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TOWARDS A EURASIAN UNION: OPPORTUNITIES AND THREATS IN THE CIS REGION

IEMS EMERGING MARKET BRIEF

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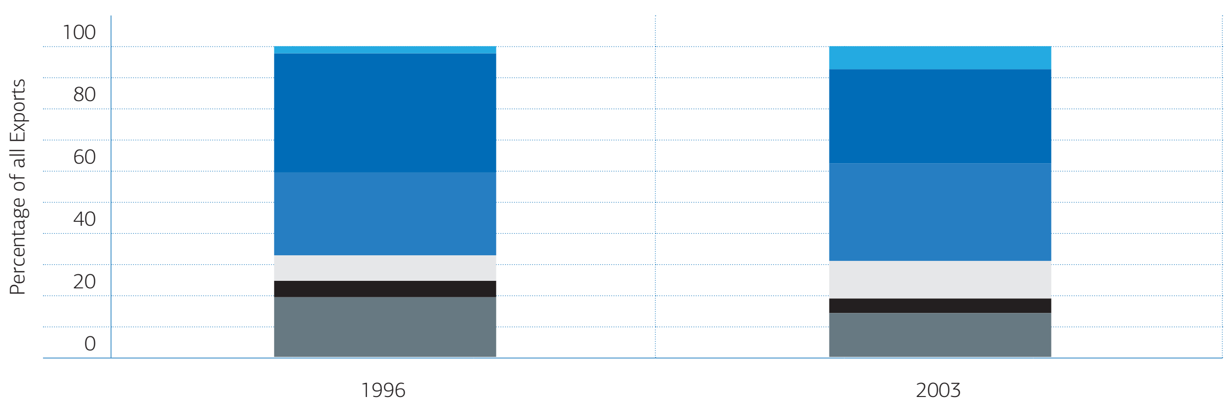
I. Introduction

Greater economic integration within the Commonwealth of Independent States (CIS) has been a goal of some policymakers ever since the fall of the Soviet Union 20 years ago, with "hundreds of initiatives and projects that aim for deeper cooperation between countries in the region."[1] While there have been many false starts, integration may finally be on the intended track. On January 1, 2012, the customs union of Belarus, Kazakhstan, and Russia took a big step in this direction by removing all barriers to trade, capital, and labor movements between the three countries.[2] Policymakers, especially in Russia, have signaled that even this landmark step is merely a way station en route to a comprehensive "Eurasian Union," a "'Eurasian Schengen' (free movement of people among the three countries, built on the example of the European Union) by 2015, followed by a currency union and, ultimately, full economic integration."[3]

But as the European Union, a successful model for regional integration, enters the most difficult phase of its existence as an economic and political union, policymakers need to consider whether the idea of a "Eurasian Union" is a good one. At face value, the Eurasian proposal has merit if it can contribute to increasing trade in a region of the world in which trade has been difficult. According to the World Bank's Doing Business rankings, no country in the CIS is even in the top 100 in terms of ease of "trading across borders," with Armenia being the highest-performer at 104 and Uzbekistan last at 183, be-

> Greater economic integration within the Commonwealth of Independent States (CIS) has been a goal of some policymakers ever since the fall of the Soviet Union 20 years ago

Figure 1: Percentage of Exports from the CIS, by Category, 1996 and 2003



Legend: Food & feeds, Agricultural raw materials, Ores & Metals, Fuels, All Manufacturing, Other

1/ Evgeny Vinokurov and Alexander Libman, "The EDB System of Indicators of Eurasian Integration: General Findings," in Eurasian Development Bank Eurasian Integration Yearbook 2010, available online at: http://eabr.org/media/img/eng/research-and-publications/IntegrationYearbook/2010/a_n3_2010_full%20version.pdf

2/ Vladimir Putin, "A New Integration Project for Eurasia," Izvestia, October 4, 2011.

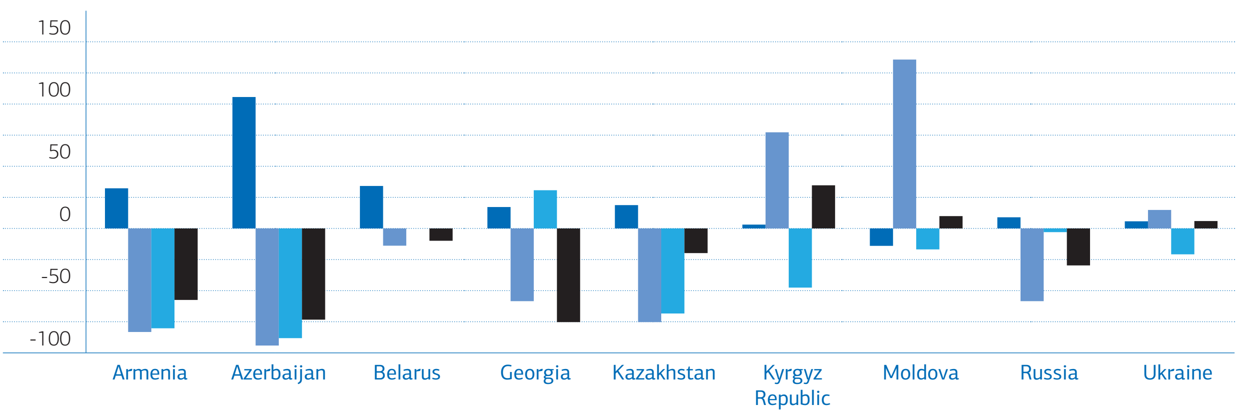
3/ Dmitri Trennin, "Russia's Eurasian Integration," Japan Times, November 9, 2011, available at: http://www.japantimes.co.jp/text/e020111109a1.html.

hind such free-trade stalwarts as Zimbabwe and Afghanistan (see Table 1). This performance is even worse when compared to former Soviet countries that refuse to participate in the CIS, such as the Baltic States, or who have withdrawn (Georgia). All of these countries are ranked in or near the top quarter of all countries worldwide. Thus, any move towards trade liberalization could only benefit an area of the world that has seen precious little.

However, there are worries that greater Eurasian integration will not lead to sizable gains in living standards in the countries that opt to enter into the union. In the first instance, the countries that are most likely candidates for a Eurasian Union are precisely those CIS members that have not liberalized. If membership in the CIS hasn't led to growth, why would increasing integration with similarly situated countries? Even if trade is expanded, there are worries that the output of each country is too similar to other potential members of the Eurasian Union to have much of an economic boost. Over the post-Soviet period, trade from the CIS has skewed heavily towards natural resource-intensive exports (Figures 1 and 2). Finally, it is possible that only the larger states of the Eurasian Union (in particular Russia) could derive benefits from increased integration, with a new union leaving Russia as the head of a series of economically dependent states.

The purpose of this paper is to examine the prospects for a Eurasian Union and what its effects could potentially be in the region. In particular, we will examine the possible effects on trade in goods, capital, and labor and attempt to derive some policy conclusions on the desirability and feasibility of such a union.

Figure 2: Change in Factor Intensity of Exports by Country, 1996-2003



Legend: ■ Skilled labor □ Natural resources ■ Capital-intensive ■ Unskilled labor

Source: World Bank.

