because of its importance to formal integration process. The timely and successful resolution of this question will have an impact on the future of the EurAsEC, a body described as the most advanced integration association in the post-Soviet space. Without a customs union, EurAsEC will become indistinguishable from other, more amorphous, formations (for example, the CIS). Between 2000 and 2006, only 2 per cent of the import duties in Russia, Belarus and Kazakhstan had been unified. Out of 73 measures due to be implemented between 2003-2006 as part of the creation of a customs union, only 20 had been put in place by the end of that period<sup>5</sup>. This illustrates how efforts to harmonise member country import and export duties have been carried out ineffectually and the significant difficulties surrounding certain aspects of this initiative.

We think this situation, like other delayed integration initiatives in the post-Soviet space, is caused by a number of factors.

#### REASONS FOR THE LACK OF PROGRESS IN POST-SOVIET INTEGRATION

The key obstacles to integration include the varied structures of EurAsEC member country economies; the decline in trade and economic cooperation between member countries; and differences in their economic strategies and national models of economic development.

1) The EurAsEC member countries have tangible **differences in the structure of their domestic economies**. For example, Russia and Kazakhstan are major exporters of raw materials and produce a very wide range of goods (especially Russia), while Belarus specialises in producing finished goods from raw materials imported from third countries. Uzbekistan, Kyrgyzstan and Tajikistan, which lag behind other EurAsEC member countries in terms of industrial production, are importers of a large number of industrial goods from non-CIS countries. Because of this, Russia is keen to protect its economy by using duties on a wider range of products than would its EurAsEC counterparts. In addition, since the average weighted rate of customs duties in Russia is falling, Russia levies

<sup>5</sup> *Soyuznoye Veche, 2006, 25-31 May, p. 1.*

lower import tariffs on some goods than its partners do. Kazakhstan's customs tariffs differ considerably from those of Russia and Belarus (the Kazakh economy is liberalised to a larger extent).

Except for Kyrgyzstan, which is a member of the WTO, the longer the country's membership of the EurAsEC, the greater the level of harmonisation of customs duties. For example, 80 per cent of Tajikistan's national tariffs had been harmonised with the EurAsEC's Basic List of Common Customs Tariff (BL CCT) by 2007, while this figure stands at only 30 per cent for Uzbekistan, which was one of the last countries to join the organisation. Moreover, level of protectionism in Uzbekistan's foreign trade policy is higher than in other EurAsEC countries.

The harmonisation of export duties is also causing considerable difficulties. Export duties, currently imposed by EurAsEC member countries on certain goods, contribute hugely to national budgets (for example, the oil export duty in Russia), which is why their abolition or reduction during the harmonisation of trade regulation instruments is almost impossible in the short term.

Disparities in the way national economies are structured also hinder implementation of joint projects. That is why activity in the energy sector, especially Russia's, is particularly visible. It is important to note, however, that there is significant potential for conflict (mainly hidden) in this sector because of differences in EurAsEC member countries' interests. For example, Russia, Kazakhstan and Uzbekistan are major oil and gas exporters, while Belarus is an importer and a transit corridor to the West. Moreover, Kazakhstan and Uzbekistan are trying to diversify their export routes.

Problems relating to these different national economic structures within EurAsEC member countries can be resolved by concerted efforts to define the priorities of their development; the implementation of a coordinated industrial policy; and a system of compensation from the EurAsEC's budget to mitigate the losses of member states and certain producers in cases where shifting customs duties affect industries which are strategically important to a country's economy.

However, EurAsEC member countries have not yet adopted a coordinated structural policy. The issue of compensation for budget losses resulting from customs tariff harmonisation has not been resolved since it entails substantial costs for Russia especially, which it is not ready to pay.

2) As well as the difficulties relating to the different interests of EurAsEC countries, linked to their economic structures, another problem stands in the way of foreign trade policy harmonisation and deeper integration, i.e., **Russia's role in the post-Soviet space**. The Russian economy is considerably bigger than those of the other EurAsEC member countries. As a result, Russia falls into a kind of "trap". On the one hand, it is regarded (and it sometimes behaves) as a powerful player, imposing

its rules on others. This raises concerns for other EurAsEC member countries, who fear that they will end up being dependent on Russia. They then recoil from processes which would involve them ceding part of their sovereignty to supranational bodies. This in turn hinders the development of integration. On the other hand, where necessary, Russia, as the largest player, is able to initiate integration processes in the post-Soviet space and act as their “sponsor”<sup>6</sup>.

