

**Perspectives on CIS Integration**  
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The basic message of the previous paper by Dr. Grinberg (*Russia in the Post-Soviet Space: Search for Rational Behavior and Prospects of Economic Integration*) is that progress on re-integrating the CIS countries has been disappointing, but there are a number of promising avenues that can be pursued to promote additional integration. He focuses largely on the political dimensions of these issues and provides rather broad guidelines as to how to proceed.

Although these political concerns are quite important, and I want to return to them in a minute, I thought a significant omission in his paper was the failure to examine more closely the economic rationale for re-integration in the CIS. An examination of the economic logic of re-integration can perhaps help explain why progress on this front has been so limited, and can provide important insights in how to proceed.

First, let's assess quickly the current state of affairs. Trade amongst the CIS countries fell dramatically after the break-up of the Soviet Union and central planning. It is estimated that CIS trade dropped by perhaps 90 percent in the immediate years after the break-up, and although recovering slightly, trade has remained far below its previous levels. Although this seems like a very large decline, it is actually consistent with what one might expect. Even within the U.S.-Canada FTA, Canadian provinces trade about 12 times more with each other than they do with states in the U.S. that are a similar distance away. Thus when regions change from belonging to the same country to being a different country, there is nothing unexpected about trade declining by 90 percent. Thus even if the Soviet Union had been a market economy, its break-up into 15 countries would have produced a drastic decline in trade. Borders have a profound effect on trade flows. In addition, it has been argued that regional specialization and trade was excessive in the Soviet Union due to the nature of central planning and the absence of much external trade. This is all the more reason for expecting a significant reduction in intra-CIS trade.

A number of empirical studies using gravity models have concluded that the current levels of trade amongst the CIS are roughly in line with average global trading patterns. Thus there is nothing particularly unusual about the current level of intra-CIS trade. This is all the more true given that there is probably a bias towards undervaluation in current data due to under-reporting, inadequate customs procedures, and barter trade. For many, however, because intra-CIS trade is so low relative to its historical pattern, there is the feeling that it is unnatural, and policy is needed to return it to its previous levels. However, the situation is really the opposite, the current situation is normal, and the question is whether it makes sense to return to the levels of integration of the past.

The break-up of the Soviet Union is similar to the process of decolonization that occurred after the second world war, some countries were eager to assert their independence and wanted to avoid any dependence on the mother country, while others wanted to preserve as much as possible the economic ties that existed.

The fundamental problem today is that each of the CIS countries has a different view of what type of integration would be desirable; some want a FTA, some a customs union, and others a economic union and some want very little. Within each country, the political parties differ as well, and as governments change so do their positions on this issue.

Further integration can be promoted in basically two ways; either by the creation of preferential trading relationships (PTA) such as a FTA or a customs union, or by less discriminatory policies.

Since a significant amount of the focus on deeper integration has been concerned with the formation of a preferential trading arrangement, let me concentrate on that. Despite a number of more far reaching agreements, out of 132 bilateral trade flows in the CIS, there are approximately 50 where trade is relatively free, but even with these there are extensive product exclusions. Should the basic objective be a free trade area covering all the CIS? Should this further develop into a customs union?

For preferential trading arrangements, one doesn't first decide to have one and then work out the details. The desirability of having one depends very much on the details. This is more relevant for a customs union than a FTA since with an FTA you have a fairly clear picture of the outcome before you start.

The basic advantage of a PTA is that it provides a larger market which will allow firms to achieve scale economies. This would be especially good for CIS manufacturing industries since they were the sectors hardest hit by the break-up of the Soviet Union and central planning; and these are the sectors that need to be expanded in order to create employment and growth. However, a PTA does not just create trade amongst its members, so-called trade creation, but it can also reduce trade with the outside world, so-called trade diversion. It is the relative size of these two forces that determines the overall effect of a trade agreement on welfare.

At first glance, the case for further integration of the CIS countries through preferential means would appear to be compelling. Several members are quite small, and a larger market would allow firms to reap the benefits of scale economies. There are already significant flows of goods, labour and capital amongst them which is supported by an existing stock of physical infrastructure and existing commercial and personal contacts. The countries share many borders, and, relatively speaking, are close to each other.

Here in Europe when we think of a customs union, we naturally think of the European Union. Those pushing for a CIS customs union imagine it to be an eastern EU.

