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## Trade among the Post-Soviet states : evolution and policy issues

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# Kiel Working Papers

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**Trade Among the Post-Soviet States: Evolution and Policy Issues**

by

Rolf J. Langhammer and Matthias Lücke

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## **Abstract**

This paper analyses the causes of the precipitous fall in trade among the twelve CIS countries since 1990; points out the implications for industrial restructuring; and discusses the policy options for regional reintegration. The main finding is that the decline in intra-CIS trade was initiated by the institutional void left by the collapse of the central planning system. However, the high volume of trade among the former Soviet republics reflected largely their isolation from the rest of the world economy, as well as other policy-induced distortions. Therefore, if market-oriented economic reforms in the CIS countries are successful, intra-CIS trade flows will remain substantially smaller than during the Soviet period.

**JEL Classification:** F14, F15

**Keywords:** Commonwealth of Independent States; regional integration; intra-regional trade; industrial restructuring

## 1. Introduction<sup>1</sup>

The purpose of this paper is first, to identify the main causes of the decline in trade among the CIS countries since 1990. This will be followed by a discussion of the implications for trade policy reform and overall systemic change in the Post-Soviet states.<sup>2</sup>

It is widely accepted that during the Soviet period, economic planners aimed at achieving a high degree of autarky from the rest of the world while operating an intensive division of labour among the member republics of the Soviet Union. In the medium to long run, the market-oriented economic reforms begun in 1992 can therefore be expected to lead to a decline in the relative importance of intra-CIS trade compared to trade with the rest of the world. However, a reduction in the relative weight of intra-CIS trade need not be accompanied by, and thus does not constitute a sufficient explanation for the large decrease in its volume.

Explanations may be sought in two broad directions: On the one hand, the disintegration of the former Soviet Union may have created "artificial"

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<sup>1</sup> This is a contribution to L.T. Orłowski and D. Salvatore (eds.), *Trade and Payments in Central and Eastern Europe's Transforming Economies*; to be published as Volume 6, *Handbooks of Comparative Economic Policies*, Greenwood Publishing Group, Westport, CT. The paper draws on the authors' involvement in several research projects on the external economic relations of CIS countries. In the course of these projects we have greatly benefited from discussions with many colleagues in the CIS countries and elsewhere. All errors remain our own.

<sup>2</sup> This discussion does not extend to the Baltic countries because their development perspectives, policy environments, and position in the international trading system are diverging more and more from those of the remaining Post-Soviet states.

barriers to trade among the former Soviet republics in the sense that, if these barriers were eliminated, trade would return to its former level. Similarly, if the reduction in trade was mainly caused by macroeconomic fluctuations, trade could be expected to recover with the next upturn. On the other hand, it is conceivable that a large proportion of the trade flows among the former Soviet republics reflected distortions induced by the central planning system. Such trade flows may become unviable as market-oriented reforms are implemented in the CIS countries, and intra-CIS trade will be permanently reduced. The validity of these (partly conflicting) hypotheses is assessed in Section 3 of this paper.

The following section prepares the ground by surveying the available data on trade among the CIS countries since 1990. These data suffer not only from the usual inadequacies of the statistical reporting systems of the CIS countries, such as reliance on enterprise surveys rather than customs data for foreign trade statistics.<sup>3</sup> The data are also difficult to interpret because they are simultaneously affected by sharply declining trade volumes, very high inflation, and substantial changes in relative prices. We present estimates by Michalopoulos and Tarr (1994) who attempt to disentangle these various effects, and analyse changes in the commodity composition of intra-CIS trade on the basis of trade volumes of important products.

Finally, in Section 4 we discuss the policy implications of this analysis, starting with the continuing need for institutional reforms to allow intra-CIS trade to take place on a free market basis (Subsection 4.1). A crucial

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<sup>3</sup> Such surveys tend to underestimate trade because they usually cover only state-owned enterprises and do not account for the foreign trade of joint ventures, foreign-owned and private domestic firms (Iltarionov, 1994).

question is posed by the potential role of intra-CIS regional integration in trade policy reform, and by the choice of an appropriate institutional framework (Subsection 4.2). Subsection 4.3 considers the implication of intra-CIS integration from the point of view of OECD partner countries. Section 5 concludes on the main findings.

## **2. Trade Among the CIS Countries Since 1990: Volume, Direction, and Commodity Composition**

The first Soviet publication containing comprehensive data on the direction and commodity composition of inter-republican trade appears to have been *Vestnik Statistiki* (1990), covering the years 1987 and 1988. Trade flows were expressed in internal producer prices, which deviated substantially from world market prices. As regards the commodity composition, the published data were only disaggregated down to the level of about twelve broadly defined sectors, although more detailed data (at the level of 105 sectors) were subsequently made available to Western researchers (Tarr 1993).<sup>4</sup>

Since 1991, the statistical reporting system maintained by the Soviet Goskomstat on a union-wide basis has collapsed in large part along with the union-wide economic planning mechanism, and has not yet been replaced by statistical systems appropriate for market economy conditions on the part of the newly founded national statistical offices. The limited data on the total nominal value of trade that have become available since

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<sup>4</sup> These data were not collected by statistical authorities on a regular basis, but were apparently constructed using input-output matrices for the individual republics and foreign trade data for the whole former Soviet Union (Illarionov, 1994).

then are estimated largely on the basis of payment flows. Furthermore, these data are difficult to interpret for two related reasons: The disintegration of the Soviet Union in 1991 led to large increases in the real prices of some goods that had been systematically undervalued, with concomitant declines in the physical volumes of trade. At the same time, nominal trade values in Russian rubles increased vastly because of hyperinflation. Therefore it is difficult, without detailed information on the commodity composition of trade, to distinguish the changes in the terms of trade from changes in trade volumes.

The most comprehensive estimates available of the evolution of the CIS countries' external trade have been produced by the World Bank (Michalopoulos and Tarr 1994). They relate to the years 1990 through 1993 when a large part of the adjustment of relative prices in inter-state trade to world market conditions took place. The basic approach was to convert current trade values denominated in Russian rubles into US dollars at implicit exchange rates based on world market prices. Estimates of the commodity composition of trade and of current ruble prices for individual commodity groups were taken from a variety of sources and in some cases are based on heroic assumptions. Nevertheless, these are the best data available.