3) Since the break-up of the USSR, **trade and economic cooperation between EurAsEC member countries have been diminishing** in comparison to their cooperation with third countries. However, this trend is not constant: in 2000-2005, trade between member countries increased. In 2005-2006, it decreased once again. The dynamics of trade between EurAsEC member countries are largely defined by the nature of the goods traded, compared to those traded with third countries. For example, machinery makes up a substantial share of trade within the bloc and price increases for these products are below than for goods produced by the fuel and energy sector. Trade within the bloc is also declining because of a drop in the global competitiveness of goods made in the EurAsEC compared to goods from third countries. Another factor which impinges on trade is the continuing competition between EurAsEC producers in the Community’s market. Competition arises from similarities in the structure of their economies, and specifically the dominance of low-value-added sectors (mining, agriculture and metallurgy). This provokes moves to raise barriers to intra-bloc trade and can lead to trade wars. Despite declarations that such barriers do not exist, in practice EurAsEC members (in particular, Russia and Belarus) have been waging trade wars more often, which have had a negative impact on trade and economic cooperation. Protracted debates between Russia and Belarus over conditions imposed on Belarusian sugar supplied to Russia and Kazakhstan’s imposition of sugar import quotas are immediate examples to this matter.

Protective measures do not only reduce trade but also undermine the basis of integration, creating barriers to foreign economic relations instead of removing them.

Such developments have slowed the growth of trade between EurAsEC member countries in recent years compared to trade with third countries, and led to a reduction in intra-EurAsEC trade as a proportion of member countries’ total foreign trade (Table 1). For Russia in particular, trade with EurAsEC countries declined from 9.5 per cent of total foreign trade in 2002 to 8.7 per cent in 2007. However, this figure did increase from 8.3 per cent in 2006 to 8.7 per cent in 2007<sup>7</sup>. This might be an indication that trade disintegration has passed its lowest point. One particularly

<sup>6</sup> Golovnin M. (2006) *Prospects for Multilateral Cooperation in the post-Soviet Space from Russia’s Point of View. Information and Analytical Bulletin of the Centre for Globalisation and Integration of the Institute of Economy, Russian Academy of Sciences, No. 4 (8), p. 9.*

<sup>7</sup> *From customs statistics (including data on Belarus) released by the Russian Federal Statistics Service ([http://www.gks.ru/bgd/free/b04\\_03/IssWWW.exe/Stg/d030/i030780r.htm](http://www.gks.ru/bgd/free/b04_03/IssWWW.exe/Stg/d030/i030780r.htm)). as of July 2008).*

interesting trend is the continuing fall in EurAsEC imports from within the bloc, which are not affected the "VAT factor"<sup>8</sup> or the dynamics of energy prices. Since Russia is the engine of trade in the EurAsEC, this has also reduced intra-bloc trade in the EurAsEC. The low share of EurAsEC trade in Russia's total foreign trade would seem to indicate Russia's lack of interest in advancing integration in the post-Soviet space.

	2004	2005	2006
<b>Belarus</b>			
Exports	48.1	37.0	36.5
Imports	68.2	60.7	59.0
<b>Kazakhstan</b>			
Exports	16.0	12.8	12.1
Imports	39.5	41.4	41.6
<b>Kyrgyzstan</b>			
Exports	34.7	43.4	46.5
Imports	53.5	56.5	54.6
<b>Russia</b>			
Exports	9.0	7.5	8.0
Imports	13.4	10.2	8.9
<b>Tajikistan</b>			
Exports	7.7	19.1	12.4
Imports	36.1	46.0	48.4
<b>EurAsEC</b>			
Exports	12.2	9.8	10.1
Imports	25.6	20.9	19.5

**TABLE 3. 1**  
Trade with EurAsEC member countries as a share of total foreign trade for selected EurAsEC countries, per cent

Source: Calculations based on information released by the Interstate Statistical Committee of the CIS (<http://www.cisstat.com>)