Tajikistan, Turkmenistan, and Uzbekistan are not shown for lack of data. However, given the reliance of these economies on natural resources, it is safe to assume that they, too, saw a large increase in resource-intensive exports over this period.

Table 1: Trading Across Borders Rankings in the Former Soviet Union	
Economy	Trading Across Borders Ranking
Singapore	1
Hong Kong SAR, China	2
Estonia	3
Latvia	15
Lithuania	28
Georgia	54
Armenia	104
Moldova	134
Iran, Islamic Rep.	138
Ukraine	140
Sudan	151
Belarus	152
Russian Federation	160
Côte d'Ivoire	161
Azerbaijan	170
Kyrgyz Republic	171
Zimbabwe	172
Kazakhstan	176
Tajikistan	177
Afghanistan	179
Iraq	180
Uzbekistan	183

Source: World Bank Doing Business 2011

II. The Prerequisites for Further Integration in Eurasia: Are They There?

Current moves towards a Eurasian Union follow in the footsteps of initiatives that have proceeded in the CIS region almost from the moment that the Soviet Union disintegrated. Integration efforts over the past 20 years have at times involved all, some , or only a few of the members of the CIS, with five major geographic groupings of integration[4]:

1. CIS-12 (all post-Soviet countries, excluding the Baltics, but including Georgia);
2. EurAsEC-5 (Russia, Kazakhstan, Kyrgyzstan, Belarus, and Tajikistan);
3. EurAsEC-3 (the three largest EurAsEC countries: Russia, Kazakhstan, and Belarus);
4. CES-4 (the four largest post-Soviet economies: Russia, Ukraine, Belarus, and Kazakhstan, named after the failed Single Economic Space in 2003–2004); and
5. CA-4 (the four Central Asian states participating in integration: Kazakhstan, Kyrgyzstan, Uzbekistan, and Tajikistan).

Of these various initiatives, the grouping that has progressed the furthest is the EurAsEC-3, which is currently implementing the Common Economic Space (CES). Even this success has been a long time in the making, beginning in 1995 with an agreed-upon customs union between Belarus and Russia, expanding to Kazakhstan and Kyrgyzstan in 1996 and Tajikistan in 1998; however, there was little movement towards implementation "due to the enormous discrepancies between the partners' interests."[5] By 2000, this "Customs Union" was transformed into the Eurasian Economic Community (EurAsEC) among the signatory countries. It wasn't until 2007, however, that a formal agreement was signed between Russia, Belarus, and Kazakhstan, putting in place the Customs Union Commission (CUC) to oversee key issues of integration. This was followed by harmonization of legislation in December 2008 on customs procedures and regimes, procedures for goods customs declaration, and the formation of a legal environment for a customs union within the EurAsEC.[6] The CUC held its first session in February 2009, and a common customs tariff was agreed upon by October of that year. By January 1, 2010, the common tariff was enacted by the three countries, and the presidents of Russia, Kazakhstan, and Belarus re-announced the creation of a single economic space by January 1, 2012.

With the political will for integration finally materializing, current levels of integration can offer clues as to where the EurAsEC-3 can focus its efforts for the future. In particular, two main areas of integration may show the opportunities for expanded cooperation, as well as warn of areas that are either already tightly integrated or are not ripe for integration: [7]

- Integration of markets: Mutual flows of commodities, services, and production factors, including:
- General trade integration and labor migration integration; and
- "Functional" integration, or integration in the three priority sectors of the CIS countries (electric power, agriculture, and education); and
- Convergence of economic systems: Convergence of macroeconomic policies, financial development policy, fiscal policy, and monetary policy.

We will examine these two components in turn.

Integration of Markets: Will CIS Markets Benefit from Increased Integration?

According to the Eurasian Development Bank (EDB), over the period of 1999–2008, the EurA-

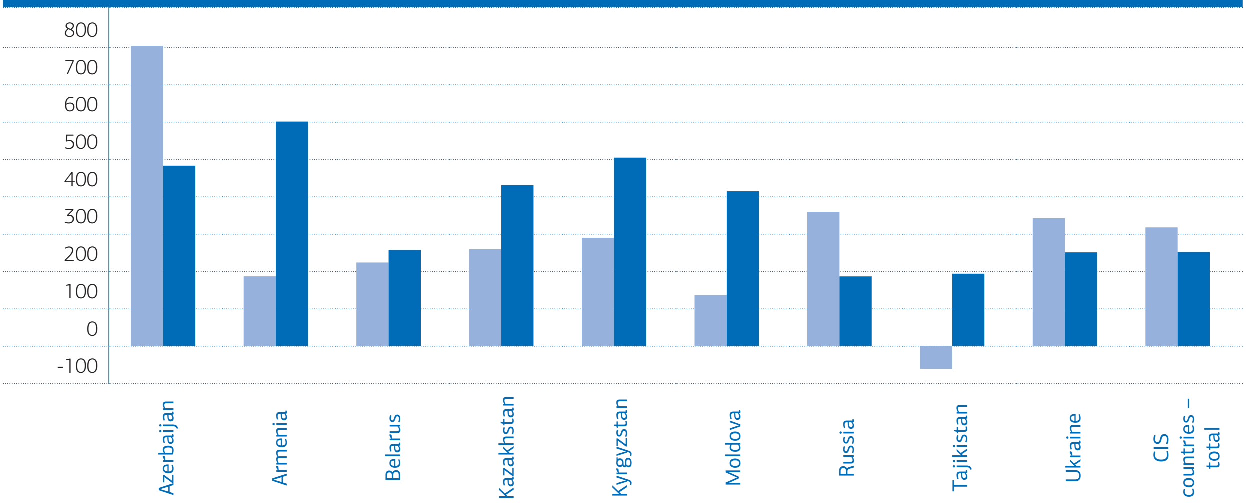
4/ Evgeny Vinokurov and Alexander Libman, "The EDB System of Indicators of Eurasian Integration: General Findings."

5/ Iwona Wisniewska, "Who Needs the Customs Union?" EastWeek, publication of the Centre for Eastern Studies (Warsaw), December 2, 2009, available online at: http://www.osw.waw.pl/en/publikacje/eastweek/2009-12-02/who-needs-customs-union.

6/ Igor Krotov, "Customs Union between the Republic of Belarus, the Republic of Kazakhstan and the Russian Federation within the framework of the Eurasian Economic Community," World Customs Journal, Vol. 5 No. 2 (2011), available online at: http://www.worldcustomsjournal.org/media/wcj/-2011/2/Krotov.pdf.

7/ These components are based on the European Development Bank's "System of Indicators of Eurasian Integration" (SIEI), found in Evgeny Vinokurov and Alexander Libman, "The EDB System of Indicators of Eurasian Integration: General Findings." The EDB includes a third component, institutional integration, which focuses mainly on participation in intra-regional groupings such as the CIS Statistical Committee or the Customs Union Committee.