Table 1 presents a summary of these estimates as well as preliminary 1994 data from the CIS Statistical Committee. In spite of the general uncertainty affecting the data, several trends can be identified: First, sharply rising trade values in current Russian rubles from 1990 through 1994 demonstrate the impact of hyperinflation. Second, the volume of trade among the CIS countries decreased by almost two thirds from 1990 to 1993, as evidenced by trade values in US dollars converted at implicit



Table 1 — Trade among the CIS Countries, 1990-1994<sup>a</sup>

	1990		1993				1994	
	Exports	Imports	Exports		Imports		Exports	Imports
	billion current Russian rubles							
Armenia	3 428	3 508	116		149		189	468.5
Azerbaijan	6 105	4 247	590		432		673	1 141
Belarus	1 7224	14 841	2 900		3 140		2 981	8016
Georgia	5 724	4 949	277		406			660.5
Kazakhstan	8 443	14 314	2 932		3 354		3 797	6 432.4
Kyrgyzstan	2 445	3 179	265		355		494	376.5
Moldova	5 853	4 992	597		697		492	2 715
Russia	7 4710	67 284	14 775		9 892		30 000	18 032
Tadzhikistan	2 377	3 359	111		186		185	971.5
Turkmenistan	2 469	2 923	1 624		822		3 589	603
Ukraine	3 8319	38 989	5 318		8 616		14 368	16 997
Uzbekistan	8 169	11 864	1 956		2 087		2 571	2 925.6
<b>Total CIS</b>	<b>17 5265</b>	<b>174 448</b>	<b>31 460</b>		<b>30 136</b>		<b>59 339</b>	<b>59 339</b>
	1990		1993				1994	
	Exports	Imports	Exports		Imports		Exports	Imports
	million US\$							
	(converted at implicit exchange rates)				(converted at commercial exchange rates)			
Armenia	3 509	5 477	583	999	124	159	81	201
Azerbaijan	8 213	7 300	1555	1 526	629	461	289	490
Belarus	27 660	28 740	12 144	13 739	3 092	3 348	1 281	3 445
Georgia	5 168	7 608	573	1 321	295	433	n.a.	284
Kazakhstan	13 993	24 810	7 863	11 788	3 126	3 576	1 632	2 764
Kyrgyzstan	3 250	5 120	814	1 175	282	378	212	162
Moldova	4 984	8 442	1 203	2 417	636	743	211	1 167
Russia	146 183	95 802	55 355	34 109	15 752	10 546	12 892	7 749
Tadzhikistan	2 760	5 375	292	611	118	198	80	417
Turkmenistan	4 603	4 042	2 734	2 717	1 731	876	1 542	259
Ukraine	60 348	71 841	17 628	35 294	5 669	9 185	6 174	7 304
Uzbekistan	11 327	18 818	4 100	5 243	2 085	2 225	1 105	1 257
<b>Total CIS</b>	<b>291 998</b>	<b>283 375</b>	<b>104 844</b>	<b>110 939</b>	<b>33 539</b>	<b>32 128</b>	<b>25 500</b>	<b>25 500</b>
	1990		1993					
	Exports	Imports	Exports	Imports				
	per cent of total foreign trade (converted at implicit exchange rates)							
Armenia	97.0	86.5	95.3	84.2				
Azerbaijan	91.9	83.8	81.6	86.4				
Belarus	88.9	84.5	94.3	94.6				
Georgia	90.9	83.1	72.1	74.2				
Kazakhstan	88.7	88.4	83.7	90.3				
Kyrgyzstan	97.3	79.8	87.9	91.3				
Moldova	92.5	85.5	87.4	92.0				
Russia	64.4	53.6	55.8	50.8				
Tadzhikistan	81.9	89.1	52.6	62.0				
Turkmenistan	95.9	88.5	70.3	78.4				
Ukraine	81.8	81.9	73.7	88.2				
Uzbekistan	89.1	89.5	73.7	80.4				
<b>Total CIS</b>	<b>73.8</b>	<b>70.7</b>	<b>65.1</b>	<b>71.9</b>				

<sup>a</sup>Including trade with the Baltic countries in 1990 and 1993.

exchange rates. Third, the share of intra-regional trade in the total trade of CIS countries declined somewhat in the case of exports (from 74 percent of total exports in 1990 and 65 percent in 1993), but did not change markedly on the import side.<sup>5</sup>

Implicit exchange rates for the conversion of current trade values denominated in Russian rubles into US dollars are not available for 1994. A comparison is possible, however, between trade values in 1993 and 1994 converted into US dollars at the market exchange rate. Apart from further adjustments in relative prices, it is important to note that this comparison is also affected by the real appreciation of the Russian ruble from 1993 to 1994. Hence the volume of trade almost certainly decreased by more than one fifth (which is the rate of decline suggested by the figures in Table 1, i.e. from approximately 33 to 26 billion US dollars).

The 1994 data also show that only Russia, Kyrgyzstan and Turkmenistan ran surpluses in intra-CIS trade. In principle at least, Russia intends to stop subsidising its partner countries through soft loans to finance balance

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<sup>5</sup> It is difficult to say whether the apparent exceptions from these trends in the case of certain countries are genuine or the result of statistical errors. Not surprisingly, especially large declines in trade volumes were registered by states that were involved in military conflicts, i.e. Armenia, Azerbaijan, Georgia, Moldova, and Tadzhikistan. Intra-CIS exports by Ukraine fell by 71 percent, while its corresponding imports were reduced by only 51 percent. That discrepancy probably reflects the preponderance of heavy industry in Ukrainian exports, which suffered a particularly large decline in demand, as well as the dependency of Ukraine on imports of energy materials whose consumption was impossible to reduce in the short run. Less-than-average declines in trade volumes were registered by Belarus and Kazakhstan, whose governments attempted for some time to halt the economic decline by maintaining a large measure of state control over their economies.

of trade deficits. As few of these countries run significant trade surpluses with the rest of the world or enjoy access to the private international capital market, they will only be able to sustain their trade deficits in relation to Russia if they obtain concessionary financing. Otherwise, more downward adjustment in intra-CIS trade will be inevitable.

Although Russia accounts for about one half of total intra-regional exports and one third of intra-regional imports by CIS countries, the relative importance of trade with Russia varies considerably among the individual CIS countries. Table 2 presents the direction of trade among the CIS countries in 1994. Trade among the European CIS countries (Russia, Ukraine, Belarus, Moldova) accounted for a particularly large proportion of their total intra-CIS trade (Russia: 74,2 percent of exports and 73,0 percent of imports; Ukraine: 94,0 percent and 90,5 percent, respectively; Belarus: 94,5 percent and 97,6 percent; Moldova: 90,9 percent 98,4 percent). In the case of Russia, these figures rise to 89,3 percent of exports and 89,5 percent of imports when neighbouring Kazakhstan is included in this group. As the largest CIS economy, Russia is also the most important trading partner of most of the Caucasian and other Central Asian republics. At the same time, however, the latter also trade amongst themselves to a significant extent.

Although no comprehensive data are available on the commodity composition of intra-CIS trade, the direction of trade in roughly 60 important products, measured in physical quantities, among all 12 CIS countries has been published for the years 1990 through 1994.<sup>6</sup> These

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<sup>6</sup> Data for are not available in 1990, and only a few data have so far been published for 1994; no data are available for natural gas deliveries.