**4) Differences in the economic strategies pursued by EurAsEC member countries** have an adverse impact on the coordination of foreign trade policies and on integration process in general. During their transformation period, EurAsEC countries followed different models of transition to market economies. Some countries (Russia, Kazakhstan and Kyrgyzstan) based their models on more liberal principles, while others (Belarus and Uzbekistan) granted the state a greater role in the process of transformation and chosen a more gradual path to a market economy. These models also changed during the transition period (in Russia and Kazakhstan, for example). The resulting mix of economic and institutional systems continues to hinder the development of a single economic policy

<sup>8</sup> In the beginning of 2005, VAT collection in Russian export to CIS countries was turned to a destination basis (for all countries except for Belarus it was applied to energy goods, for Belarus – to all goods). So, this measure had a one-time negative quantitative impact on the amount of Russian export to the CIS countries.

and imposes serious obstacles to integration, the customs union in particular. This problem can be solved only if member countries draft a coordinated development strategy for the EurAsEC and, correspondingly, an agreed model for protecting their markets in the global economy. The other possible scenario would involve countries opting for a unified mode of development which encourages an active exchange of expertise and experience in the field of economic policy. In this scenario, differences in economic models play a positive role by offering greater scope for choice.

It is very hard to make a clear distinction between objective and subjective obstacles to integration. Modern objective factors (for instance, economic development models) may have developed as a result of subjective decisions and, conversely, objective trends create subjective influences. Nevertheless, in the context of this study, the most important subjective factors discussed are **the lack of an effective means of coordinating interests and implementing decisions** and differences in EurAsEC member countries' capacities to create a customs union.

1) The lack of an effective means of coordinating interests and implementing decisions. We believe that the current mechanism for coordinating the interests of member countries, notwithstanding the fact that a number of provisions are already in place (in particular, the aforementioned principle of "weighted" voting), has several shortcomings which are preventing the implementation of adopted decisions. While the key player – Russia – is not always willing to cede its national interests to a supranational association, other countries are trying hard to escape Russia's influence. This is one of the negative manifestations of Russia's dominant role in the post-Soviet space. In case of foreign trade, Russia would prefer other countries adapting its own regulatory system. As a result countries may face losses owing to differences in economic structure, which Russia will not compensate them for.

Integration is largely limited to foreign trade. Until recently, other aspects of integration have received inadequate attention. For example, hardly any major joint investment projects have been implemented. The situation has changed since Russia and Kazakhstan set up the Eurasian Development Bank (which we discuss later), but it will be some time before this institution is able to fund large-scale projects.

All this reduces the motivation to implement agreements and thereby hinders the creation of a customs union and other integration procedures. In practice, "disadvantageous" decisions are not implemented resulting in "integration on paper". A typical "integration on paper" works as follows: first, the basic integration decisions are taken and corresponding measures are drafted and started to implement; the implementation of these measures is then delayed, with some elements even rolled back. After this, new integration documents and new measures are drawn up (many of which are, in essence, inherited from the previous un-implemented documents), but their implementation is then delayed once again.

It is obvious that successful implementation of agreements depends entirely upon countries' vested interests, i.e. the degree to which the negotiated result corresponds to an agenda of interest groups involved. That is why efficacy in implementing decisions could be enhanced significantly if integration partners (particularly Russia) pay greater attention to the interests each EurAsEC member has in the agreement, and take account of each country's individual circumstances.

Barriers to the creation of a customs union are typified by the failure to coordinate EurAsEC member country positions vis a vis accession to the WTO.

In 1997, signatories to the Customs Union Treaty agreed to coordinate negotiating positions in their progress towards WTO membership. Although Russia, Belarus, Kazakhstan and Tajikistan agreed in 2002 to adopt Russia's position in these negotiations, in practice the coordination mechanism is not working perfectly. Kyrgyzstan's separate accession to the WTO is an example of the EurAsEC partners' poor coordination of their activities regarding WTO membership. One of the latest solutions to this problem of coordination over a customs union and WTO membership has been offered by Russian Deputy Prime Minister Sergey Naryshkin: "The heads of states of a future customs union have agreed that Russia will be first to join the WTO, after which the customs union will start functioning, and ultimately other member countries, as members of the customs union, will join the WTO".<sup>9</sup>

Obviously, this approach has practical merit but it also postpones the creation of a customs union indefinitely. Moreover, Russian conditions for WTO membership may turn out to be unacceptable to other countries, and this will either hold up the process of building a customs union for several years or will halt it completely.