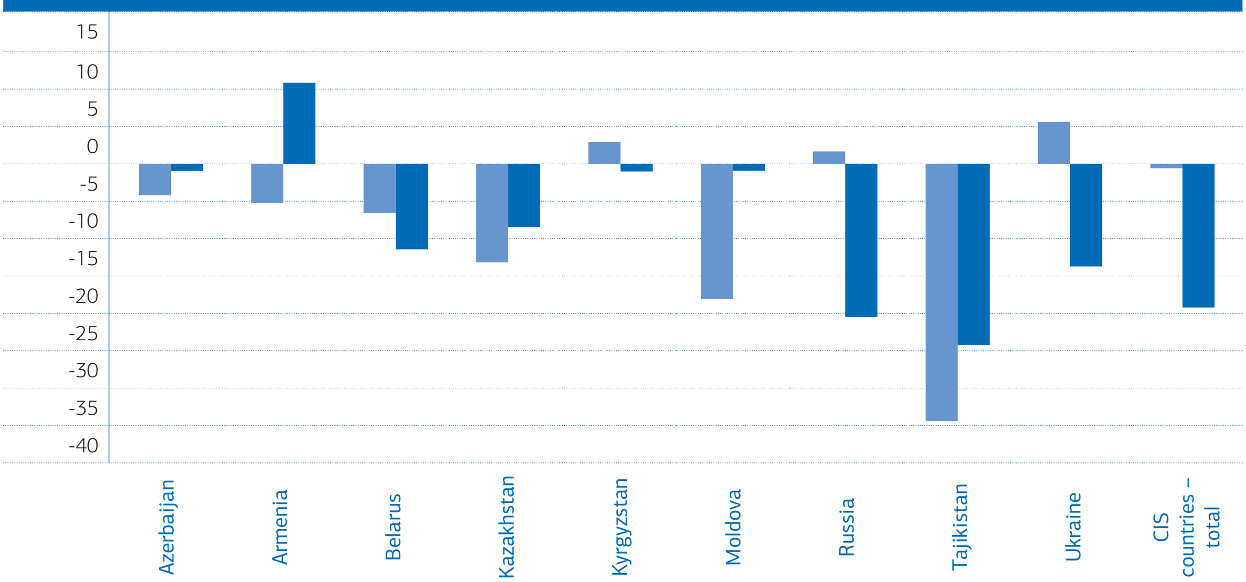
Figure 3: Percentage Change in Absolute Volume of Trade in the CIS, 2000-2010 (Billions of US$)



Legend: Change in Imports Change in Exports

Source: Statistical Committee of the CIS

Figure 4: Change in Relative Volume of Trade in the CIS, 2000-2010



Legend: Change in Imports Change in Exports

Source: Statistical Committee of the CIS, Author's calculations sEC-5 saw an increase in overall integration, with Belarus, Russia, and Kazakhstan seeing the largest moves in market integration (an obvious situation, given that these three countries were also the leaders in integration initiatives). This trend has been particularly true in general trade integration in the years leading up to the global financial crisis and even beyond; for example, Belarus is Russia's largest trading partner in the CIS, surpassing Ukraine in 2009, with large imports of energy from both Russia and Kazakhstan and exports of agricultural and heavy industrial goods (including tractors and trucks) to its fellow customs union members. However, the trade statistics reflect the relative size of Russia in the customs union as—while Kazakh-Russian and Belarusian-Russian trade is on the increase—trade between Kazakhstan and Belarus is still miniscule (Belarus is also a mere 0.1% of Kazakh exports and 1.5% of Kazakhstan's imports). From the Russian side, a total of about 7% of Russia's export trade is with Belarus and Kazakhstan.

While the integration of markets in the countries actively working for integration has increased, trade integration has actually decreased over time throughout the broader CIS-12 region

While the integration of markets in the countries actively working for integration has increased, trade integration has actually decreased over time throughout the broader CIS-12 region. By the metrics of the EDB, the richest and largest countries (including Azerbaijan, Ukraine, Kazakhstan, and Russia) are the least integrated within the whole CIS-12 grouping, while the Central Asian countries tend to be integrated with each other. This does not mean that trade itself has slackened: intra-CIS trade has actually increased from 2000 to 2010 (see Figures 3 and 4). As Figure 3 shows, the absolute volume of trade within the CIS region has continued to expand in some countries by a considerable amount: Azerbaijan, which saw only token flows to the CIS in 2000, expanded its exports by 744% as its oil reserves came online, while Armenia and Kyrgyzstan began to import much more from the CIS.

However, while the absolute volume of both imports and exports have been on the rise in the CIS (apart from Tajikistan, with declining exports since 2000), the proportion of trade that has occurred within the CIS realm has been declining. Figure 4 shows the change in CIS trade as a proportion of all trade from 2000 to 2010 and paints a much different picture. Whereas absolute volumes are on the rise, the relative importance of CIS trade to each CIS member has decreased, with the notable exception of Ukraine, which now exports a mere 6% more to the CIS than it did in 2000, and Armenia, which imported 11% more of its trade from the CIS over the same period.

Behind these broad numbers are trends in the specific "functional" facets of market integration (Table 2). For example, while Tajikistan is less reliant on exports to the CIS, it exhibits "cooperation…in the key sectors of functional integration, especially electric power." [8] Indeed, energy is a key area where the CIS region has seen both greater integration and an increase in trade. In addition to Kazakhstan, oil-rich Azerbaijan is 62nd in the world in merchandise exports (as opposed to landlocked Armenia, ranked 145th), while Ukraine also relies heavily on the energy outputs of Russia and Kazakhstan (one of the arguments for Ukraine's inclusion in an expanded Eurasian Economic Union).[9] This increased trade in natural resources continues the trend from the first decade of transition (according to a World Bank study, the share of natural resources in CIS exports grew the fastest of all exports), and it appears to have intensified as projects such as the Baku-Tbilisi-Ceyhan pipeline have come online and investment has

8/ Ibid.
9/ All data from 2010 and the WTO: http://stat.wto.org/CountryProfile/WSDBCountryPFHome.aspx?Language=E.

Table 2: Functional Market Integration in the CIS, 1999-2008

Index	General Dynamics of integration in CIS-12	Leading country pair (2008 index)	Leading country pair (increase in index)	Leading country in integration with CIS-12 (2008 index)	Leading country in integration with CIS-12 (increase in index)
Trade	↓	Russia-Ukraine	Kazakhstan-Ukraine	Belarus	Kyrgyzstan
Labor migration	↑	Kazakhstan-Kyrgyzstan	Kazakhstan-Kyrgyzstan	Tajikistan	Tajikistan
Energy	↓	Uzbekistan-Tajikistan	Russia-Ukraine	Tajikistan	Ukraine
Agriculture	↓	Kazakhstan - Azerbaijan	Kazakhstan-Turkmenistan	Kyrgyzstan	Turkmenistan
Education	↑	Kyrgyzstan - Uzbekistan	Uzbekistan-Kazakhstan	Kyrgyzstan	Kyrgyzstan

Source: Reproduced from the EDB's Eurasian Integration Yearbook 2010. The General Dynamics column refers to changes in integration over the period of the index.

poured into extractive industries.[10] The CIS thus evolved from a series of economies devoted to capital- and skill-intensive exports (at independence) to ones reliant on natural resources, with a "lack of diversification [that] makes CIS countries vulnerable to unfavorable terms of trade shocks."[11]

In regards to other functional areas of integration, as shown in Table 2, the movement of capital and people within the CIS space tell a much different story beyond that of simple trading relationships and points to an area where economic realities have pushed for significant integration. Capital flows into and out of the region and the movement of people within the former Soviet Union have had significant and lasting effects, and both realistically can also expect to be affected by any move towards re-integration.