Table 2 — Direction of Trade Among the CIS Countries, 1994 (per cent of each country's exports or imports)

Exports from	Armenia	Azerbaijan	Belarus	Georgia	Kazakhstan	Kyrgyzstan	Moldova	Russia	Tadzhikistan	Turkmenistan	Ukraine	Uzbekistan	Share in total intra-CIS imports
Armenia			0.1		0.0	0.0	0.1	1.0		4.2	0.1	0.0	0.8
Azerbaijan			0.5		1.7	0.8	6.7	1.3		11.5	1.5	0.2	1.9
Belarus	1.1	2.8			2.3	1.4	6.1	20.8	3.8	0.2	10.8	2.5	13.5
Georgia	4.2	5.8	0.1		0.0	0.2	0.1	0.4		13.2	0.1	0.0	1.1
Kazakhstan	0.2	6.4	3.1				44.9	1.6	15.1	13.0	17.2	2.1	23.1
Kyrgyzstan		0.7	0.1		1.8		0.1	0.7	2.2	0.5	0.1	2.1	0.6
Moldova	0.0	3.7	1.3		0.2	0.2		3.7		0.1	10.6	0.2	4.6
Russia	63.0	53.0	79.1		78.2	22.3	74.0		43.8	3.5	72.6	43.5	30.4
Tadzhikistan	0.0	0.4	0.2		0.4	1.4	0.1	1.1		0.5	0.1	22.5	1.6
Turkmenistan	25.9	5.6	0.3		1.8	3.6	0.2	0.8	2.2		0.7	2.9	1.0
Ukraine	5.3	20.4	14.1		4.8	4.7	10.8	49.7	4.3	32.8		3.0	28.6
Uzbekistan	0.3	1.0	1.1		8.8	20.4	0.2	5.4	30.8	16.3	1.3		4.9
Total exports (billion rubles)	189.0	673.0	2 981.0		3 797.0	494.0	492.0	30 000.0	185.0	3 589.0	14 368.0	2 571.0	59 339.0

Table 2 continued

Imports by	Armenia	Azerbaijan	Belarus	Georgia	Kazakhstan	Kyrgyzstan	Moldova	Russia	Tadzhikistan	Turkmenistan	Ukraine	Uzbekistan	Share in total intra-CIS exports
Imports from													
Armenia			0.0	1.2	0.0		0.0	0.7	0.0	8.1	0.1	0.0	0.3
Azerbaijan			0.2	5.9	0.7	1.3	0.9	2.0	0.3	6.3	0.8	0.2	1.1
Belarus	0.6	1.3		0.5	1.4	0.8	1.4	13.1	0.6	1.5	2.5	1.1	5.0
Georgia													
Kazakhstan	0.0	5.7	1.1	0.0		18.1	0.3	16.5	1.5	11.3	1.1	11.4	6.4
Kyrgyzstan	0.0	0.4	0.1	0.2	3.5		0.0	0.6	0.7	3.0	0.1	3.5	0.8
Moldova	0.1	2.9	0.4	0.1	0.1	0.1		2.0	0.1	0.2	0.3	0.0	0.8
Russia	64.0	34.2	77.8	18.2	70.4	55.8	40.9		34.0	39.8	87.7	55.4	50.6
Tadzhikistan			0.1		0.4	1.1		0.4		0.7	0.0	1.9	0.3
Turkmenistan	32.2	36.2	0.1	71.8	9.6	4.8	0.1	0.7	1.9		6.9	20.0	6.0
Ukraine	3.0	18.9	19.4	2.1	4.7	3.7	56.1	57.8	1.4	16.7		6.4	24.2
Uzbekistan	0.0	0.4	0.8	0.2	9.2	14.3	0.2	6.2	59.5	12.4	0.5		4.3
<b>Total imports (billion rubles)</b>	<b>468.5</b>	<b>1 141.0</b>	<b>8 016.0</b>	<b>660.5</b>	<b>6 432.4</b>	<b>376.5</b>	<b>2 715.0</b>	<b>18 032.0</b>	<b>971.5</b>	<b>6003.0</b>	<b>16 997.0</b>	<b>2 925.6</b>	<b>59 339.0</b>

Source: Statkom SNG, Statisticheskii Bjulletin', 1995, No. 3.

data are summarised in Table 3. Products have been aggregated into four categories (industrial intermediates, capital goods, food, other consumer goods), and median rates of change of exports and imports have been calculated for each product category and CIS country.

Although the data are quite heterogeneous, it may be concluded that at the aggregate level of total intra-CIS trade, no significant differences exist between the rates of change for the four product groups. From 1990 through 1993, trade in all categories declined by broadly similar rates. It is too early to judge whether the apparent, less rapid fall in trade in food products between 1993 and 1994 (compared with industrial intermediates) represents a turning point. If all product groups experienced similar declines, it follows that the share of industrial intermediates in the current nominal value of intra-CIS trade must have increased substantially in line with the increase in their relative prices.

### **3. Causes for the Decline in Trade**

A wide variety of factors have been cited as possible causes of the fall in trade among the CIS countries. This section distinguishes between the immediate causes of the decline, which are essentially short-term developments that may be reversed, and structural adjustment in the course of market-oriented economic reforms, i.e. the elimination of systemic distortions that used to favor intra-CIS trade. As regards short-term factors, the sharp decline in inter-state trade after 1990 raised the question whether the process was initiated primarily by falling aggregate demand, or rather by the erection of new trade barriers among the Newly Independent States and the breakdown of institutions crucial to the operation of the planning system. Subsection 3.1 surveys this debate.

Table 3 — Rates of Change of Trade Among the CIS Countries in Individual Products, 1990-1994 (per cent)<sup>a</sup>

	1990-91			Exports 1991-93					1993-94		
	Industrial intermediate goods	Capital goods	All products	Industrial intermediate goods	Capital goods	Food products	Non-food consumer goods	All products	Industrial intermediate goods	Food products	All products
Armenia	-61.3 (1)	-39.9 (2)	-46.8 (3)		-95.0 (2)			-95.0 (2)			
Azerbaijan						-73.1 (5)	-91.3 (10)	-87.8 (15)	-60.3 (4)		-60.3 (4)
Belarus	-17.7 (13)	-8.8 (7)	-15.4 (20)	-86.8 (11)	-60.5 (7)	-57.8 (6)	-55.1 (16)	-60.9 (40)	3.0 (5)	-16.9 (3)	-2.3 (8)
Georgia											
Kazakhstan	-14.9 (14)	-3.1 (5)	-11.5 (19)	-60.5 (14)	-74.8 (5)	-43.5 (11)	-11.9 (11)	-52.4 (41)	-52.6 (7)	-64.2 (5)	-58.4 (12)
Kyrgyzstan	-9.5 (5)	-0.6 (4)	-3.5 (9)	27.0 (5)	-72.0 (4)	-93.7 (6)	-7.9 (9)	-54.2 (24)	34.8 (1)	39.5 (5)	37.1 (6)
Moldova						-28.0 (10)	-52.1 (14)	-36.3 (24)		-25.9 (4)	-25.9 (4)
Russia	-26.6 (18)	-24.5 (13)	-25.0 (31)	-61.0 (18)	-70.8 (12)	-81.3 (13)	-80.2 (17)	-70.8 (60)	-43.5 (7)	135.6 (5)	-37.6 (12)
Tadzhikistan	-26.7 (5)	-35.1 (1)	-30.9 (6)	-67.6 (5)	-95.9 (1)	-90.4 (3)	-80.7 (8)	-78.6 (17)		471.7 (1)	471.7 (1)
Turkmenistan	26.6 (6)		26.6 (6)	-79.2 (5)		-84.5 (5)	-98.0 (5)	-86.8 (15)	-34.1 (5)	-26.3 (1)	-30.2 (6)
Ukraine	-29.7 (17)	-11.7 (11)	-16.9 (28)	-66.8 (17)	-70.3 (11)	-66.3 (13)	-75.6 (17)	-69.2 (58)	-86.9 (2)	-21.9 (5)	-50.9 (7)
Uzbekistan	-11.0 (12)	-37.5 (4)	-17.0 (16)	-78.0 (11)	-44.2 (2)	-80.6 (7)	-84.3 (10)	-78.1 (30)	-34.1 (7)	669.9 (2)	-9.1 (9)
GUS	-27.9 (18)	-22.8 (13)	-24.8 (31)	-56.2 (18)	-68.8 (13)	-66.3 (13)	-67.2 (17)	-65.3 (61)	-46.2 (7)	-12.1 (5)	-32.7 (12)