**2) Differences in EurAsEC member countries' capacity to join a customs union and to progress to the next stages of integration.** In terms of preparedness to become a member of customs union (i.e. the level of custom tariff harmonisation), EurAsEC countries clearly fall into two groups:

1. Russia, Belarus and Kazakhstan (most prepared);
2. Kyrgyzstan, Tajikistan and Uzbekistan (least prepared).

These groupings shaped up historically: the first group was negotiating on cooperation for a longer time, while the second group joined them later. However, the underlying reason for this division is the difference in the level of their economic development (Table 2) and the structure of their economies. Such a differentiation challenges feasibility of an effective customs union among 6 member states concerned and raises an issue of modes of economic integration in EurAsEC.

---

<sup>9</sup> Prime-TASS, 16 October 2007.

## INSTITUTIONAL INTEGRATION

**TABLE 3. 2**  
GDP per capita in EurAsEC  
member countries

	GDP per capita at the official exchange rate (2006, dollars)	GDP per capita in pur- chasing power parity (2005, dollars)
Russia	6 915	10 845
Kazakhstan	5 045	7 857
Belarus	3 793	7 918
Uzbekistan	643	2 063
Kyrgyzstan	542	1 927
Tajikistan	402	1 356

Sources: *the Interstate Statistical Committee of the CIS* ([www.cisstat.com](http://www.cisstat.com)); *Human Development Report 2007/2008*. United Nation Development Programme, 2007

### MODES OF INTEGRATION

Geographic expansion of the Agreement on Customs Union and subsequently of the EurAsEC itself, created preconditions for strengthening political status of the organisation. At the same time, however, it diluted the economic foundation of the Community.

Comparison of countries by GDP per capita clearly shows two groups of countries within the EurAsEC: Russia, Kazakhstan and Belarus that are relatively better off, and Uzbekistan, Kyrgyzstan and Tajikistan that are less advanced in terms of market transition (Table 2). Disparity is also seen in both the analysis of GDP per capita at the official exchange rate and in purchasing power parity.

Membership of relatively poorer countries in the EurAsEC was a lesser problem when it included only Kyrgyzstan with a population of 5.19 million people (as of end 2006) and Tajikistan with a population of 7.07 million people (as of 2006, preliminary data). But in early 2006, Uzbekistan with a population of 26.7 million people (preliminary official data) joined the organisation.

Comparison of average wages by country provides similar observation. In 2006, the nominal average wage in Russia was slightly over \$391.1, in Kazakhstan and Belarus it was \$323.5 and \$271.2 respectively. In Kyrgyzstan nominal average wage recorded at \$81 and in Tajikistan – at \$35<sup>10</sup>.

With Uzbekistan's accession to the EurAsEC, the polarisation of levels of social development between the member countries has increased considerably. The same observations apply to the status of economic reforms, with Uzbekistan being at a much earlier stage compared to many other EurAsEC member states<sup>11</sup>. Therefore, opportunities to implement formal integration projects shrunk.

The solution to this situation was the proposed leadership of the three founding states (Russia, Belarus and Kazakhstan) within EurAsEC, so

<sup>10</sup> *The Interstate Statistical Committee of the CIS* ([www.cisstat.com](http://www.cisstat.com)). Data is unavailable for Uzbekistan in 2006.

<sup>11</sup> *EBRD (2007) Transition Report 2007*. EBRD: London.

called “troika”. Following the decisions ratified in Dushanbe on 6 October 2007, these countries would form the basis of a customs union. EurAsEC documents were amended to this end, since they did not envisage a possibility for member states to integrate at different pace. A formal decision was thus adopted creating an “integration nucleus” within the EurAsEC made up of the abovementioned countries, which are already part of another integration grouping – the Single Economic Space. SES includes Russia, Belarus and Kazakhstan plus Ukraine. For the purposes of this paper, we suggest to define them as SES-3 countries. Other countries will join this core group as and when prepared. At the first sight, this scenario may speed up integration, since it decreases the number of parties in negotiations, and focuses on countries with more developed negotiating capacity and comparable levels of economic development. However, the issue of differing economic systems remains. Higher convergence is theoretically possible though given recent liberalisation in Belarus, increased state involvement in the economy in Russia and Kazakhstan. These structural differences are very significant even among the countries that form the core of customs union. The Russian economy is diversified to a greater extent; mining sector dominates in Kazakhstan and in Belarus machine-building plays a key role.