The countries of the CIS (with the notable exception of Russia) have continued to be relatively low on any investor's wish list for the same reasons that have influenced trade flows: small market size and political and institutional stagnation have sent many investors elsewhere. However, as the region rebounded from the effects of the Russian crisis, capital finally began to flow into the CIS (Table 3), but the investment (especially portfolio flows and trade) was highly skewed towards the lucrative natural resource industries. Intra-CIS flows have also increased, radiating from Russia to the periphery, although it is more difficult to ascertain the exact magnitude, as "locational BIS International Banking Statistics cover bank flows between countries, but as Russia is not within the BIS reporting area, it is impossible to infer anything about the pattern of lending within the region."[12] Further muddying the waters is the fact that (mainly) Russian investors use offshore financial centers, which leads to situations such as in 2007, when 65% of Russian FDI outflow went to Cyprus, the Netherlands, and British Virgin Islands, while in that same year 50% of Ukraine's FDI inflows came from the same three centers (officially, however, only

10/ Harry G. Broadman (ed.,) From Disintegration to Reintegration: Eastern Europe and the Former Soviet Union in International Trade (Washington, D.C.: World Bank), 2005.

11/ Oleksandr Shepotylo, "Export Diversification across Industries and Space: Do CIS Countries Diversify Enough?" Working Paper, August 2009, available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1458272.

12/ "Russia: Selected Issues," International Monetary Fund (IMF) Country Report 08/308, September 22, 2008, available online at: http://www.imf.org/external/pubs/ft/scr/2008/cr08308.pdf.

Table 3: Private Capital Inflows to CIS Countries as % of GDP, 2002-2010									
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Armenia	4.72	4.30	6.79	4.72	7.19	7.51	8.01	8.34	6.11
Azerbaijan	17.10	32.32	26.88	3.70	-6.20	-15.31	-1.82	0.02	0.37
Belarus	3.04	0.99	0.97	0.86	0.88	3.82	3.55	3.66	4.64
Georgia	4.60	8.31	9.15	8.70	17.12	16.66	16.57	6.24	9.09
Kazakhstan	3.72	1.05	11.63	-3.21	2.67	3.23	2.80	11.39	7.64
Kyrgyz Republic	-0.46	2.69	5.52	1.82	6.32	5.01	6.84	3.60	13.04
Moldova	3.38	2.52	5.31	6.15	7.47	11.80	11.59	2.44	3.44
Russia	0.84	-1.46	0.39	-1.47	2.25	1.13	-0.97	-0.76	-0.76
Tajikistan	3.08	2.06	13.36	2.36	11.96	9.68	7.28	0.32	0.39
Ukraine	2.44	4.54	5.82	11.95	8.65	10.49	4.79	2.64	7.31

Sources: World Development Indicators, World Bank. Turkmenistan and Uzbekistan are omitted due to a lack of data.

3.3% of Russia's outward investment went to Ukraine).[13] Thus, one can surmise that Russia does indeed dominate capital flows in the region, but the extent to which this domination extends is unknown.

While capital flows to the region are relatively small (again except in Russia) and intra-CIS flows are difficult to ascertain, the movement of people around the region is a more visible trend since the transition began. Labor flows are one of the most significant aspects of the economies of Central Asia and the Caucasus. As Table 4 shows, the vast majority of emigrants from the CIS countries go to work in Russia, with a snapshot from the early 2000s showing that for some countries (such as Tajikistan), Russia was the only place that attracted emigrants. Common language abilities, the relative advancement of Russia versus the CIS countries on the periphery, and, in many cases, social support networks and/or familiarity with Russian cities combine to make Russia an attractive place for CIS citizens to move and work, more so than other destinations (including France and the United States). And, as Table 2 shows, labor migration can account for a large part of the perceived "integration" of some countries, notably Armenia and Kyrgyzstan, which have the highest levels (proportionally to their own populations) of labor migration to Russia. Moreover, in much of the CIS, migration to Russia is not done as a whole family unit; instead, many families have at least one family member in Russia working and sending money back to the family. Indeed, these remittances buoy many of the economies of the CIS countries, with Tajikistan, Moldova, and the Kyrgyz Republic having over one-third of their economies reliant on remittances.[14]

Integration of Economic Systems: Is There Enough Convergence in the CIS to Make Integration Work?

In regards to the convergence of economic sys-

13/ Ibid.

14/ Based on World Bank data for 2007. According to this, Tajikistan and Moldova are one and two in remittance/GDP ratio, while Kyrgyzstan in four in the world. Tiny Pacific nation Tonga is number three. Additionally, given the high proportion of migrants from the CIS to Russia and the resulting transfer of money, Russia's capital flows are even greater than the IMF estimates.

Table 4: Migrant Workers in the Early 2000s, in thousands of workers

CIS country	Migrant workers abroad	Migrant workers in Russia
Armenia	800-900	650
Azerbaijan	600-700	550-650
Georgia	250-300	200
Kyrgyzstan	400-450	350-400
Moldova	500	250
Tajikistan	600-700	600-700
Ukraine	2,000-2,500	1,000-1,500
Uzbekistan	600-700	550-600
Russian Federation	2,000-3,000	-

Sources: Irina Ivakhnyuk, "Migration in the CIS Region: Common Problems and Mutual Benefits," based on data from "Overview of the CIS Migration Systems," International Center for Migration Policy Development (ICMPD), Vienna, 2006.

tems among the CIS countries grouping (see Table 5), for the most part there has been divergence among macroeconomic policies within the broader CIS. In particular, the Central Asian countries appear to be going their own way in terms of macroeconomics and fiscal policy, with little convergence with the rest of the CIS or even with each other. While inflation rates have moved in lockstep (see Figure 5), much of this is due to the region's reliance on commodities (and increasing commodity prices) rather than a conscious attempt to synchronize monetary policies across governments.[15] Finally, in regards to financial sector policies, the entire region is characterized by a lack of liberalization of financial systems, with Kazakhstan the most open (rating 2.7 out of 4.33 on the EBRD's scale). Most other countries in the region have much lower scores, with Turkmenistan having barely liberalized (see Figure 6). This tight state control may be more to blame for financial convergence than "a consequence of market integration, a result, for example, of the development of an integrated market for financial services," as the only banks that have really penetrated the region are Russian or, in some instances, Kazakh ones.[16]

Where convergence in economic policies has occurred in the CIS has been in the EurAsEC-3 (with slightly less convergence among the SES-4 group, which includes Ukraine), mainly in the area of monetary and financial policies. The monetary convergence can be seen in Figure 7, which shows that the inflation rates in the SES-4 countries since 2001 have converged somewhat around the 8% mark in 2010 (indeed, this is true across all the CIS countries, with a high of 9.38% in Ukraine and an official low of 5.68% in Azerbaijan). This has occurred without formal coordination of either monetary or exchange rate policies, which have moved somewhat independently since the Russian crisis of 1998–1999; for example, Belarus uses a state-administered exchange rate policy allowing for multiple rates, with its interest rate policy based on a basket of currencies including the ruble and the U.S. dollar. Kazakhstan, by contrast, aware of

15/ See Jax Jacobson, quoting the IMF, in "Central Asia Facing Inflationary Pressures, Rising Commodity Prices," Central Asia Newsline, May 18, 2011, available online at: http://www.universalnewswires.com/centralasia/viewstory.aspx?id=4080.