Table 3 continued

	Imports										
	1990-91			1991-93					1993-94		
	Industrial intermediate goods	Capital goods	All products	Industrial intermediate goods	Capital goods	Food products	Non-food consumer goods	All products	Industrial intermediate goods	Food products	All products
Armenia	-30.0 (15)	-39.0 (12)	-35.4 (27)	-95.8 (10)	-95.5 (5)	-97.4 (12)	-95.2 (16)	-96.5 (43)	-47.6 (6)	-29.2 (4)	-47.6 (10)
Azerbaijan	-24.8 (17)	-31.6 (12)	-25.4 (29)	-75.8 (14)	-84.3 (11)	-62.7 (13)	-90.6 (17)	-79.1 (55)	-12.7 (4)	-21.8 (5)	-21.8 (9)
Belarus	-17.7 (18)	-7.6 (13)	-17.5 (31)	-55.9 (18)	-75.8 (12)	-71.0 (12)	-61.6 (17)	-64.9 (59)	-15.2 (7)	255.9 (4)	-11.8 (11)
Georgia	-42.2 (18)	-39.0 (12)	-41.0 (30)	-89.4 (18)	-97.9 (6)	-91.0 (12)	-95.0 (17)	-94.3 (53)	-54.8 (7)	14.0 (3)	-53.5 (10)
Kazakhstan	-19.7 (18)	-20.7 (13)	-20.7 (31)	-55.5 (18)	-39.1 (13)	-81.5 (13)	-75.3 (17)	-62.2 (61)	-44.2 (7)	16.0 (5)	-12.1 (12)
Kyrgyzstan	-17.9 (16)	-4.3 (11)	-14.8 (27)	-72.4 (16)	-91.5 (12)	-73.2 (11)	-92.7 (17)	-86.7 (56)	-54.9 (6)	-16.3 (4)	-48.8 (10)
Moldova	-15.7 (17)	-26.7 (12)	-22.2 (29)	-50.4 (17)	-88.3 (11)	-81.7 (12)	-65.6 (17)	-67.7 (57)	-57.3 (6)	-46.9 (3)	-55.3 (9)
Russia	-18.7 (18)	-14.8 (12)	-17.4 (30)	-70.2 (18)	-69.8 (12)	-64.2 (13)	-52.6 (17)	-68.1 (60)	-20.1 (7)	-38.8 (5)	-29.4 (12)
Tadzhikistan	-20.8 (16)	-24.2 (12)	-22.5 (28)	-69.9 (16)	-86.5 (10)	-45.5 (11)	-83.5 (17)	-80.5 (54)	-50.4 (7)	-44.4 (3)	-47.4 (10)
Turkmenistan	-21.6 (16)	-23.4 (11)	-22.2 (27)	-24.2 (14)	105.3 (13)	-69.3 (12)	-52.9 (17)	-23.1 (56)	-60.2 (4)	-75.7 (4)	-73.2 (8)
Ukraine	-28.6 (18)	-21.5 (13)	-28.3 (31)	-66.0 (18)	-81.3 (12)	-84.7 (13)	-81.6 (17)	-79.5 (60)	-39.8 (7)	223.2 (5)	-26.0 (12)
Uzbekistan	-28.0 (18)	-32.2 (12)	-29.1 (30)	-58.5 (18)	-66.9 (12)	-76.5 (13)	-81.2 (17)	-75.7 (60)	-70.4 (6)	-39.5 (4)	-68.9 (10)
GUS	-27.9 (18)	-22.8 (13)	-24.8 (31)	-56.1 (18)	-68.8 (13)	-66.3 (13)	-67.2 (17)	-65.3 (61)	-46.2 (7)	-12.1 (5)	-32.7 (12)

<sup>a</sup>Median of growth rates for products in each category (number of products in parentheses).

Source: Statkom SNG, Mezhhgosudarstvennyy obmen tovarami narodnogo potrebleniya v 1991 g. Moscow 1992; Mezhhgosudarstvennyy obmen produktsiyey proizvodstvenno - tekhnicheskogo naznacheniya v 1991 g. Moscow 1992; Mezhhgosudarstvennyy obmen produktsiyey proizvodstvenno - tekhnicheskogo naznacheniya i potrebitel'skimi tovarami v 1993 g., Moscow 1994; Statisticheskiy Bjuletin', 1995, No. 3; own calculations.



Subsection 3.2 analyses the extent and future relevance of four sources of distortions that may have favored intra-CIS trade in the past, and are now bound to be eliminated by market-oriented economic reforms: inappropriately low prices for raw materials (especially energy) and environmental sources (Subsection 3.2.1); arbitrary location of enterprises due to insufficient attention to the true transport and coordination costs (Subsection 3.2.2); excessively large enterprises because control costs are lower when there are fewer individual enterprises (Subsection 3.2.3); and politically motivated isolation from trade with the rest of the world (Subsection 3.2.4).

### **3.1 Output Decline, Collapse of Institutions, Barriers to Trade**

The decline in intra-CIS trade coincided with a substantial fall in aggregate output in the CIS countries, with the collapse of the payments system among the former Soviet republics, and with the erection of various trade barriers (mostly export controls) between the post-Soviet states. This process started as early as 1990, and hence before any market-oriented economic reforms were undertaken that might have led to structural adjustment. Together, therefore, these interrelated developments may safely be regarded as primarily responsible for initiating the decline in trade.

There is no need to describe the evaluation of events in detail because they have been documented extensively elsewhere (for example: IMF, 1994). Two interrelated issues are of wider importance, however, and will be discussed briefly. First, what is the relative importance of the three factors in causing the decline in intra-CIS trade? This question was raised especially in 1992 and 1993 because the policy implications following from each possible cause differed, and there seemed to be a good

chance of halting the decline in trade through stop-gap policy measures. Second, what is the continuing relevance of these factors now that considerable progress has been made in creating institutions appropriate for market economy conditions?

On the first question, it seems clear that the output decline had a large impact on intra-CIS trade. This immediately raises the additional question of what caused the output decline. The literature has identified a variety of contributing factors, including demand constraints (reduced state orders for military equipment, tight macroeconomic policies), supply side factors (slow adjustment to changing relative prices), institutional constraints, and statistical inaccuracies (overestimation of true output decline) (Rosati 1994). Schmieding (1993) concludes from a detailed evaluation of alternative explanations that the single most important cause of the output collapse must have been the institutional void experienced by the transition economies: When the central planning mechanism had broken down, the transition economies lacked most of the institutions that are crucial for facilitating economic transactions in market economies. This conclusion has particular force in the case of the former Soviet Union. The decline in aggregate output and inter-republican trade started as early as 1990 when centralized control over the economy began to crumble. By contrast, market-oriented economic reforms which may have entailed structural adjustment were only implemented as from the beginning of 1992.

