12th Conference of the Eurasian Development Bank
Issues of Eurasian integration were discussed, as is now traditional, at the annual EDB conference in October. This year’s conference focused on finding new drivers for Eurasian integration, and discussed ways to promote integration in finance, investments, infrastructure, foreign trade and humanitarian cooperation. A plenary session titled Eurasian Integration: Stagnation or Growth? also touched on the subject of pursuing closer international cooperation within the EEU framework. A breakout session titled Challenges and Prospects for Economic Growth. Views of Chief Economists featured a discussion of inequality within and between countries that is holding back global economic growth. The idea that infrastructure should be developed as a key factor instrumental to overcoming the geographic restrictions faced by Eurasian countries and as a means of transforming the regional geography into a comparative advantage was a recurring topic during both sessions.

PLENARY SESSION:
EURASIAN INTEGRATION: STAGNATION OR GROWTH?

The first stage of Eurasian economic integration is now over, having heralded breakthroughs across a whole range of issues. A single customs space, an elaborate system of institutions, and a common labor market have all been created. The Eurasian Union is now embarking on a strategically important period that calls for a great deal of patience and dedication. The plenary session participants discussed current progress and future prospects of integration processes.

ADVANTAGES OF INTEGRATION

Speaking of the positive aspects of institutional transformation within the Union, Eurasian Economic Commission Board Chairman Tigran Sarkisyan highlighted the structural changes and growing volumes of mutual trade and investments that show that integration is progressing despite the challenges encountered along the way.
“Integration is one of the five key elements that determine the future and the rate of economic growth of both Russia in particular and EEU member states in general.”

A. Kudrin

Alexey Kudrin, Deputy Chairman of the Economic Council under the Russian President, estimated that in order for Russia to achieve annual growth of 3-4% given the existing structural constraints, non-commodity exports should be doubled from USD 109 billion in 2016 to USD 200-220 billion in 2024. In light of this, one of the priorities involves supporting exports and eliminating any barriers in their way as far as possible, through simplified foreign exchange controls and customs formalities, and the unification of trade relations both within the EEU and with third countries. In this context, integration acts as the primary vehicle of international trade, new technologies and services. To quote Alexey Kudrin, integration is one of the five key elements that determine the future and the rate of economic growth of both Russia in particular and EEU member states in general. According to the estimates quoted, if all trade restrictions (including non-tariff regulation) were removed, Armenia would add 6.5% to its current GDP growth, Belarus – up to 12%, Kyrgyzstan – 7.5%, and Kazakhstan and Russia – up to 1%.

Tigran Sarkisyan believes that diversification of the economy and economic growth can be stimulated by properly structured trade and economic relations, including those with third countries. With this in mind, the session participants highlighted the priority aspects for expansion of economic cooperation. The number-one spot belongs to China, where trade cooperation is viewed both in terms of institutional and trade/economic relations and in the form of traditional free-trade zone agreements. It is followed by Vietnam, where a free-trade zone agreement took effect early this year. Other countries in the order of priority are Singapore, Iran, India, Egypt, and Israel, where the process is currently at the negotiation stage. “These are the primary tracks we have launched, these seven directions carry what I believe to be formidable potential for both economic growth and modernization of the Eurasian Union,” Mr. Sarkisyan said.

In his presentation, Eurasian Development Bank Chairman Dmitry Pankin highlighted the positive aspects and challenges involved in implementing the Silk Road project with China. On the one hand, given the current transportation cost per container, there is a potential for continued growth in container flows without any major new investments as part of trans-Eurasian transit across Russia, Kazakhstan, and Belarus (China - EU - China) to reach 200,000 FEU (40-foot containers) in 2020, i.e. threefold in the space of three years. On the other hand, the Chinese government’s subsidies for exports by rail are the main reason behind the annual doubling of the number of container trains and volumes of container cargo between China, the EEU, and the EU in 2013-2016. What is now effectively a zero-percent rate for container transportation across China from several provinces in Central China has contributed to a swift changeover in Chinese exporters’ cargo flows from seaports to rail transport. Against this background, there is a risk that China might scale back its subsidies.
“Infrastructure always comes with new growth and connects cities. This has an effect on workforce mobility and the placement of industrial facilities.”

A. Kudrin

Another important aspect of trans-Eurasian transit is the lagging infrastructure development of the Polish railway system, where the infrastructure and the fleet of locomotives need to be upgraded and renewed. While container trains travel at a fairly acceptable rate of speed (45-50 km/h on average) through the EEU member states, their speed slows down drastically to 18-20 km/h in Poland. The EU also imposes a number of restrictions on the length of container trains, which in some cases requires rebuilding trains at the border. “Without a doubt, we must consider the vast Chinese market and this powerful economy. Yet I believe that hoping that we can make a living from Chinese transit and reap dividends off it is wishful thinking,” Dmitriy Pankin summarized.