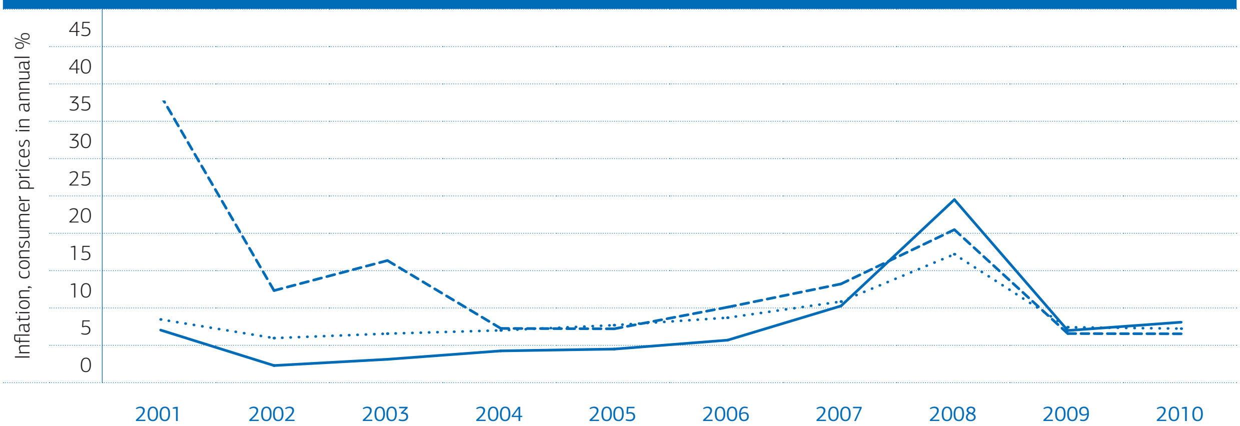
16/ Alexander Libman and Evgeny Vinokurov, "Regional Integration and Economic Convergence in the Post-Soviet Space: Experience of the Decade of Growth," MPRA Paper No. 21594, March 24, 2010, available online at: http://mpra.ub.uni-muenchen.de/21594/.

Table 5: Progress on Economic System Integration

Index	General Dynamics of Integration	Leaders in Integration, CIS-12	Most Divergent from CIS-12
Macroeconomics	↓	Kazakhstan	Turkmenistan
Monetary Policy	↑	Belarus	Moldova
Financial Sector	→	Ukraine	Kyrgyzstan
Fiscal Policy	→	Russia	Kyrgyzstan
Business Cycles	↓	Belarus	Russia

Source: Compiled from EDB Integration Yearbook (2010), IMF Country Report for Russia 2008, and author's calculations

Figure 5: Inflation Rates in the Central Asian Republics, 2001-2010



Legend: • • • • • • • Kazakhstan ———— Kyrgyz Republic ------- Tajikistan

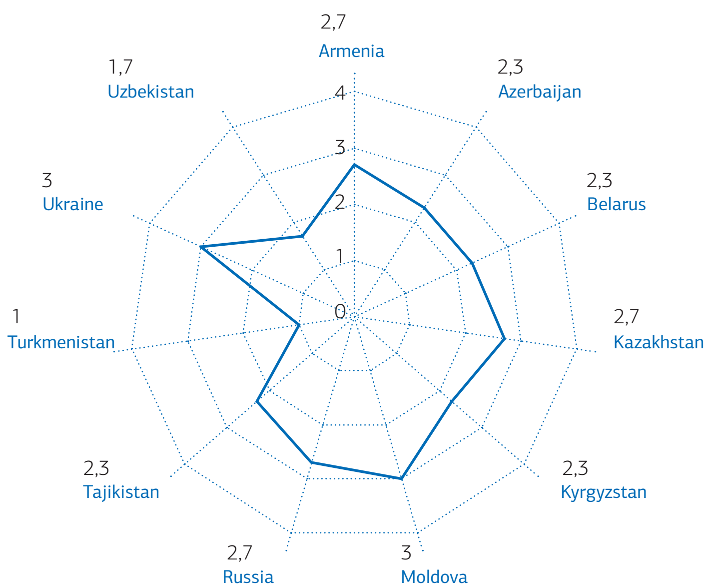
Source: World Bank Development Indicators. Data is unavailable for Turkmenistan and Uzbekistan.

its economy's dependence on oil, has focused on the common practice of inflation targeting via the interest rate for its monetary policy, while Russia targets money supplies for both inflation and exchange rate management. Bringing these differing approaches to monetary and exchange rate policies will be a challenge for the EurAsEC-3, which has laid down the framework for a common monetary policy (in the Customs Union Resolution of January 27, 2010, "On Organizing Work to Form the Common Economic Space"), but have yet to begin the hard work of harmonizing monetary management.

Conversely, in the financial sector, Russia has already begun work on legislation to "harmonize the Russian, Belarusian and Kazakh national laws regarding the banking sector, currency and securities markets, and insurance… before December 31, 2013."[17] The IMF's work examining the current integration of the financial markets of the CES-4 countries also shows some convergence among this sub-set of CIS countries, but it is limited mainly to Ukraine and Kazakhstan, with Russia more integrated

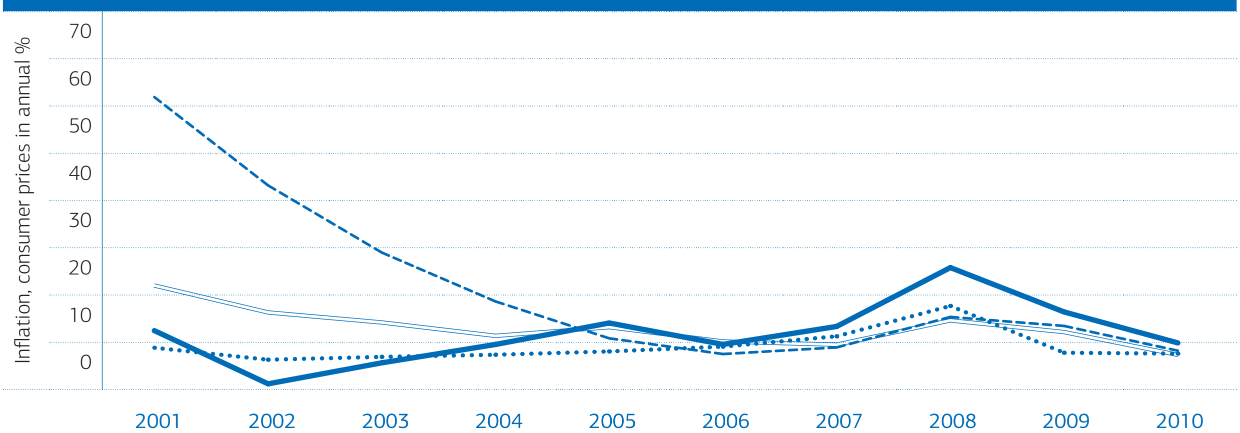
17/ "Agreement on Free Capital Movement in CES Submitted with Duma," Interfax Russia & CIS Banking and Finance Weekly, June 10, 2011, available online at: http://business.highbeam.com/436284/article-1G1-259763229/interfax-russia-amp-cis-banking-and-finance-weekly.