It should not be forgotten that integration nucleus includes another association – the Union State of Russia and Belarus. Despite a recent cool-down in relations between the two countries and a gap between real integration and its declared goals, progress in cooperation between Russia and Belarus is quite significant compared with other CIS countries. High level of customs duty harmonisation and absence of customs barriers between the two countries are immediate examples to this end.

In the variable-pace model of integration, keeping other EurAsEC members in the troika’s sphere of influence seems a serious problem, as delays in implementing integration initiatives may reduce the non-core members’ interest in cooperation. It is extremely important to involve them in mutually beneficial projects which could bring tangible economic effects. These include the development of hydro power sector in Kyrgyzstan and Tajikistan and machinery in Uzbekistan, addressing migration issues, and so on.

Obviously, Russia does not intend to limit integration potential of the post-Soviet space to the EurAsEC only. Hence, it attempts to involve Ukraine, CIS second largest economy with enormous industrial potential, in the integration process by means of Single Economic Space and offer to join the EurAsEC. However, it should be noted that Ukraine, and other countries whose integration policies target Europe, will not be keen to build a customs union with predominant Russian influence. Therefore, in pursuit of this goal it is important for Russia to offer incentives and attractive initiatives to such countries, rather than provoke their resistance by imposing unacceptable decisions. One such initiative might be the creation of an integration group according to the principle of “open regionalism”, as the third “concentration circle” of post-Soviet

integration after SES-3 and EurAsEC-6. Russia must not present this project as an alternative to EU. Moreso, Russia ought to seek collective solutions to common problems of countries that are part of this group. CIS could provide a foundation for such a regional grouping. A free trade zone within the group could be an option for formal integration, provided that all positive and negative effects for Russian economy are carefully examined. It is perhaps more important to adopt a project approach and seek opportunities for a joint project financing, for instance, by establishing a regional development bank with a mission to facilitate mutual trade and favourable trade environment. Many CIS countries are now bearing costs of their trade wars to Russia and redirecting their foreign trade flows to other destinations, hence growing even further apart from economic cooperation in post-Soviet space.

Finally, the future of the integration nucleus (SES-3) poses some important questions, too. Growth of cooperation beyond customs union seems unlikely in the foreseeable future. Gradual abolition of restrictions on the movement of goods and services would require coordination of economic policies, and currently member-states are just not prepared for this. Therefore, attention should be focused on the creation of a customs union and implementation of mutually beneficial projects reaching to as many CIS countries as possible, including EurAsEC member countries. One of the most promising projects, we believe, is the strengthening of financial cooperation between the EurAsEC member states.

#### FINANCIAL COOPERATION AMONG EURASEC MEMBER STATES

Preconditions for financial cooperation in the EurAsEC are gradually emerging owing to active expansion of Russian and Kazakh financial institutions into other member countries' markets. In the EurAsEC banking system Russian banks are mostly targeting markets of Kazakhstan and Belarus. For instance, Sberbank bought an 80 per cent stake in Texakabank (Kazakhstan); Vneshtorgbank has a majority ownership in Slavneftbank (Belarus); Alfa Bank has a subsidiary bank in Kazakhstan and is entering the Belarusian market; Rosbank and Gazprombank have subsidiary banks in Belarus. Kazakhstan's banks spearhead their investments even wider:

- Kazkommertsbank has two subsidiary banks in EurAsEC member countries (Moskommertsbank in Russia and a bank in Kyrgyzstan), and is establishing a subsidiary bank based on a representative office in Tajikistan;

- Kazakhstan's BTA Group includes Slavinvestbank, Omsk Bank, BTA Kazan, Agroinkom Bank (all in Russia), Astanaeximbank (Belarus) and Investment Export Import bank (Kyrgyzstan);

- Halyk Bank has subsidiary banks in Russia (NBK Bank in Chelyabinsk) and Kyrgyzstan (Halyk Bank Kyrgyzstan);

- ATF Bank owns 94.17 per cent of shares in ATF Bank Kyrgyzstan, 100 per cent in Sibir Bank and 75.1 per cent in Sohibkorbank (Tajikistan).