Alexey Kudrin pointed not only to the transit potential for the EEU countries from the China – EU transport infrastructure but also to the development of connections between our regions. Infrastructure always comes with new growth and connects cities. This has an effect on workforce mobility and the placement of industrial facilities.

INTEGRATION IN THE MONETARY SECTOR

According to Ksenia Yudaeva, First Deputy Chairperson of the Bank of Russia, low inflation is a precondition for the wider use by countries of national currencies in both mutual and domestic payments. Current trends in the EEU member states are seen as an important vector in this direction. Low inflation, growing trust in national currencies, and improving macroeconomic stability will generally promote continued dedollarization of the economies of EEU member states.

Alexey Kudrin pointed out that in light of its record-breaking price fluctuations over a short period of time the Russian rouble is not a convenient payment currency as of yet and lags the dollar and euro in this regard. The rouble’s positions as an international payment currency will strengthen further in the event of low inflation as Russia reduces its oil dependency.

Participants observed that the ongoing policy of sanctions (particularly new sanctions that prohibit Russian companies from doing business not just with the USA, but with the rest of the world) creates risks for foreign currency transactions and could accelerate the introduction of the rouble in international payments.
**PROSPECTS FOR DIGITAL TRANSFORMATION**

“**Digital transformation is an obvious global trend.**”

T. Sarkisyan

Speaking of the digital transformation in the EEU space, Russian Deputy Foreign Minister Alexander Pankin mentioned the adoption in 2017 of the major aspects of implementation of the digital agenda up to 2025. Under this document, innovative projects will maximally cover the industry-specific, cross-industry, and infrastructure sectors.

Mr. Sarkisyan contributed to confirm that government leaders of the EEU member states have already approved the procedure for implementing this digital agenda, which defines the implementation mechanisms of the major aspects. The first initiative of fundamental importance involves creating a mega database, exchanging data, creating cross-industry digital platforms, etc.

**STAGNATION OR GROWTH**

“I believe that integration is a process. There will never come a day when everybody says: that’s it – we have integrated. There will still be areas that require continued efforts.”

A. Pankin

Plenary session participants remarked that the rate of integration in the Eurasian space has slowed somewhat. New challenges have appeared on the agenda. For example, Dmitry Pankin pointed out an acute shortage of synchronization among the efforts of EEU member states in implementing transboundary infrastructure projects and when it comes to planning in general. There are situations in practice where infrastructure projects are implemented in a non-synchronized manner, which drastically reduces the effectiveness of business operations within the Union framework and limits any prospects for growth. Countries launch certain infrastructure projects on their own at a time when they are de facto parts of international transport corridors. In this context, participants pointed out the importance of efforts launched by the Eurasian Economic Commission to analyze the transport projects being contemplated by the EEU member states.

“The number-one task today is expanding the scope of the commission’s authority in order to ensure that the commission is also accountable.”

T. Sarkisyan

Tigran Sarkisyan expressed the view that time has shown that creating a supranational body to promote integration in the region is a necessary, albeit insufficient measure. Yet when an agency is not authorized to enforce laws, conflicts are bound to arise between countries over the different interpretations of the provisions of the integration association. This is where the conflict between short-term interests of national governments and long-term goals of an integrated association comes to the fore. Therefore, the number-one task today is expanding the scope of the commission’s authority in order to ensure that the commission is also accountable.
“Cooperation in the humanitarian sector could become the next stage of further integration.”

Dmitriy Pankin

Alexey Kudrin seconded this position, stating that the EEU has accumulated a great deal of problems and that this integration association has reached a certain milestone. The approaches that used to generate growth have been mostly exhausted. There is a need for new steps and new ideas today: “In this context I support the idea of increasing the role of supranational bodies and delegating more authority to them.”

According to Natalia Korzhova, President of the Financial Academy of the Ministry of Finance of the Republic of Kazakhstan, a need has formed in the field of humanitarian cooperation and development of human capital to reach a level of education that would enable today’s graduates from master’s degree or Ph.D. programs to come and either teach the next generation or train professionals for whom there is currently a large market demand, financial analysts, manufacturing industry experts, and other forward-looking people who understand where the EEU and other integration associations will find themselves in the future.