Figure 6: Banking Sector Reform in the CIS, 2010



Source: EBRD Transition Indicators 2011. Banking Sector Reform is scored on a scale from 0 to 4.33, with 0 being no reform and 4.33 being the highest level of liberalization.

Figure 7: Inflation Rates in the EurAsEC-3 + Ukraine, 2001-2010



Legend: Kazakhstan Ukraine Russia Belarus

Source: World Bank Development Indicators.

with world markets than with CIS countries.[18] Indeed, the IMF notes that the links between Russia and the CIS financially are much smaller than their history would predict, as "there does not seem to be any significant pattern of regional co-movements.... Financial markets in smaller CIS countries...may be influenced by a substantially different set of idiosyncratic trends."[19]

18/ "Russia: Selected Issues," International Monetary Fund (IMF) Country Report 08/308, September 22, 2008, available online at: http://www.imf.org/external/pubs/ft/scr/2008/cr08308.pdf. This analysis relies on examination of stock exchange co-movements, however, missing the extent of Russian bank penetration into the "near abroad."

19/ Ibid. Of course, this analysis came right before the global financial crisis—it would be interesting to revisit this question.

III. Towards a Eurasian Union? Integrating for the Future

Thus far, there is no clear pattern to integration within the CIS

Thus far, there is no clear pattern to integration within the CIS. Indeed, the countries that are pushing the hardest for integration (Russia, Belarus, and Kazakhstan) are also those that are least integrated at present with the broader CIS-12. Thus, we are faced with a paradox: formal integration has proceeded due to a core of countries that in reality are little integrated with each other, but instead are integrated with other groupings (as in Kazakhstan's regional leadership vis à vis Kyrgyzstan). Additionally, the trade generated by the three core countries seems to be similarly based (with an emphasis on natural resources). What benefits can then be derived from closer integration?

Benefits within the EurAsEC-3

As noted earlier, Russia, Belarus, and Kazakhstan became a full-fledged common economic space (CES) in January 2012, with no restrictions on trade, capital, and labor movements among the three countries. While it is still early to see the effects of this integration, the Eurasian Development Bank recently produced an assessment that models the possible effects of the CES. The key finding of the report is that the greatest beneficiary of the CES will be Belarus, with GDP gains of up to 15% over a non-integration scenario by 2030.[20] However, as Belarusian researchers have noted, this simulation assumes that "states to adjust their macroeconomic policies in accordance with international agreements, get used to free market competition, and accept the coordinating role of the supranational Eurasian Economic Commission," once again moving away from the "predominantly administrative economy where the state's share is about 80% and only some elements of market economy exist."[21]

In regards to the gains supposedly accruing to Russia and Kazakhstan, as well, the assumption underlying the model is that primary energy commodities would see modest price growth, while world GDP would remain sluggish through 2030. While these may be plausible, there also is an assumption of "production-efficiency equalization," meaning that the economies of Russia and Kazakhstan become more market-oriented in tandem with the reorientation of trade flows. If integration can help to push forward this continued liberalization, then indeed it is plausible that gains can accrue to all economies not just because of decreased transaction costs in the area of trade, but because of greater openness in the economy with all countries and across all sectors. If integration only allows liberalization among these three nations, however, then it is likely that gains will be muted, if at all.

Ukraine: The Elephant in the Room

While there may be large benefits in terms of liberalization within the CES, the long-term goal is to bring Ukraine into the fold. Indeed, the EDB report has 4 of its 6 scenarios on integration including Ukraine in some form, and it does appear that a key determinant of beneficial economic effects within a Eurasian Union would be the participation of Ukraine. While integration with Ukraine is not currently contemplated in the move towards the CES, and Ukraine itself (as noted above) has taken this option off the table, this does not mean that there will not bargaining in order to expand the CES to include Ukraine in the near future.

20/ "Comprehensive Assessment of the Macroeconomic Effects of Various Forms of Deep Economic Integration of Ukraine and the Member States of the Customs Union and the Common Economic Space," Eurasian Development Bank Centre for Integration Studies Report 1, January 24, 2012, available online (in English) at: http://www.eabr.org/general//upload/reports/Ukraina_doklad_eng.pdf.

21/ Yaugeni Priegerman, "Belarus as the Biggest Beneficiary of the Eurasian Integration?" Belarus Digest, January 30, 2012, available online at: http://belarusdigest.com/story/belarus-biggest-beneficiary-eurasian-integration-7538.

Ukraine matters for the success of a single economic space with the existing EurAsEC countries on several levels:

1. Size: As the second-largest country in the CIS, Ukraine would automatically bring a much larger market to the CES than, say, tiny Tajikistan;

2. Location: Moreover, Ukraine's position adjacent to both the EU and Russia, combined with its history of talks for EU accession, can make it a conduit for CES goods to Europe. Moreover, Ukraine is a country that really does bridge Europe and Russia, with a cultural understanding in the western regions similar to Poland and a high-proportion of Russians in the east. Having it moored in both camps can assist in pan-European integration; and

3. Complementarity: Unlike the economies of Russia and Kazakhstan (and to a much lesser extent, Belarus), the economy of Ukraine is not based on extractive industries but is much more diversified. There may be many more opportunities for trade between Ukraine and other countries in the CES than among the countries that currently are party to it.

However, these advantages for the CES may not translate into similar advantages for Ukraine itself. Simulations have noted that Ukraine already somewhat over-performs in trade with the CIS and underperforms in EU trade than what would be predicted by gravity models.[22] Moreover, even the EDB's integration scenario modeling predicts that if Ukraine fully commits to intensive integration (including creation of a unified currency and accession to all CES agreements), exports could plummet over 10% by 2030. Less intensive scenarios may have much less effect on Ukraine; for example, a scenario where Ukraine accedes to the free trade zone with exemptions would be equivalent to the status quo, while full accession to the CES would see an annual increase in GDP over the no-integration scenario of over 1% in 2015, falling to 0.73% annually in 2030.[23]

Ukraine's energy needs are driven by its Soviet-era, highly inefficient heavy industries, such as steel, which comprise a large proportion of its exports

The constant in the EDB modeling in regards to Ukraine focuses on the country's heavy energy dependence on Russia. A further scenario envisaging Ukraine entering a free trade agreement with the EU conjectures that Ukrainian GDP will fall by as much as 1.28% off the baseline scenario by 2015 due to energy needs from the east. While Ukraine's energy needs will be substantial as the economy continues to develop, an avenue not modeled was the effect of an EU free trade agreement that diversifies away from Russian oil and gas. This scenario would benefit Ukraine the most, as even within a CES there is no guarantee against the use of energy as a political weapon. [24] More importantly, Ukraine's energy needs are driven by its Soviet-era, highly inefficient heavy industries, such as steel, which comprise a large proportion of its exports. If free trade was pursued towards the EU, there is a chance that Ukraine's economy could finally follow the avenues available in a free market, economizing on energy and moving into services or other industries that are better suited.

The danger, as well as the opportunities, for Ukraine is thus two-fold: it could seek out an agreement that would help to feed the current economic structure by joining the CES and seeing lower energy prices. This path may be eas-

22/ Oleksandr Shepotylo, "Gravity with Zeros: Estimating Trade Potential of CIS Countries," (February 23, 2009), available online at: http://ssrn.com/abstract=1347997 or http://dx.doi.org/10.2139/ssrn.1347997.