Apart from the output decline, there is evidence that the decline in intra-CIS trade was accelerated by the disintegration of the Soviet payments system and new trade barriers (Michalopoulos and Tarr 1994). Specifically, Anderson (1993) has shown with the help of a computable general equilibrium model of the former Soviet economy (distinguishing

Russia from the remaining republics) that in 1992 intra-CIS trade declined by more than one would have expected given the fall in aggregate output. The imposition of trade barriers, mainly in the form of export controls, can be traced to the bilateralization of economic relations among the CIS countries after the ruble zone broke down (cf. IMF (1994) for a detailed discussion). In that sense it may be stated that the decline in intra-CIS trade was accelerated by the breakdown of institutions (particularly the payments system) that had been its backbone during the Soviet period. It was against this background that proposals were made for a payments union among the CIS countries in the framework of an Inter-State Bank. Gros (1994) discusses the rationale for this project as well as the reasons for its failure to materialize.

In assessing the continuing relevance of these factors, two points need to be noted. First, as of mid-1995, many obstacles to trade have been eliminated. Nearly all CIS countries now have national currencies that are convertible at least against the Russian Ruble for current transactions. Financial system reforms have led to the establishment of currency markets and networks of correspondent accounts among commercial banks. Hence there now exists a working (though still expensive) payments system for intra-CIS transactions.

Second, the institutional void created by the demise of the central planning system and the disintegration of the Soviet Union only initiated the decline in intra-CIS trade. Therefore trade will not automatically recover when new institutions are put in place. The ongoing systemic transformation will progressively eliminate the distortions caused by the central planning mechanism. Hence some production activities and trade relationships which went into decline initially because of the collapse of institutions, may become permanently unviable. The following

Subsection 3.2 discusses the empirical evidence on the extent of such distortions.

## **3.2 Structural Adjustment**

### *3.2.1 Adjustment of Relative Prices*

During the Soviet period, producer prices for goods were calculated on a "cost-plus" basis, and served merely for accounting purposes. As a result, natural resources were undervalued (relative to world market prices) because resource rents were not included in the producer price, while many capital goods that were manufactured inefficiently were correspondingly overpriced (Orlowski 1993). It may be noted for the sake of clarity that consumer prices, on the other hand, were set to equate the quantity demanded to (politically determined) supply. The resulting differences between producer and retail prices were covered by product-specific consumption taxes or subsidies.

It is sometimes stated by Western observers that Soviet central planners based their investment decisions not on accounting prices but on shadow or world market prices. Such behaviour would certainly be plausible, particularly in the case of raw materials where the opportunity cost of domestic resource use in terms of export revenue foregone is especially obvious. This assertion is contradicted, however, by the frequently documented, excessive use of raw materials and energy throughout the Soviet economy, including household consumption. Therefore it seems a tenable assumption that the structure of the post-Soviet economies was the result of a planning process based on input prices that were not fundamentally different from the prevailing producer prices. By implication,

world market prices had only a limited impact on the choice of production technologies.

Since 1992, prices in intra-CIS trade have gradually been adjusted to reflect world market conditions. Furthermore, the explicit, budgetary income transfers among the former Soviet republics were eliminated in 1992 (cf. Orlowski 1995). They were replaced by inter-governmental credits whose conditions became increasingly market-oriented during the following years. Hence the budget constraints faced by the governments of CIS countries in intra-CIS trade have been hardened considerably. This process benefited especially the net energy exporters among the CIS countries: Russia's terms of trade in intra-CIS trade improved by 20 percent between 1990 and 1993, and Turkmenistan's by 52 percent. All other CIS countries saw their terms of trade deteriorate: moderately in the case of relatively resource-rich countries such as Azerbaijan (-2 percent), Kazakhstan (-3 percent), Uzbekistan (-8 percent), and Ukraine (-11 percent); strongly in Belarus (-17 percent) and Kyrgyzstan (-19 percent); and by 25 percent or more in the remaining countries (Michalopoulos and Tarr, 1994, Table 1.9).

CIS countries with deteriorating terms of trade needed to depreciate their national currencies in real terms, which implies a reduction of the prices of non-tradables relative to tradables (or, equivalently, a reduction of the wage rate measured in foreign currency). The decline in real income can then be expected to reduce import volumes of all product categories, while the relative price effect should result in a particularly large reduction in the imports of energy and raw materials. On the other hand, one would expect to see increased exports whose competitive position should be strengthened by the devaluation.

In reality, however, no such increase in exports from countries with deteriorating terms of trade occurred. One probable reason is that changing terms of trade coincided with the liberalization of Russia's foreign trade with the rest of the world (cf. Subsection 3.2.4 below). Due to technological backwardness, for example, CIS exporters were probably unable to expand or even maintain their export sales in the face of increasing competition from non-CIS suppliers, especially in light industries. Their competitiveness in relation to Russian producers may also have been hampered by the fact that Russian enterprises continued to benefit from lower energy prices than those prevailing either in the world market or in Russian exports to CIS countries. Due to such constraints on export expansion, the deteriorating terms of trade of net-energy-importing CIS countries were absorbed almost entirely by import compression. Only to a limited extent could imports be financed by external credits which had to be obtained at increasingly market-oriented conditions.

### *3.2.2 Declining Competitiveness of Arbitrarily Located Enterprises*

It has frequently been asserted that the location of many enterprises in the former Soviet Union was determined by political rather than economic considerations. Their economic viability might therefore be endangered by market-oriented economic reforms. Decisions on location might have been guided, for example, by regional policy objectives, or by a politically motivated desire to make non-Russian, potentially independence-minded republics economically dependent on the rest of the Soviet Union, or by strategic considerations (such as rendering militarily important industries less vulnerable in the case of war). Similarly, neglect of transportation costs (because energy was underpriced) could also have meant that

enterprises were located in areas where their economic viability would be threatened under market economy conditions.

There is plenty of anecdotal evidence that politics played a role in the location of particular enterprises. This relates especially to some strategic industries, such as aluminium plants. It is difficult, however, to find sufficient direct evidence to permit a comprehensive view. What is more, two pieces of indirect evidence suggest that distortions in the division of labour *among* the former Soviet republics have been limited (taking as given the country's politically determined economic isolation from the rest of the world).

First, the direction of trade among the member republics of the former Soviet Union is correctly predicted by a gravity model (Gros and Dautrebande 1992). That is, bilateral trade was higher the higher the gross domestic products of the two republics (reflecting higher absorptive capacity), and the closer they were geographically (reflecting lower transportation costs). This is the same pattern as found among market economies.

Second, the commodity composition of inter-republican trade followed by and large the pattern predicted by Heckscher-Ohlin trade theory (Lücke 1992; a similar finding is reported by Murrell 1990, for the foreign trade patterns of all East European countries). Republics with high levels of human and physical capital per head specialized in the production and export of relatively sophisticated products, and vice versa. This is what one would expect as the result of a rational planning process.

In sum, this indirect evidence supports the conclusion that the most important distortion affecting the structure of the economies of the former member republics of the Soviet Union was not a suboptimal division of

labour among the republics, but the country's economic isolation from the rest of the world (Subsection 3.2.4 discusses this point in detail). The emphasis that some observers have placed on supposedly arbitrary location decisions within the former Soviet Union appears to be based on anecdotal evidence that conveys a somewhat misleading impression.

### *3.2.3 Restructuring of Larger-than-Optimal Enterprises*

It has frequently been argued that the efficiency of Soviet industry suffered from an excessive average size of enterprises. This might have been the result of the central planning mechanism in the sense that a given quantity of output may be easier to "plan" when it comes from a small number of large production units, rather than a larger number of relatively small plants. Large size would have implied that many enterprises were monopolists or oligopolists, especially in the capital goods industries where economies of scale are important relative to the size of the Soviet or East European market. Such market power, in turn, would have limited the incentives for enterprises to maintain a high standard of efficiency.