BREAKOUT SESSION: CHALLENGES AND PROSPECTS FOR ECONOMIC GROWTH. VIEWS OF CHIEF ECONOMISTS

Representatives of international and regional financial development institutions presented their vision of current macroeconomic trends both in the world and in specific regions. A key topic for the breakout session was the issue of inequality within and between countries, which holds back global economic growth. Discussion participants pointed out that the causes of this phenomenon extend beyond the traditional concept of income-based inequality. It is also important to address no less fundamental factors of inequality such as geography and different transportation costs for producers of countries with and without access to the sea.

“The paradox of the global economy is that countries that require economic integration more than others experience a shortage of integration partnerships.”

Y. Lissovolik

According to Yaroslav Lissovolik, Chief Economist of the EDB, the issue of inequality of economic integration (when the regions that most need integration are least involved in the processes of globalization of international trade) has received insufficient attention both in economic research and macroeconomic discussions. This phenomenon should be studied through the prism of the “continentality” concept. The World Bank estimates that higher transportation costs cause the GDP of countries without access to the sea to grow at a rate that is 1.5% slower, and to have a 30% smaller turnover compared to maritime countries. Countries without access to the sea (excluding EU and EFTA countries) have 2.5 free-trade zone agreements on average, while maritime countries have 7.5 FTAs (according to the WTO database). If you consider all types of integration agreements, the difference between the two groups of countries is still more than twofold (countries without access to the sea have 4 agreements on average vs. 9 agreements for maritime countries).
If one compares countries with high and low incomes (as defined by the World Bank), it turns out that the average number of FTAs in low-income countries is 0.3, vs. 14.7 in rich economies (a more than 40-fold difference). The difference between the two groups of countries in terms of the total number of integration agreements (including FTAs) is more than 10-fold.

Countries without access to the sea account for roughly one-fifth of WTO members. At the same time, thirty percent of non-WTO members have no access to the sea.

These facts are graphic evidence that continental countries and/or developing countries in need of integration have a low level of involvement in integration associations.

Such conditions give rise to the need to create new integration mechanisms that would be more inclusive of countries with low incomes or no access to the sea. One example of such an integration project is China’s One Belt One Road (OBOR), which encompasses 69 countries. This project aims to develop infrastructure and reduce transportation costs in the continental Eurasian space. The OBOR is unique in that more than 30% of all countries of the world and 75% of Eurasian countries without access to the sea have joined the project.

Another example is the Eurasian Economic Union (EEU): none of its member states except Russia has access to the sea. And even Russia is a predominantly continental type of economy with an acute shortage of port capacity.

Integration, including through the creation of transport infrastructure, is one of the primary ways to overcome geographic restrictions faced by Eurasian countries, which in turn requires an economic policy focused on long-term macroeconomic stability.

In this context, the current macroeconomic parameters of the EDB member states create favorable conditions for a new round of integration. The recovering economic growth, declining inflation and interest rates create good conditions to implement integration projects in the region.

“Infrastructure development is a key factor instrumental to overcoming the geographic restrictions.”
Y. Lissovolik

“The European Union’s experience in overcoming the crisis and approaches to integration into the global economic space” were presented by Rolf Strauch, Chief Economist of the European Stability Mechanism. The Eurozone, being the world’s largest and most open economy, has more successfully addressed the challenges of the global economic crisis than the USA and Japan. In terms of the foreign trade turnover of goods and services, the openness of the Eurozone increased from 50% of GDP in 1995 to over 80% of GDP in 2016. Exports, including internal trade between member states, acted as a driver of economic growth that enabled the Eurozone to recover from the global crisis sooner than other developed countries.

“Economic integration can be preserved only by unfailing decisiveness in rectifying macroeconomic imbalances, no matter how painful this process may be.”
R. Strauch
According to forecasts, exports will continue to play a key role in the foreseeable future. The primary success factors have been the political will and staunch determination to implement reforms aimed at eradicating the causes that provoked the crisis, along with the striving to re-balance the economies within the Eurozone, however painful this process may be. Owing to the fiscal consolidation implemented as part of the ESM program, the fiscal and external positions of the Eurozone are currently evaluated as stable.

"Strengthening of the economy’s structural integration is a guarantee of a country’s successful integration into the global economic space."

R. Strauch

In the context of integration into the global economic space, the Eurozone faced the challenge of raising both structural and price competitiveness. Eurozone countries worked hard to eliminate barriers that prevented the development of free enterprise and to remove obstacles in the way of commodity and capital flows. Competitiveness indexes are graphic evidence of the success of this policy. The Eurozone is home to a third of the world’s most competitive economies. Structural reforms aimed at improving the conditions for doing business have reinforced the positions of the EU in world globalization trends.