23/ "Comprehensive Assessment of the Macroeconomic Effects of Various Forms of Deep Economic Integration of Ukraine and the Member States of the Customs Union and the Common Economic Space," Eurasian Development Bank Centre for Integration Studies.

24/ For an excellent summary of energy frictions in the region, see Steven Woehrel, "Russian Energy Policy Toward Neighboring Countries," Congressional Research Service (CRS) Report for Congress, January 17, 2008, available online at: http://fpc.state.gov/documents/organization/101737.pdf.

ier, but could lead to lower growth in the long run, as well as preclude other opportunities to the west. Alternately, it could take a chance on orienting westwards and allowing the economy to develop in response to the new set of incentives that will be created by this change. However, the danger in turning westward, beyond worries about energy usage, also include the EU's current turmoil and whether accession to a free trade area with the EU is even feasible; there is a (not unfounded) fear in Ukraine that it will be the EU's "perennial neighbor."[25] The progress of discussions with the EU, coupled with the manner in which the current Eurozone troubles play out, may tip the scales in favor of Ukraine's accession to the CES.

Eurasian integration as currently envisaged for Central Asia might not actually go far enough, thus limiting gains

Bringing in the Central Asian Republics

Finally, despite their status as small fish in the world trading pond, there is an implicit goal in creating the CES that it would eventually also encompass Kyrgyzstan and Tajikistan, with possible involvement of Uzbekistan. As with Ukraine, there would be benefits and losses to the Central Asian republics if they were to enter into more intensive integration arrangements with the current EurAsEC-3, although the scale will obviously be smaller.

As noted earlier, the Central Asian countries suffer from their landlocked nature, their relatively small markets, and, perhaps worst of all, their poor infrastructure.[26] Much of the hysteresis that has occurred in Central Asian trade is precisely because of this lack of infrastructure, or, rather, lack of infrastructure oriented anywhere but to the CIS. While even Soviet-era infrastructure is degenerating quickly, the main rail and transit links point north to Russia and continue to be poorly integrated into international transport corridors. The relatively high cost of exporting thus pushes businesses in these countries towards goods that are lower cost to transport relative to other goods, such as cotton and primary metals, while restricting other goods that may become profitable if trade links were better (such as tobacco, fruits, and vegetables).[27]

A comprehensive ADB study from 2006 noted these issues and concluded that integration would "reduce transport costs, make transit times shorter and more predictable for international shipments through increased regional cooperation in transport and customs transit [and] in turn help the CARs expand trade, take more active part in [global production networks] and related trade in manufactured products, and diversify trade in terms of both commodity composition and geographical distribution."[28] This progress could be accomplished through both increased physical investment in infrastructure and the harmonization of the various legal and regulatory schemes, including, most crucially, elimination of visa requirements (which can add days to time needed to ship).

However, in order for the full rewards to accrue to the region, this harmonization would also need to be completed throughout the region. This fact means that Eurasian integration as currently envisaged for Central Asia might not actually go far enough, thus limiting gains; for example, Kyrgyzstan and Tajikistan already have a relatively free visa regime towards each

25/ Mikhail A. Molchanov, "Ukraine and the European Union: A Perennial Neighbour?" European Integration, Vol. 26, No. 4 (December 2004).
26/ Gael Raballand, Antoine Kunth, and Richard Auty, "Central Asia's transport cost burden and its impact on trade," Economic Systems, Vol. 29 (2005): 6–31.
Ibid.

27/ Ibid.
28/ "Central Asia: Increasing Gains from Trade through Regional Cooperation in Trade Policy, Transport, and Customs Transit," Asian Development Bank Report, 2006, available online at: http://www.adb.org/Documents/Reports/ca-trade-policy/ca-trade-policy.pdf.

other, while Uzbekistan requires visas of foreign drivers from both countries. If the EurAsEC-5 were to create a common economic space, the omission of Uzbekistan would continue to cause problems in the region, especially in the Fergana Valley, where Uzbekistan, Tajikistan, and Kyrgyzstan all swirl together uneasily. This applies to other issues noted in the ADB report, such as transport permits and, perhaps most importantly, customs and cross-border documentation. Here, greater regional cooperation can help to dismantle long-existing barriers and allow trade to flourish.

Beyond the issue of infrastructure, the effects of proposed integration in the CES on trade flows and contributions to GDP are decidedly more mixed. Surprisingly perhaps, gravity simulations of trade in Central Asia have found that the Central Asian countries perhaps trade too much with the EU at present (even when energy is accounted for), while relatively underperforming in trade with China and India.[29] However, others have noted that "the countries have been rapidly disintegrating over time," meaning that "the land-locked nature and high dependence on natural resources of those countries suggest the impossibility of increasing trade by creation of an agreement."[30] Thus, at least at present, Central Asia's trade potential may be reached, but the direction of trade is somewhat skewed. This argues that the countries of Central Asia should be looking outward and not inward in order to integrate regionally.

29/ Oleksandr Shepotylo, "Gravity with Zeros: Estimating Trade Potential of CIS Countries," (February 23, 2009).
30/ Elvira Kurmanalieva and Evgeny Vinokurov, "Holding Together or Falling Apart: Results of Gravity Equation of the CIS trade," MPRA Paper No. 32003 (July 2011), available at http://mpra.ub.uni-muenchen.de/32003/.

IV. Policy Recommendations

While the proposal for a Eurasian Union among the CIS countries can help movement towards the goal of creating trade and liberalizing institutions through the removal of customs' barriers and increasing ease of movement of goods, capital, and labor, there is no guarantee that this integration is the solution for the region's current underperformance in trade. Indeed, it is quite possible for integration to go in two diametrically different directions.

On the negative side, the danger for greater integration is that it can merely extend current institutions and attitudes towards trade that, unfortunately, suggest that "the Soviet economic framework has not been completely dismantled."[31] As Table 6 shows, the various CIS countries have varying levels of trade freedom, with Armenia and Moldova leading the way and Russia and the Central Asian Republics liberalizing only slowly (if at all).[32] Heavy government intervention in countries such as Uzbekistan and Russia means that trade is still, in some sense, directed rather than liberalized, thus distorting both its composition and its direction. Worse still for producers and traders, trade policy exhibited much volatility over the past 20 years in the CIS, with year-on-year changes creating uncertainty; one only need look at the change in trade freedom in Russia from 2007 to 2008 (and then back again) to see this.

While the exact contribution of institutional stagnation to trade performance has not been quantified, the policy vacillations of the past decades have compounded the other disadvantages that the CIS countries continue to face in expanding its trade: market access problems, weak product quality, and (especially in reference to Central Asia) the continued lack of infrastructure that has increased transportation costs prohibitively.[33] This reality, of slowly developing institutions, means we must ask, under integration, whose institutions will be extended across all three countries as the blueprint? Will it be more liberal countries or will it be Uzbekistan?

