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Editorial

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International Trading System – Does it really represent a public good

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Abstract

During last several years international trading system has experienced substantial difficulties in its performance most vividly demonstrated by realization of Doha round of the World Trade Organization (WTO) multilateral negotiations. Under the circumstances the very nature of the system needs serious theoretical reinterpretation. Public choice theory might provide stimulating prospects for this analysis. Present paper attempts to test functions of the WTO against basic pure public good criteria. The author concludes that three major functions have clear features of either congestible public good or excludable public good.

***Keywords*:** Russia, World Trade Organization, Global public goods, International trading system
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Introduction

Current state in development of international trading system provides more than enough reasons for criticism from almost everyone involved. These are members of business community, academics, state officials from various agencies, and at last but not least representatives of civil society. Doha round of the WTO multilateral negotiations might be perceived as a vivid manifestation of existing problems. “Crisis”, “stalemate”, “deadlock” – are the characteristics most frequently used by different commentators with regard to implementation of Doha Development Agenda (DDA). Under the circumstances there have been many appeals to mutual concessions and compromises, all sorts of medication to facilitate the process have been proposed. But so far close to nothing could be registered in terms of positive tangible results. Within the framework of a present paper the author would like to discuss some fundamental feature of modern international trading system from public choice theory perspective. Hopefully it might help to generate more adequate and comprehensive assessment of the phenomenon under review as well as to suggest possible clues to some problems.

Formulating a problem

It is known that public choice theory in general was initially elaborated as an attempt to define a niche, which national state as an institution has to occupy in modern economic system. Provision of various public goods is one of the major goals justifying economic dimension in performance of the state. Under the circumstances whole set of non-market decisions has to be made. Their efficiency, possible repercussions and specific mechanism of decision-making ultimately constitute public choice theory subject-matter (For a concise review of the theory see, for example: *A Guide to Modern Economics* P.65-109). From the point of view of a present paper one should take under consideration that already for certain period of time influence of globalization on the totality of public good started to attract attention of researchers. Respectively, they claimed emergence of particular international/global public goods sub-totality. Its elements are both vitally needed and available to either all or overwhelming majority of people living on our planet. Environmental protection and conservation of biological diversity represent the most obvious examples of global public

goods. (*W.Nafziger,* P.434-437)[1]. In addition to these, various processes and phenomena (FDI inflows to least developed countries, reduction of uncertainty level in international economic cooperation, international stability, international humanitarian aid, fundamental scientific knowledge, etc.) are also put on the list by different authors (*Ch.Kindleberger; J.Stiglitz).* Under the circumstances one might sensible ask whether international trading system and the WTO rules as its core have to be included into the group. Affirmative answer to this question in particular is given by Ronald U. Mendoza. At the same time, as a result of analysis he concludes that international trade regime constitutes global public good only formally, while failing to meet respective requirements in content. With due respect to above-mentioned conclusion, the author of a present paper would prefer to elaborate more specifically on formal conformity. It looks like at least some doubts are appropriate in this context. It is known that so called pure public goods has two fundamental features – non-excludability and non-rivalry. The former relates to the impossibility to deny via market mechanism of an access to both enjoying benefits of consumption and sharing production costs for a certain good. The latter means that additional consumers do not influence negatively possibilities for the initial ones. Is international trading system in conformity with these two characteristics? Let's try to answer this question with respect to main functions the WTO has to perform according to Article III of Marrakesh Agreement[2]. This is more specific approach in comparison with general assessment of international trading system in Mendoza's paper.

Testing WTO with basic pure public good criteria

First function WTO has to perform is defined as ***implementation, administration and operation of the Agreements***. In fact it relates to the whole set of activities aimed at enforcement of the contracts negotiated between the members with respect to key parameters of their trade policies. One could sensible argue that this is in a way similar to the main task, which at the level of an individual country national state has to pursue. In terms of ***non-excludability*** no serious problems tend to appear. One might claim that the function of implementation, administration and operation of the WTO Agreements is in almost total conformity with this criterion. The fact that any intergovernmental economic organization in its contract enforcing capacities is less powerful than national state does not mean much from the point of view of our discussion. Meanwhile in comparison with World Bank (WB) or International Monetary Fund (IMF)[3] World Trade Organization is to certain extent worse equipped. Indeed, at the first stage it can just record the mere fact of infringement and demand certain steps to be taken by respective infringer-member in order to put its trade policy in compliance with the existing rules[4]. In case this basically moral pressure doesn't generate sufficient result victim might be allowed to retaliate in this or that way to compensate damage[5].

In case of ***non-rivalry*** criterion the situation is not that clear. The point is that efficiency of implementation and administration is connected with a number of member-states in a complicated way. On the one hand, having in its disposal no serious instruments of direct compulsion WTO has nothing to do but to rely upon sincere commitment of its members to the obligations they have accepted. Under the circumstances increase in a number of member-states results in growing moral prestige and authority of the institution, contributes to its status of one of the leading international economic organizations. Simultaneously same rules and norms start to cover larger volume of international trade and other related transactions[6]. On the other hand, under the circumstances one has to control increasing total number of both potential and real infringers of existing "rules of the game". This means that *paribus ceteris* less attention could be given to each individual infringement[7]. As a result quality of implementation and administration of the Agreements would seriously suffer[8]. Hence, with regard to this function of the WTO

[1] It is worth mentioning that while making the subject of scientific discussion quite recently, global public goods *per se* have already existed for a long time. As an example, metrical system had been initially introduced in France in 1795. It became international in 1875 when17 countries adopted Metrical Convention. At the same time, only as late as expansion in scope and scale of international economic collaboration achieved certain level of maturity metrical system turned into significant factor able to reduce transaction costs and ultimately got global public good status. Similarly, atmosphere from the very beginning had been among crucial preconditions of a people's life. Meanwhile, until recently human activity could not meaningfully influence atmosphere. Hence, there was no sense to debate its protection.