The capabilities of Eurozone countries are somewhat limited in terms of regulation of price competitiveness. The EU lost its price competitiveness during the global crisis. Restoring it required lowering production costs, which has been rather painful for some of the EU member states. Price competitiveness has now recovered to the pre-crisis level, which has improved the positions of the Eurozone compared to China and the USA.

As regards the inequality of economies, an important conclusion drawn from the way the Eurozone countries have overcome the crisis is the inclusive nature of the recovery that happened on equal terms for all EU members. The major factors have been the all-encompassing nature of the job creation process and a more equal distribution of incomes in the Eurozone countries as opposed to the USA, for example. The European model for overcoming the crisis has proven to be successful from the point of view of those who lost in the globalization process.

Continued plans to reinforce integration in the Eurozone include an initiative to distribute risks among countries. If shocks are asymmetrical, there should be either government or market mechanisms capable of balancing out the inequalities among countries. Market mechanisms are private capital flows, funding, and private sector financing, which implies creating a banking union (a single oversight agency and a single mechanism for dispute resolution). In addition, a single capital market for transboundary investments is currently at the formative stage.
The creation of a fiscal union as one of the ways to reduce inequality between countries in Europe is an issue that remains to be discussed in the context of stepping up European integration efforts.

Global economic growth forecasts were presented by Gabriel Di Bella, chief of the International Monetary Fund mission in Russia. According to the IMF World Economic Outlook published in October, the current period is favorable for the global economy. In the wake of the global crisis, most countries of the world have started to demonstrate positive growth; the Eurozone is experiencing a dynamic economic recovery; US economic growth is strengthening; and economic activity in Japan is recovering. Among the emerging economies, Russia has demonstrated faster economic growth. The economic growth forecast for China has also been upgraded. Low inflation in the Eurozone and the US is still cause for some concern. The risks are relatively balanced and do not raise concerns in the short term. Risks of a deterioration predominate in the medium term. In this context, the economies should use this window of opportunity to build buffers and implement those economic policy measures that are hardest during economic downturns.

Demographic factors play a growing role in the context of fiscal position planning. The demographic situation in the world varies greatly from region to region: developed nations are demonstrating a trend toward an aging population, which gives rise to a number of challenges for these countries: the need to increase labor participation rate, changes in the structure of consumption, and a growing burden on the budget. In countries with emerging markets, the demographic factor will make a positive contribution to economic growth for several decades.

The IMF has revised the global economic growth forecast upwards for the first time in a long while. The growth rates in the Eurozone, USA, and emerging markets are higher under the baseline scenario compared to the previous forecast.

A highlight of the current cyclical growth phase is that economic activity is recovering under the conditions of low inflation. Inflation still remains below central bank targets. This poses risks in terms of the effectiveness of monetary policy in matters of stimulation of economic activity.

Stagnation of labor productivity is yet another feature of the current recovery phase. There is a lot of talk about robotization, a digital economy, and development of the FinTech industry. The paradox is that despite all of these innovations introduced since the beginning of the world crisis, the overall productivity of the factors of production demonstrates weak growth. Such modest growth in labor productivity is expected to continue in the foreseeable future, and per capita growth will be lower than the level achieved in 1995-2005.
Despite all the optimism, risks of higher financial instability are present on the forecast horizon. High economic growth in China was partly fueled by excessive expansion of lending, which increases the risk that China may not achieve the target of doubling its GDP by 2020.

Another aspect of risk relates to the Eurozone and the US, where monetary policy is normalizing at a slower-than-expected rate. In light of this, the risks of acceleration of normalization of monetary conditions in the USA and Eurozone could cause elevated volatility in the financial markets of emerging economies caused by the turnaround of capital flows.

Additional risks are contained in the possible deregulation of the financial system of developed countries. A great deal of progress has been achieved in the wake of the economic crisis in terms of increasing the stability of the banking sector, amassing capital, and introducing macro-prudential oversight. After this tremendous amount of work, deregulation of the financial sector would represent a major step back that would bring high risks with it.

The growing protectionist sentiments that seek to protect national interests by closing the borders along with geopolitical disagreements could also undermine this global growth.

As for Russia, to secure stable growth in the medium term, the implemented macroeconomic policy measures such as the introduction of the fiscal rule and the transition to inflation targeting should become an integral part of economic policy and be implemented consistently in order to ensure stability of the macroeconomic environment. Demographics are a challenge for Russia, which requires a decisive reform of the pension system. Russia’s continentality and high level of logistical costs also impose restrictions on economic growth opportunities. In this case, integration into global trade and ensuring a more uniform distribution of incomes by improving government spending on infrastructure and social needs will help to overcome the problems of inequality.