However, the share of EurAsEC member states banks' in the banking systems of other countries is insignificant with an exception of Kazakhstan's equity in the banking system of Kyrgyzstan<sup>12</sup>). For example, as of 1 September 2007, Russian capital accounts for mere 1.8 per cent of the total capital of the Belarusian banking system even though Russia is the largest foreign investor in the Belarusian banking system.

Investment companies are also entering neighbouring markets. This mainly concerns Russia and Kazakhstan:

- The KIT Finance company of St Petersburg has set up a KIT Finance subsidiary in Kazakhstan;

- Renaissance Capital demonstrates active presence in trade sector in Kazakhstan . For example, Renaissance Capital acquired a 15 per cent stake in Kazkommertsbank during an assault on the bank's shares on the Kazakh and London stock exchanges in February 2008 (on behalf of its client)<sup>13</sup>.

- Russia's Troika Dialogue enters the Kazakh market through acquisition of Almex Asset Management<sup>14</sup>.

- The Aton Investment Group has been active on the Kazakh stock market for some time. In April 2007, it offered investors a new index for the Kazakh stock market.

- East Capital, operating in Russia, is part of an investment and banking holding within Moskommertsbank. This company has representative offices in all the EurAsEC countries.

- Russia's Centras Capital investment company is a member of the Kazakh Centras Investment Group. The company has begun to expand into Kyrgyzstan.

- The Kazakh BTA Group includes Russian companies TuranAlem Finance, BTA Finance and BTA Capital.

- NBK Finance, owned by Kazakh Halyk Bank, is operating on the Russian market.

Financial systems of EurAsEC member-states are generally underdeveloped, with the exception of the Kazakh banking system and the Russian stock market (Table 3). Banking systems of Belarus and Uzbekistan are under strong state regulation, while Kyrgyzstan and Tajikistan have the least developed banking systems among EurAsEC member-states. Tajikistan does not have an organised stock market, and stock markets in Kyrgyzstan and Uzbekistan are very weak, although they have been growing rapidly<sup>15</sup>. The Kazakh stock market, despite

<sup>12</sup> The share of Kazakh banks in the Kyrgyz banking system is about 37%. <http://www.24.kg/economics/2008/03/04/78359.html>.

<sup>13</sup> *Central Asia Monitor*, 7 March 2008.

<sup>14</sup> *Delovoy Kazakhstan*, 7 March 2008. This deal has been finalised in summer 2008.

<sup>15</sup> In 2005, the ratio of stock market capitalisation to GDP was close to 0 in Uzbekistan and 1.7% in Kyrgyzstan.

## INSTITUTIONAL INTEGRATION

dynamic progress in recent years, is lagging behind Russia's market in terms of capitalisation and liquidity.

	Banking systems (as at 1 January 2007)			Stock market (2006)
	Assets	Loans	Capital	Capitalisation
Russia	52.8	29.6	6.4	104.4
Kazakhstan	101.7	68.7	13.4	54.7
Belarus	36.7	26.2	6.6	...
Uzbekistan	34.7	...	5.2	4.3
Kyrgyzstan	26.7	11.4	4.8	3.1
Tajikistan	19.8*	15.3*	2.7*	-

**TABLE 3.3**  
Financial development indicators in EurAsEC countries (per cent of GDP)

Sources: *Kommersant Bank*, 5 April 2007; *Transition Report 2007. Life in Transition. EBRD*, 2007.

\* Data for 2004

These trends suggest potential directions of financial integration, including assistance from more advanced countries (Russia and Kazakhstan) in establishing financial markets in less developed countries. Although this is unlikely to yield sizeable profits in the short run, long term benefits will accrue from strengthened strategic positions on these markets. This is particularly the case in conditions of fierce competition for foreign markets and their infrastructure. For example, the Deutsche Börse, Scandinavian OMX Group and the Warsaw and Istanbul stock exchanges are all showing great interest in the CIS market and this poses serious challenges<sup>16</sup>. Russian and Kazakh companies have already made most of their IPOs on foreign trading floors (mainly on the London Stock Exchange and its AIM segment). The Russian stock market increased its share in Russian companies IPOs from 36 per cent in 2006 to 44 per cent in 2007 owing to Sberbank placing all of its shares and Vneshtorgbank placing 35 per cent of its shares in Russia (in total, these two IPOs accounted for 48 per cent of all deals in 2007)<sup>17</sup>.