The converse to this possible negative effect is that proposed further moves towards increased integration can raise welfare if it fulfills the "second-best" alternative: that is, if integration itself can allow for greater policy and institutional liberalization in the integrated countries. Most pressingly, trade could be allowed to go its own way, with removal of unnecessary trade barriers and regulations. Integration may help with this; from a political standpoint, many barriers to trade and integration remain in place because there are vested interests in keeping these barriers, and unilateral liberalization is often politically impossible. Liberalization within the CIS could erode the support for these barriers over time, especially if liberalization within the CIS does produce some of the gains that the EDB report suggests. With growth obtained through liberalization, it will be harder politically to justify retaining barriers to the rest of the world.

Unfortunately, early signs are not encouraging on this front: over 400 kinds of "sensitive in nature" goods have already been excluded

The danger for greater integration is that it can merely extend current institutions and attitudes towards trade that, unfortunately, suggest that "the Soviet economic framework has not been completely dismantled

31/ Gael Raballand, Antoine Kunth, and Richard Auty, "Central Asia's Transport Cost Burden and Its Impact on Trade."

32/ The Heritage Index of Economic Freedom began in 1995, and extensive coverage of all CIS countries only began in 1998 due to severe data issues commonly found in transition economies.

33/ Gael Raballand, Antoine Kunth, and Richard Auty, "Central Asia's Transport Cost Burden and its Impact on Trade," Economic Systems, Vol. 29 (2005): 6–31.

Table 6 – Trade Freedom in the CIS, 1995-2011

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Armenia	-	69.0	83.0	75.0	75.0	77.0	77.0	81.4	81.2
Azerbaijan	-	55.0	55.0	55.0	55.0	55.0	66.8	74.4	71.6
Belarus	60.0	60.0	77.2	79.0	57.6	57.6	70.2	75.4	66.0
Georgia	-	69.0	69.0	69.0	69.0	69.0	75.6	79.2	64.8
Kazakhstan	-	-	-	61.0	61.0	67.0	65.0	65.0	65.0
Kyrgyz Republic	-	-	-	65.0	65.0	65.2	65.0	65.0	69.4
Moldova	52.0	75.0	75.0	75.0	75.0	75.0	76.4	76.0	80.4
Russia	-	52.0	46.0	58.6	53.2	52.4	52.2	57.4	57.4
Tajikistan	-	-	-	68.4	68.4	75.0	69.0	69.0	69.0
Turkmenistan	55.0	-	-	40.0	40.0	25.0	25.0	25.0	85.0
Ukraine	-	66.0	66.0	53.0	53.0	70.0	70.0	71.0	74.6
Uzbekistan		-		50.0	50.0	50.0	50.0	50.0	22.0
CIS Average	55.7	63.7	67.3	62.4	60.2	61.5	63.5	65.7	67.2

Sources: Heritage Foundation Index of Economic Freedom, various years. The Index is scaled from 0-100, with higher scores denot
formally exited the CIS in 2009 and its change numbers are excluded from the CIS average calculation.

from the joint customs tariff among the EurAsEC-3, meaning that perhaps not every area is benefitting from integration.[34] This brings up another important point for integration to be effective; if it indeed does push liberalization, integration needs to be broad-based and comprehensive. Exclusion of several hundred goods from agreements based on politically-determined "sensitivity" can create rent-seeking opportunities and distort production choices in the economy, and thus liberalized integration needs to be binding on all. As seen in the example of visa regimes in Central Asia, broader pushes for cooperation can have more effects than limited initiatives.

Looking East...or West?

While the internal institutional arrangements and scope of integration are important issues for a Eurasian Union, there is another area that has been relatively neglected in the debate, and that is the relationship of the new Eurasian Union to the old, existing European Union. CIS trade with the EU has underperformed since the collapse of the Soviet Union; while the EU-15 was the CIS's largest trading partner in 1993 and in 2003, merchandise exports with the EU declined from a high of 46.2% of all trade to 39.6% of trade in 2003 (barely ahead of the 39.3% of trade that went regionally). Moreover, the trade that has occurred with the EU has been mostly in the form of energy, which has dominated Russian exports to the region, with little movement towards diversification.

The development of a Eurasian Union, if it indeed occurs (with or without Ukraine), must seek to become a complement, rather than an alternative, to the European Union. The worst-case scenario would be to have two opposing trading blocs facing each other across a divide drawn between Poland and Belarus, each protected behind their own high tariffs and focused on inward rather than outward trade. Admittedly, the European Union has not been blameless in its slow expansion eastwards, facing its own growing pains and causing Russia to express frustration about the EU's willingness to

34/ Iwona Wisniewska, "Who Needs the Customs Union?" East-Week, publication of the Centre for Eastern Studies (Warsaw), December 2, 2009, available online at: http://www.osw.waw.pl/en/publikacje/eastweek/2009-12-02/who-needs-customs-union.

2004	2005	2006	2007	2008	2009	2010	2011	Change
80.0	80.0	80.6	85.6	85.0	86.4	80.5	85.5	16.5
69.2	69.2	72.6	77.6	78.4	78.4	77.1	77.1	22.1
65.8	69.0	67.2	67.2	52.2	67.2	80.3	80.3	17.1
65.2	65.2	67.6	71.8	71.0				
65.0	65.0	69.2	69.2	86.2	86.2	85.9	80.9	19.9
69.4	69.4	76.4	81.4	81.4	87.6	75.9	63.2	-1.8
80.4	77.2	79.4	79.4	79.2	81.6	79.9	80.2	11.2
63.2	63.2	62.6	62.6	44.2	60.8	68.4	68.2	16.2
69.0	68.4	70.8	71.0	77.8	82.6	82.5	82.5	14.1
85.0	81.6	79.2	79.2	79.2	79.2	79.2	79.2	27.5
74.4	76.2	77.2	77.2	82.2	84	82.6	85.2	19.2
22.0	71.6	68.2	68.2	68.4	65.4	65.1	66.2	16.2
67.4	71.3	72.6	74.2	73.8	78.1	77.9	77.1	16.2

more freedom. The last column denotes the change in trade freedom from the first year data is available to 2011. Georgia

negotiate.[35] However, development of a Eurasia Union should not be used to counter the EU, but rather be utilized to help bring about the benefits that the EU has conferred on Western and Central Europe (but is not ready or able to confer on the East):

- Political stability, referring to lessening conflict and reducing the chance for inter- and intra-regional clashes;
- Internal economic liberalization, as noted above, pushing for adoption internally of best-practice institutions and policies regarding foreign investment, trade, protection of private property, and monetary and fiscal policies; and
- Continued engagement with its periphery, which in this case means with China, India, and other important expanding economies bordering or nearby to the proposed Union.

In this sense, the Eurasian Union will be taking upon itself what it appears it had been waiting for the EU to do. Acting as an ersatz EU, the Eurasian Union will take the liberalizing steps that perhaps one or more countries could not do on their own.

In summation, Eurasian integration can either be a boon for liberalization in the CIS countries, or it can ossify countries into the old Soviet ways and divert trade from its preferred destination. Only time will tell which route integration takes, but it is recommended that policymakers use integration to push for increased liberalization both inside and outside of the blocs for its own sake. In this way, bringing together former Soviet republics can this time have a beneficial effect for all involved. This, too, would be a revolution.

35/ Mikhail A. Molchanov, "Ukraine and the European Union: A Perennial Neighbour?" European Integration, Vol. 26, No. 4 (December 2004): 451–473.

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