Apurva Sanghi, the World Bank’s Leading Economist in the Russian Federation, discussed the findings of the World Bank study titled Competitiveness of Cities. According to the study, over 80% of global economic activity is generated in cities. More than one half of the world population lives in urbanized districts. Even though Russia is experiencing a declining rate of population growth, the country’s urbanization is on the rise.
The World Bank has created a database of the world’s 750 largest cities. An analysis of data from these cities was used to determine which cities grow at the fastest rate. Since the early 2000s, roughly three-quarters of the cities analyzed have been growing more quickly than their respective national economies. Competitive cities demonstrate high economic growth, job creation, and income growth. The top 75 cities in the ranking achieved average GDP growth of 13.5% versus 4.5% in other cities between 2000 and 2006. The average annual rate of new job creation exceeded 9% and income growth – 10%. Factors such as the availability of natural resources, or being a capital city or a port town are not decisive when it comes to accelerating GDP growth.

For example, the Turkish city of Gaziantep does not have natural resources, and is not a capital city or a port town. However, light industry enterprises in Gaziantep export their products to 175 countries of the world. Exports increased tenfold in just 11 years from USD 620 million in 2002 to USD 6.2 billion in 2013. This city ranked ninth in the global ranking of economic growth between 1999 and 2009. Average GDP growth was 6.3% and average employment growth was 3.6% between 2005 and 2012.

What factors enable the city to join the most competitive cities in the world? First: long-term sustainable growth is ensured by stable growth of employment in two or three sectors that create a commercial product, rather than in retail or the public services sector. The second factor is the effective governance structure of the urban municipality. Third: competitive cities focus on transforming strategies into real actions through strategic budgeting and solving problems as they arise during the implementation of plans. Notably, such factors as leadership skills of the city’s mayor or fiscal incentives do not play a key role in helping cities achieve the status of the most competitive cities in the world.

Natalia Orlova, Chief Economist with Alfa-Bank, presented her own vision of the prospects for Russian economic growth and the risks that curb its quality growth.

Against a background of a global economic recovery, the Russian economy also started demonstrating positive growth. For the first time since 2014, the Russian economy has grown by 1.5% in the first half of the year. Alfa-Bank estimates that GDP growth will amount to 1.5-2.0% by the end of 2017. Despite the major structural shifts in the economy, the achievements of macroeconomic policy can be described as successful: the transition to a floating exchange rate and more stringent controls over government spending. Inflation is expected to be 3.0% in 2017.
“Positive achievements of Russia’s macroeconomic policy are complicated by the unequal growth structure.”

N. Orlova

The flip side of macroeconomic policy success is the structure of economic growth, which reflects an unequal distribution of incomes and unequal development of specific Russian regions. In past decades, growth was recorded in the majority of economic sectors and regions of Russia, whereas the current recovery of investments is driven almost 90% by three regions: the city of Moscow due to the renovation of the city; the Crimea, where a major infrastructure facility is under construction; and the Far East, which utilizes Chinese investments in the oil and gas industry. The consumer sector is also demonstrating uneven growth. The number of people living below the poverty line has been rising since 2013.

Presently, some 19-20 million Russians have incomes that place them below the poverty line. This presents new challenges for fiscal policy. While in previous decades the budget involved redistributing revenue from the oil industry to other sectors of the economy, there is presently a need to redistribute incomes from the middle class to the most vulnerable groups of the population. It is expected that the year 2018 will see the implementation of fair mechanisms for the redistribution of fiscal cash flows in order to reduce the inequality of incomes.

On the one hand, Russia has been showing strong macroeconomic achievements. On the other hand, risks attributable to the structure of growth are present. In 2008, when the global financial crisis broke out, many economists claimed that Russia had sufficient strength in reserves to withstand the pressure of the crisis wave. Time has shown, however, that macroeconomic stability is an essential albeit insufficient condition for stable economic growth. The level of potential growth of the Russian economy has declined from 6.0% to 1-2% between 2008 and 2017. This means that a balanced macroeconomic policy should be complemented by structural reforms.

The challenges of deeper integration and economic inequality discussed at the plenary and breakout sessions, respectively, can hardly resolve themselves. In the context of an improving macroeconomic environment, now is a suitable time to implement reforms aimed both at stepping up integration and overcoming the factors of inequality. A special role in this process is reserved for development banks and other international financial institutions. At the same time, it is essential to understand that the elimination of imbalances with the help of the government and international institutions should not undermine the effectiveness of market forces.