Alternatively, it is conceivable that relatively large production units were established in order to take advantage of economics of scale. Economics of scale, however, are limited by the extent of the market. Large production volumes of a limited number of product varieties were probably consistent with the preferences of central planners. Under market economy conditions, however, demand will become increasingly differentiated. Large production units, with traditional technologies embodied in sometimes outdated equipment, may lack the flexibility to respond to such changes in consumer preferences. Both insufficient flexibility and monopoly-induced inefficiency may have placed many large



enterprises in a difficult position when they faced increasing competition after the liberalization of foreign trade in many CIS countries in 1992. This process may have contributed to the decline in intra-CIS trade.

The hypothesis of widespread monopolism is usually supported by reference to Soviet statistics listing a large number of products (mostly from the metal and engineering industries) for which there existed only one or a few producers (e.g. Kroll 1991). This approach has been challenged by Brown et al. (1993) who argue that looking at monopolistic positions at the product level is misleading because, under market economy conditions, enterprises might diversify their output portfolios into related product ranges. Brown et al. (1993) carefully evaluate data on Russian industry from the 1987 Soviet Census of Industry which have recently become available in machine-readable format, with enterprises grouped according to the United States Standard Industrial Classification (SIC). If the four-digit level of the SIC is accepted as representing the possible range of diversification, then industry in Russia was not significantly more monopolistic than in the United States.

It is important to notice that Brown et al. (1993) compare Russian "enterprises" to US "firms". Both entities may consist of several separate plants or, technically speaking, establishments. It is therefore conceivable that establishments in the former Soviet Union were excessively large by market economy standards, although this was not apparent at the firm or enterprise level because US firms on average consisted of a larger number of establishments. Although the available data are difficult to compare, Lücke (1994) concludes tentatively that, on average, manufacturing establishments in the former Soviet Union were indeed larger than in the United States or Western Europe.

In addition, small and medium-sized enterprises (with up to 500 employees, for instance) account for a significant proportion of employment and output in most manufacturing industries in the US and Western Europe, but are practically non-existent in the former Soviet Union. It is frequently argued that such firms represent a particularly dynamic sector of industry, quick to exploit new opportunities and flexibly adjusting to changing conditions. As a result, they have accounted for a disproportionate share of newly created industrial jobs in many Western countries during the last two decades. Therefore, even if the impression of wide-spread monopolism in the former Soviet Union is incorrect, the absence of small- and medium-sized firms is bound to slow down the structural adjustment of CIS manufacturing and to reduce the competitiveness of local firms vis-à-vis suppliers from outside the region.<sup>7</sup>

#### *3.2.4 Overcoming Past Isolation from the World Economy*

The former Soviet Union was characterized by a highly developed division of labour among its constituent republics. Trade with the rest of the world (including the member countries of the former Council for Mutual Economic Assistance), however, was far smaller than one would have expected on the basis of the country's size and the trade to GDP ratios found in market economies (Michalopoulos and Tarr 1994, Table 1.8). This was not only the result of voluntary isolation from the rest of the world, but also of trade barriers on the part of OECD countries (Pohl and

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<sup>7</sup> Another implication of the large average size of establishments was that the manufacturing sector in individual regions of the former Soviet Union was less diversified than in the United States (Lücke, 1994). Hence structural adjustment will probably be more painful because fewer alternative employment opportunities are locally available for redundant labour from shrinking industries.

Sorsa 1992). Restrictions on exports of high technology goods to the Soviet Union (and to other members of the Warsaw Treaty Organization) played an important role in preventing the Soviet Union from integrating into the international division of labour according to its comparative advantage.

As a result, the overall trade dependence of the CIS countries today is not much higher than in market economies of comparable size, considering their total trade to GDP ratios. What seems excessive, however, is the share of intra-CIS in total trade. One would expect that, as the after-effects of the iron curtain disappear in the course of time, the CIS countries will tend to re-orient a large proportion of their trade away from the region towards the rest of world.

Gros and Dautrebande (1992) have used a gravity model approach to develop estimates of the "long-run" share of intra-regional trade in the total foreign trade of CIS countries, assuming that their trade follows the same pattern as trade among market economies. The gravity model explains the value of trade between pairs of countries as a function of their respective gross domestic products ("mass"), and of the transaction costs of trade between them ("distance"). Transaction costs depend on such factors as geographic distance (affecting transport costs), trade policy (for example, common membership in a regional integration scheme), and cultural affinity (for example, common language, legal systems, etc.). Since model specification (especially of the variables representing "distance") may affect estimates considerably, Gros and Dautrebande have employed coefficients from three separate studies (Aitken 1973; Wang and Winters 1991; Havrylyshyn and Pritchett 1991).

The findings by Gros and Dautrebande (1992) support the view that if and when the systemic transformation in the CIS economies is successful, trade among the CIS countries will play a much reduced role relative to trade with countries outside the region. Applying the coefficients from Aitken (1973) and Wang and Winters (1991) results in estimates of the long-run, intra-CIS trade shares of less than 20 percent for all CIS countries, and less than 10 percent for Russia. Using the Havrylyshyn and Pritchett (1991) coefficients gives intra-CIS shares of no more than 25 percent for the European CIS countries as well as Uzbekistan, Tadjikistan, and Turkmenistan, between 25 and 30 percent for the three Caucasian states, 34 percent for Kazakhstan, and 50 percent for Kyrgyzstan.

Although these estimates are merely illustrative, their plausibility is strengthened by the observation that in many developing countries the share of trade with other developing countries in the same region is in the order of 10 percent (UNCTAD Handbook, Table 1.13, current issues). The somewhat higher estimates for the CIS countries reflect the fact that due to its economic size and geographical proximity, Russia is a "natural trading partner" for most of the other CIS countries (on the concept of "natural trading partners" see Wonnacott and Lutz, 1989; Jacquemin and Sapir, 1991; Kreinin and Plummer, 1992).

Furthermore, gravity models that reflect the pattern of trade among long-established market economies probably underestimate the difference in transaction costs among CIS countries on the one hand, and between CIS countries and the rest of the world on the other. In the medium term at least, there will probably be elements of path dependence that cause intra-CIS trade to remain relatively more important than the pattern of trade among market economies would suggest. For example, cultural

affinity is likely to remain of crucial importance in terms of being able to communicate in Russian, knowing and trusting trading partners because of long-standing relationships, and being used to conducting business under great legal and economic uncertainty.

To some extent, enterprises in the CIS countries are also locked into traditional, energy-intensive technologies for which intermediate goods, spare parts, etc. can only be obtained from CIS sources and for which, conversely, no market exists outside the region. At the same time, foreign exchange constraints may prevent the CIS countries from quickly replacing traditional technological by state-of-the-art equipment imported from market economies.

Furthermore, Russian attempts to maintain a dominating political and economic influence over the countries in the "near abroad" (meaning, in practice, all CIS member states) also constitute a particular form of path dependence. Such political pressures are exemplified by the hostile Russian reaction to Azerbaijan's plans to build an oil pipeline to Turkey or Iran in order to become less dependent on the Russian pipeline network for its oil exports. It is not entirely clear what policies the Russian government intends to pursue in its relations with the "near abroad".<sup>8</sup> Hence it is also unclear what links between the "near abroad" and Western countries Russia will be prepared to tolerate, and at what stage (and by what means) Russia would intervene.