The institutional basis of financial integration model suffers of same weakness as integration initiatives in other spheres, i.e., a gap between ambitious declared aims and low enthusiasm for formal cooperation and weak preconditions for implementation. These problems become more acute, because in traditional integration process financial integration comes as a final stage of economic integration. The EU, for example, has not yet established a single financial services market and is currently implementing new integration initiatives as part of the White Policy Paper on Financial Services for 2005–2010.

Transfer of European experience on post-Soviet space is merely possible because integration in other spheres shows only moderate progress, while regulations of financial markets in member states differ significantly.

<sup>16</sup> For example, the Istanbul Stock Exchange is already a major shareholder of the Kyrgyz Stock Exchange.

<sup>17</sup> *IPO in Russia: liquidity in the financial markets is slowing down growth. ReDeal Group*, 2008.

We believe that it is premature to define establishment of a common financial services market or common stock market as a key objective of the EurAsEC, especially in the short to medium term. Learning from Asian experience of financial integration, which focuses on specific challenges of financial markets development and efforts to address those, could be of benefit. Asian integration model is similar to post-Soviet context in a way that it is also implemented in the framework of numerous parallel integration organisations covering different groups of countries (APEC, ASEAN, the Asia Cooperation Dialogue, Executives' Meeting of East Asia Pacific Central Banks (EMAP) and others).

Creation of a regional bond market is an excellent example of a project implemented by Asian integration associations in the framework of financial integration<sup>18</sup>. Achievements are many, including: establishment of two Asian bond funds dealing with government securities in foreign and domestic currency; abolition of certain foreign exchange restrictions; joint efforts to address issues associated with the development of national financial markets (for instance there are six working groups in ASEAN established in the framework of the bond market initiative), etc. Such an initiative on development a specific segment of financial market – be that government securities, corporate bonds, stock or financial derivatives – could be implemented in the EurAsEC. This would be a way of demonstrating real benefits of integration to member-states, but would require financial resources from initiating countries (mainly Russia, and possibly Kazakhstan). We believe that development of a corporate bond market would generate particular interest. In some EurAsEC member countries, the state controls major enterprises, thus corporate bonds would allow them to attract additional investment without changing their ownership structure, including from member countries which have excess capital.

The first step in developing EurAsEC's financial integration could include the gradual abolition of regulations which restrict mutual access to financial markets and movement of capital between countries. In this regard, on-going foreign exchange liberalisation, which in Russia culminated with the abolition of restrictions on capital operations on 1 July 2006, is of particular significance. Kazakhstan liberalised its foreign exchange regime from 1 January 2007. This process is under way in other EurAsEC countries, but tight restrictions remain in countries with relatively strict foreign exchange regimes (Belarus, Uzbekistan and Tajikistan). In Belarus, for example, resident legal entities and individuals must seek approval from the National Bank in order to conduct the certain operations, including: direct or portfolio investment in the charter capital or securities of a non-resident company<sup>19</sup>); purchase of property

---

<sup>18</sup> Golovnik M. (2007) *Multilateral financial cooperation in the post-Soviet space: a new agenda for integration. Problemy Teorii I Praktiki Upravleniya, No 4.*

<sup>19</sup> *In general, any operations with securities issued by non-residents are conducted by permission of the country's National Bank; if a resident issues securities, they circulate without any restrictions.*

abroad; depositing money in foreign banks; and issuing loans with a maturity of over 180 days<sup>20</sup>.

Gradual abolition of mutual restrictions (specifically preferential liberalisation) will increase the presence of companies from EurAsEC member-states on the markets of other countries and strengthen their support for integration “from below”.

There are some indications that countries are searching for alternatives to integration projects within the EurAsEC. For example, Kazakhstan has set up a regional financial centre in Almaty to attract funds from Central Asian countries, the Urals and Siberia. This regional financial centre is an alternative to EurAsEC projects. Announced project on international financial centre in Russia can also be an alternative, but the opportunity still remains to direct it to the development of EurAsEC financial integration.