During the post-war period a number of developing countries tried to duplicate the experiences of the EU by creating their own custom unions. Most of these failed. Although there were a number of reasons why, including political factors, one important reason was that they were not welfare enhancing. Upon closer examination of the CIS case, it seems that the more realistic comparison would be to the customs unions of central and Latin America and not the EU. The economic factors that determine the likely welfare effects from a customs union are more similar between the CIS and these developing world examples. These factors, which include high external tariffs, a small market relative to the world market, and production using obsolete technology, suggest that a CIS custom union is not likely to be welfare increasing.

More specifically, the likely CIS external tariff is usually assumed to be the current Russian tariff. With an average tariff of about 10 percent, this is high and will lead to substantial trade diversion. Thus the CIS is not like the EU or NAFTA, where the external tariff is low and prices are close to world prices. Similarly, the market that will be created will be relatively small compared to the EU or NAFTA, and as a result importers are likely to face an upward sloping supply curve. The economic costs of trade diversion increase substantially with upward sloping supply curves. More importantly, the likely

effect of a CIS customs union will be to limit external imports of high technology capital goods. This problem of keeping state of the art technology out is a critical factor in assessing the dynamic effects of any customs union. High tech capital goods are not just another good and the consequences of external restrictions are fundamentally different than say, keeping low priced apparel or food out of a customs union. When you limit the importation of capital you raise its real costs and lower long-run productivity growth. In the EU and NAFTA, firms have access to world-class capital goods, the Latin American countries did not. Recognition of the importance of access to cheap high tech capital goods has been a fundamental factor in shaping trade policy among the ASEAN countries.

In the final analysis, a CIS customs union would likely turn into a Latin American style import substitution program. It should also be noted that FDI that attempts to jump a tariff barrier can actually be welfare reducing as can productivity growth which occurs in the protected sectors. Although the short-run effects of a preferential arrangement might look positive as investment and growth increase as was the case under import substitution programs, it is questionable if this would create a foundation for long-run dynamic growth.

If the CIS limited themselves to a FTA they could avoid some of the trade diversion but the benefits of a larger market would be reduced as well.

When you have a trade agreement there are winners and losers; the winners sometimes have to bribe the losers to go along. One possible reason as to why progress on integration in the CIS has been so limited is that there are limited gains and therefore nothing is really left to be redistributed to the losers.

In addition, the benefits of economic integration are usually not shared equally. This was recognized a long time ago and was the subject which Gunnar Myrdal, who was the first ECE Executive Secretary, chose to address in his Nobel lecture. More recent research using the newer models of economic geography further support this conclusion. The EU deals with this possibility by providing assistance to its poorer regions and by creating a political power structure which gives excessive weight to its smaller and poorer members. One reason often cited for the failure in the developing world of PTAs is that the benefits accrued mostly to the advanced nations in the group, and the poorer nations ultimately dropped out. With a preferential CIS arrangement, is Russia willing to provide this type of assistance? The proposed voting structure in the Single Economic Space is proportional to GDP, this gives Russia a controlling interest. Therefore in these ways as well, what is proposed in the CIS differs substantially from the EU model.

Although re-integration within the CIS by way of preferential policies should be pursued cautiously, further integration into the global economy should be pursued more aggressively. A major component of this is WTO membership. And although the requirements for the late-joiners of the WTO may rightly be criticized as excessive or even unfair, there is unfortunately little alternative. WTO membership, by putting a number of trade practices in the CIS under more discipline, may as a by-product further enhance intra-CIS integration. Once in the WTO, any FTA would have to be comprehensive, so WTO accession would force the countries to eliminate many of the product exclusions and reduce arbitrary backtracking.

Promoting trade through trade facilitation measures such as reducing transport and communication costs, simplifying customs procedures, and harmonizing product and regulatory standards are basically welfare increasing and should be promoted through regional co-operation. Although technically, if done in a preferential manner, they may also have a trade diverting effect, they are far less likely than preferential tariffs to be welfare reducing since there is no loss of tariff revenue. Likewise integration with the EU under the Common Economic Space is likely to be beneficial since it moves in the overall direction of liberalization.

Finally it should be recognized that there are valid foreign policy and security implications which may be just as important as the economic factors in deciding the desired extent of CIS integration. Russia does have legitimate foreign policy interests in developments in the other CIS countries covering a range of issues from military security to the rights of Russian immigrants. However, given Russia's imperialistic tendencies, under both the Tsars and communists, concerns by the other CIS about Russian intentions (either real or perceived) are also understandable. If these political considerations prove paramount in shaping CIS integration, at least the specifics of the plans should better attempt to deal with the economic factors in order to ensure that what evolves is as welfare increasing as possible.