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<sup>8</sup> In the case of the Azeri pipeline project, part of the problem may have been that the Russian state oil company was supposed to play only a small role in the project.

At any rate, Russia could use at least two levers in the narrowly economic sphere to restrict links between the other CIS member states and the rest of the world. First, many CIS countries depend on transit routes through Russia for their non-CIS exports (such as Azerbaijan for its oil exports). Most states are landlocked; transport links to neighbouring countries outside the former Soviet Union remained underdeveloped during the Soviet period, and now take time to expand. In addition to a well-working transport network, goods in transit require special facilities such as sealed means of transport, bonded warehouses, duty-free storage facilities, transshipment areas in harbours or airports, etc. Even if such arrangements are not regarded as important by the CIS countries, they are prerequisites for establishing the origin of goods to which preferential tariffs are to be applied (such as under the Generalised System of Preferences from which practically all CIS member states now benefit in most OECD markets). Creating the necessary conditions for the smooth transit of goods will therefore require the political goodwill of, and significant administrative effort by the Russian government. That gives Russia substantial leverage in its relations with many of the smaller CIS member states.

Secondly, Russia's position as a very large trading partner for most CIS states makes it difficult for the latter to pursue trade policies that differ radically from Russia's. On the one hand, imposing higher prices for particular goods than Russia would create incentives for smuggling, tariff evasion and other illegal activities which would be difficult to contain because of widespread problems with law enforcement. On the other hand, if Russia decided to pursue a significantly more protectionist trade policy, it could present the smaller states with the options of either joining a highly protectionist customs union, or being treated like any third

country as regards access to the Russian market. Faced with this alternative, the smaller states might well feel obliged to join an integration scheme that would adopt more protectionist policies against imports from third countries than they would impose if they could act individually.

Alternatively, as the main supplier of some essential products facing inelastic demand in CIS countries, Russia could even act strategically and impose optimal export taxes to improve its terms of trade. In doing so, it could induce other CIS states to lower their import taxes on these goods and seek compensation by raising import taxes on other products that are regarded as less essential. In this way, Russia would influence the import-tax-raising capacity of the smaller CIS states and restrict their national autonomy in the area of trade policy.

These considerations demonstrate that the applicability and, hence, predictive power of gravity models are subject to some uncertainty in the case of the CIS countries. It is clear, nevertheless, that if market-oriented economic reforms are successfully implemented, the share of intra-regional trade in the total trade of CIS economies will fall substantially from its present level. The 1993 figures from Table 1 together with the long-run estimates based on Aitken (1973) and Wang and Winters (1991) suggest that in most CIS countries the intra-regional shares in foreign trade might be reduced to no more than a quarter of their present levels. Allowing for the impact of path dependence, it may be concluded that the intra-regional trade shares will be roughly halved at least. To give an impression of the magnitudes involved: if the average share of intra-CIS trade in the total foreign trade of CIS countries is now approximately 70 percent (using the average of exports and imports; cf. Table 1), then its long term level will be in the order of 35 percent at best.

It is hardly conceivable that a reduction of this size can be reached at without a further fall in the volume of intra-CIS trade. The rationale behind this conclusion may be illustrated with a back-of-the-envelope calculation: Assume that both the volume of intra CIS trade and the overall trade-to-GDP ratio remain constant. If the share of intra-regional in total trade is to decrease from 70 to 35 percent, then trade with the rest of the world has to more than quadruple, and GDP has to more than double. If the trade-to-GDP ratio is allowed to rise by one half, then GDP still has to grow by 40 percent. Both a quadrupling of extra-regional trade, and a large increase in aggregate output, will hardly occur in the foreseeable future. Even if the CIS countries push ahead with market-oriented reforms, extra-regional exports will take time to expand while the distortions that favored intra-CIS trade in the past will not take nearly as long to eliminate. Therefore, if the orders of magnitude suggested by gravity models are any guide to the future at all, then intra-CIS trade will certainly not recover to anything like its pre-1990 level in the foreseeable future, and will probably decline even further from its present level.

#### **4. Policy Implications**

It has been shown in the preceding section that the decline in intra-CIS trade was initially caused by the institutional void left by the collapse of the central planning system. However, the ongoing formation of new market-supporting institutions will not permit intra-CIS trade to recover to its former level. Economic isolation from the rest of the world during the Soviet period enabled enterprises to export to protected markets within the former Soviet Union in spite of substantial, systemic inefficiency. Market-oriented reforms, especially the liberalization of trade with the rest of the world, have eliminated that protection. Furthermore, once



enterprises in the CIS countries have successfully restructured, they are likely to find profitable export opportunities increasingly outside the CIS.

These considerations suggest that it is now crucial to push ahead with economic reforms that promote enterprise restructuring and eliminate obstacles to extra-regional trade. Such reforms range widely from macroeconomic stabilization (to improve the investment climate) to the privatization of large enterprises. However, although the importance of intra-CIS trade will be reduced, the formation of market-supporting institutions still needs to be completed (Subsection 4.1). In addition, the integration of the CIS countries into the multilateral trading system requires a decision on whether to set up a regional integration scheme and, if so, what form it should take (Subsections 4.2 and 4.3).

#### **4.1 Policy Reforms to Improve the Institutional Framework for Intra-CIS Trade**

Significant progress has been made in many CIS countries in creating the institutions that are necessary for the functioning of market relations among economic agents. The task is far from completed, however, and this section lists some of the areas relevant to intra-CIS trade where there is a need for further reforms. First, although the newly created currencies of most CIS countries are in principle convertible, the currency markets are still rudimentary and in some cases subject to intransparent interventions by the national central banks. Inter-state payments can now frequently be made through correspondent accounts of commercial banks, but costs are still high. Further reform of financial systems should aim to increase the level of competition, including increased participation of Western commercial banks that could introduce much thoroughly needed know-how.

Second, export restrictions still exist in several CIS countries with the objective of insulating regulated domestic markets from higher prices in both intra- and extra-regional trade. Such price controls for tradable inputs distort competition between firms in different CIS countries, and prevent the emergence of appropriate incentives for structural change. Full internal price liberalization would reduce the waste of resources resulting from inappropriately low prices, and could also contribute to fiscal consolidation if it were linked to the introduction of a resource tax capturing the resource rents for the state budget.

Third, there are still remnants of state trading in intra-CIS trade in the form of several bilateral government agreements on trade in a limited number of products. Although all remaining agreements now appear to be indicative rather than binding on enterprises, and only set quantitative targets rather than prices (cf. Lücke 1995, for the case of Belarus), there is still a lingering suspicion that economic rents are being allocated by essential administrative procedures. If the existing agreements were allowed to expire without being replaced, this would increase transparency in intra-CIS trade and demonstrate to all enterprises that they have to market their products on their own account rather than through government agreements.

#### **4.2 Alternative Institutional Arrangements for Regional Reintegration**

Varying groups of CIS member countries have made attempts at creating a free trade area or customs union. This raises the related questions of what the advantages of any discriminatory trade agreement would be, and what form it should take. The rationale behind the integration attempts has probably been mainly to create a stable policy regime for intra-CIS

trade at a time when bilateral inter-governmental barter agreements (which were initially concluded by many CIS member states) turned out to be ineffective. At the same time, trade outside these agreements was seriously hampered by export barriers. A trade integration scheme would also benefit the smaller CIS countries by giving them guaranteed access to the large Russian market.