A separate, and in our opinion extremely important, factor in promoting financial integration is the creation of a funding mechanism for integration projects. In many international integration organisations this function belongs to multilateral development banks (i.e. Asian Development Bank for several Asian integration groupings, European Investment Bank for the EU, the Andean Development Corporation for the Andean Community of Nations, etc.). A bank which could perform such a function in EurAsEC region already exists – the Eurasian Development Bank (EDB). Thus far, however, the EDB, formally remains a bilateral bank (involving Russia and Kazakhstan only), which limits its integration potential.

The EDB has already selected and partially financed its first commitments, including development of the Zarechnoye uranium field (a joint project of Russia’s Techsnabexport and Kazatomprom, the project will last for five years and has been fully funded in the amount of \$63m); the Voskhod project to construct environmentally friendly chromite production and processing lines which will supply Russian enterprises (the project engages Western banks – WestLB and HVB; EDB has fully funded its share of \$60m); the reconstruction of production capacity at the Ekibastuz hydro power plant-2 (the project is for 10 years and will cost \$93.5m)<sup>21</sup>. As could be seen, these projects mainly relate to bilateral cooperation between Russia and Kazakhstan. In addition, the EDB is participating in syndicated lending to selected Russian and Kazakh banks.

Negotiations are under way to increase the number of the EADB’s shareholders. The most possible next participant would be Tajikistan. Belarus, Kyrgyzstan and, noteworthy, Armenia (which is not a member of the EurAsEC) are among potential shareholders. Uzbekistan, with its sizeable economy, remains beyond the reach of the bank’s activities.

<sup>20</sup> *Centre for Globalisation and Integration Problems (2007) Preconditions, Problems and Prospects for Financial Cooperation in the post-Soviet space. Scientific and analytical reports by the, Economics Institute of the Russian Academy of Sciences, No 1, page 34.*

<sup>21</sup> <http://www.eabr.org/rus/projects/portfolio/>, as of July 2008.

We think that a regional development bank, such as EDB, could potentially facilitate integration processes in the EurAsEC through viable projects.

\*\*\*

In the medium term, the creation of a customs union will play a key role in encouraging formal integration in the EurAsEC. In our view, it will face impediments which are both objective (differences in the structure of member country economies) and political in origin (Russia's self-serving approach which fails to create attractive opportunities for partners prepared to make concessions from their side). We believe that potential for further integration is constrained by the need to coordinate many aspects of hugely varying national economic policies.

Nevertheless, aspirations for customs union should not be dropped off and concerns of stakeholders should be addressed with due consideration. The most likely basis for a customs union at the moment is the SES-3 (Russia, Kazakhstan and Belarus); however, some major challenges continue to affect this association, too. Other EurAsEC member countries may gradually increase their involvement in the integration process, but their interest in joining this organisation must be courted. In a shifting to multi-paced scheme of integration, it would be beneficial to consider system of interaction between Russia and its regional partners on a wider scale. The EurAsEC may ultimately be "built-into" integration associations in the former Soviet Union, including the Union State of Russia and Belarus, the CIS and the Shanghai Cooperation Organisation. However, it is extremely important that it retains a "niche" role. This niche would most likely be in the move to formal integration and establishment of supranational bodies in common areas of interest of the member-states (primarily, but not exclusively, foreign trade).

We believe that financial sector holds the most promise for further cooperation in the EurAsEC. It is linked neither with the troubles of cooperation in fuel and energy, nor with the inefficiencies of machine-building industry inherited from the Soviet economic system. Corporate integration between Russia and Kazakhstan can be strengthened through the mutual expansion of their financial institutions. These two champions in financial services development could share their experience with others and facilitate development of the banking systems and financial markets in other EurAsEC member-states. It would be expedient, therefore, to initiate a joint pilot project in one of the sectors of the EurAsEC member countries' financial market. Development of the corporate bonds market would appear to offer most potential. We would also stress the importance of establishing a regional development bank to act as a catalyst of the EurAsEC integration process. Achieving this goal would require membership of all EurAsEC members-states in the Eurasian Development Bank.