Regarding the shape of institutional arrangements for regional integration, the choices of the CIS countries are restricted by the fact that nearly all of them have applied to join the World Trade Organization. Hence any integration scheme would need to conform to the two conditions laid down in Article 24 of GATT 1994: first, that on balance, barriers to imports from third countries should not become higher; and second, that substantially all intra-regional trade should be covered by the agreement.

The first condition should not represent a serious problem because barriers against imports from the rest of the world are not very high presently in any CIS country. The second condition, however, would imply that trade in raw materials and energy must be freed from all barriers, including those on exports, during a reasonable transition period. (Trade in energy products clearly constitutes a "substantial" share of intra-CIS trade.) Russia would thus be required either to increase its domestic energy prices to the substantially higher levels now prevailing in intra-CIS trade, or to subsidize other CIS countries by exporting energy materials at Russian domestic prices; so far, the Russian government has carefully avoided taking either measure.

If the two basic conditions laid down in Article 24 of GATT 1994 are satisfied, the choice between a free trade area and a customs union depends on how much protection against imports from third countries is

desired. As discussed in Section 3.2.4 above, however, the decisions by the smaller CIS countries are constrained by the approach chosen by Russia. Three broadly defined scenarios are conceivable:

First, Russia might adopt a liberal trade policy towards third countries, with relatively uniform levels of protection across sectors, and using only import tariffs. In this case, the smaller CIS states would be well-advised to join Russia in a customs union where the Russian tariff structure would become the common external tariff. This would give the smaller states guaranteed and preferential access to the important Russian market, and simultaneously commit them to maintaining a liberal external trade regime.

The second scenario involves Russia opting for a highly protectionist, sectorally selective trade policy towards third countries. High overall levels of protection for industry would hurt the interests of small, resource-poor CIS states in integrating fully into the international division of labour and becoming competitive exporters of non-traditional manufactures. Hence their first-best choice would be to adopt a liberal, non-discriminatory trade regime and treat imports from Russia and other trading partners alike. Doing so, however, would undermine their present preferential access to the Russian market since Russia would probably respond by subjecting imports from CIS countries to the same protectionist policy regime as imports from the rest of the world. Faced with the prospect of losing access to the important Russian market, the smaller CIS states might be coerced into a customs union with Russia.

The third scenario assumes that Russia moves towards an increasingly protectionist position without, however, making this an explicit policy or exerting pressure on other CIS member states to follow suit. To some

extent, this scenario reflects the situation prevailing in mid-1995. Under such conditions a free trade area could be implemented among the CIS countries where trade policies towards the rest of the world would be decided nationally. While this approach would accept strong economic ties with Russia as a (transitory) legacy of the Soviet system, it would also allow the smaller CIS states to benefit from free access to their main export market while Russia would not be allowed to restrict commodity exports.

A free trade area would depend on the implementation of intra-regional customs borders in order to enforce rules of origin for products benefiting from preferential treatment. The experiences with free trade areas among developing countries demonstrate that rules of origin can lead to trade barriers if they are managed restrictively and under rent-seeking targets. Likewise it is known from the EFTA experience that rules of origin are of minor importance if external tariffs of member states are similar and low, and if intra-regional trade is relatively small. The lesson for CIS countries would be to discourage rent-seeking from the very beginning by framing similar, rational trading regimes with low uniform tariff rates.

Further it would have to be decided how value added taxes should be levied. The significance of this decision is demonstrated by the single market in the European Union where intra-regional trade is no longer subject to any border controls. The country of origin principle which is now applied in the European Union would allow for competition among different national tax regulations: all domestically produced goods (including exports to CIS countries) would be subject to VAT, tax revenues would accrue to the producing country, and purchasers would be free to buy products within the CIS wherever VAT is lowest. Hence

applying the country of origin principle in the context of a customs union would render all border controls of intra-regional trade unnecessary.

On the other hand, the country of destination principle would give tax authorities more autonomy, which might be desirable in view of the need for fiscal restructuring and the difficulties inherent in implementing alternative, direct taxes. Under the country of destination principle, VAT would be levied on imports at the border, while tax paid in the course of the production chain on products ultimately exported would be refunded.

#### **4.3 The CIS Countries As Trading Partners: A View From the OECD**

Since 1993 the OECD countries have formally treated the CIS member states as separate partner countries. They have also granted preferences under the GSP on a country-by-country basis, which presupposes that each CIS state is a separate customs territory with full control over its trade policy. Given wide-spread institutional disorder in intra-CIS trade, however, the OECD approach must be viewed as anticipating the future, rather than being fully consistent with present conditions. As of mid-1995, at least, the customs territories of the individual CIS states could not, in practice, be separated from each other satisfactorily.

This state of affairs has created problems for CIS exports of sensitive, import-restricted products to the OECD. Because of the limited competitiveness of CIS producers of manufactures, these are mainly primary or basic processed commodities where certificates of origin can easily be faked due to product homogeneity. Therefore, for example, the European Union reacted to a surge in aluminium imports in 1993 by imposing a single import quota for the whole territory of the former Soviet Union (aluminium plants are spread widely across the former Soviet

Union). This procedure was at odds not only with the current political situation (the Russian and Ukrainian governments were quarreling about a wide range of issues), but also with the European Union's own foreign trade statistics where the individual CIS states were already treated as separate partner countries.

Any preferential treatment of CIS states by means of tariff quotas or tariff ceilings, or provisions for the cumulation of national value added in any future free trade agreements between OECD and CIS countries, require that the customs territories of the CIS countries are effectively separated. Therefore OECD countries would probably welcome a clear-cut decision either in favor of a CIS customs union, or a water-proof separation of national customs territories with effective border controls (for instance in the framework of a CIS free trade area). The current in-between status bears the risk that OECD countries may again be tempted to apply "total former USSR" quotas.

## **5. Conclusions**

It has been found that the proximate cause of the decline in the volume of intra-CIS trade was the institutional void left by the collapse of the central planning system in the former Soviet Union. However, the formation of market-supporting institutions, which has progressed significantly in many CIS countries, will not in itself permit a recovery of intra-CIS trade to its former level. To a large extent, trade among the former Soviet republics depended upon the protection that was provided by the economic isolation of the former Soviet Union from the rest of the world. Now that market-oriented reforms are eliminating that protection, many of the traditional trade relationships become unviable. On the other hand, fully

restructured enterprises will increasingly find promising export markets outside the CIS region.

These conclusions depend partly on the assumption that gravity models, however imprecise, provide some guidance as to the future direction of the external trade of the CIS countries, if and when market-oriented economic reforms are implemented. However, the predicted reductions in the share of intra-regional trade in the total foreign trade of the CIS countries are so large as to instill some confidence in this assumption. Even if elements of path dependence prevent the direction of trade of CIS countries from fully adjusting to the pattern found among market economies, the direction of change remains unambiguous.

These findings underline the importance of policy reforms that promote industrial restructuring, eliminate obstacles to exports to the rest of the world, and create a stable framework for investment in internationally competitive industries. Otherwise the job losses in shrinking industries cannot be compensated for. Although much reduced in importance, intra-CIS trade also requires the attention of policy-makers. The formation of market-supporting institutions needs to be completed, and a decision needs to be taken on the format, if any, of a regional trade integration scheme.



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