[2] It is interesting to note that official site of World Trade Organization (www.wto.org) adds to the list of functions indicated in Marrakesh Agreement yet another one – ***technical assistance and training for developing countries***. It aims to compensate lack of expertise hampering their full-scale participation in activities of the WTO. The goal is of course totally legitimate and urgent. At the same time, the number of benefit-recipient countries in this case is limited by definition. Hence one could hardly prove global character of this public good. Due to that reason present paper sticks to Marrakesh list of functions version.

[3] Both institutions are able to execute direct financial influence towards relatively large number of international community members while providing of refusing to provide their loans. It goes without saying that nowadays the amount of these resources is pretty modest in comparison with capital under control of private investors. Nevertheless, James Gerber (2008, p.27) reasonably claims that WB or IMF refusal is often perceived by private lenders as a serious signal to increase the price of borrowing.

[4] It is worth taking under consideration that "reasonable period of time" (which might be lengthy enough) is normally given to do that.

[5] Abovementioned compensation could be quite substantial. In particular in August 2002 WTO allowed EU to impose on import of certain products from US additional 100% *ad valorem* charge in a maximum amount of $4,043 bln. annually to neutralize American infringement of Agreement on Subsidies and Countervailing Measures. (*Daily, Michael* P.11).

[6] All abovementioned explains why the WTO is not just formally open institution but has real interest in accession of new members.

[7] From the author's point of view precisely this type of concerns provides rationale to quite a rigid mechanism of accession operating within the WTO.

[8] One might argue in some other cases normally perceived as classical examples of pure public goods situation is similar. In particular this seems to be true with regard to national security or law

clear features of so called ***congestible public good*** might be recorded[9]. It is known as a commodity or a service in case of which after certain point utility derived by already existing consumers starts to diminish hand by hand with growth in number of new ones. More than that, in contrast to pure public good congestible one after reaching "point of congestion" implies additional costs both for old and new consumers. Accession of new members to the WTO provides vivid illustration of abovementioned. Indeed, member states and candidate-country equally participate in respective negotiations allocating to this activity certain amount of human and material resources. During a bit more than decade long history of the WTO accession negotiations tended to become longer as well as more complicated for each next candidate. Of course, this trend should not be attributed to enlargement of the organization as the only reason. Nevertheless, its influence seems to be significant enough.

Next function of the WTO is ***forum for negotiations provision***. First of all it's worth mentioning that in this case some experts challenge "non-market" nature of the process *per se*. In particular, *Bernard Hoekman and Michael Kostecki* (2001, P.28) argue that multilateral trade negotiation (MTN) "is a market in a sense that countries come together to exchange market access commitments on a reciprocal basis. It is a barter market. In contrast to the markets one finds in city squares, countries do not have access to a medium of exchange; they do not have money with which to buy and against which to sell, trade policies. Instead they have to exchange apples against oranges: tariff reductions for iron against market access commitments for cloth. This makes the trade policy market less efficient than one where money can be used, and is one of the reasons that MTNs can be a tortuous process". Under the circumstances one might ask whether public choice theory designed to deal with "non-market" phenomena is applicable at all. From the author of a present paper perspective an answer to aforementioned question is unconditionally affirmative. In fact, barter type of "negotiating transactions" does not matter much. These transactions should be perceived as "non-market" ones due to "non-market" mechanism of "price setting". Indeed, "prices" (tariff reductions, etc.) are calculated by certain officials either on the basis of their own perceptions of what is "good" and "bad" for their national economy or at best taking under consideration various signals sent by different professional groups lobbing own often mutually conflicting interests. Hence, function of forum for negotiations provision belongs to the area we are interested in. At the same time from the point of view of abovementioned criteria situation appears to be different in comparison with administration and implementation of the Agreements. One might sensibly argue that in terms of ***non-rivalry*** everything is fine. The fact that delegations from countries A and B thoughtfully listen to a representative of country C making his/her speech in no way diminishes the chances for delegations from countries D, E, and F to get the same information.

More than that, the author of the present paper has already mentioned that efficiency of the WTO system largely depends upon its moral authority. This means that increment in amount of countries participating in negotiations substantially adds to their significance. In other words, utility for each individual country not just remains the same but tends to increase. Similarly, from transaction costs point of view and taking under consideration utter scarcity of resources needed for successful negotiations (availability of well-qualified negotiators, numerous time constrains, etc.) potential benefits provided by mere opportunity to exchange views on a regular basis are positively correlated with representativeness and international image of a gathering. Under the circumstances some kind of economy of scale phenomenon appears to manifest itself. In case of ***non-excludability*** criterion there are some serious problems. In particular, it is well-known that about one third of all WTO members from the group of developing and least developed countries due to the lack of financial and human resources can't afford actual participation in activities organization carries out at the level of working parties, groups and committees. Equally they do not keep permanent missions in Geneva. Hence, one might perceive this as a special type of a price, which member-states have to pay (in addition to their regular contribution to the WTO budget and the budget of the Appellate Body) for real comprehensive participation in organization's work. In addition to that yet another informal institutional barrier excluding even larger amount of the WTO members from decision making process has to be mentioned. Namely this is a practice of so called "green room" consultations[10]. Already during Tokyo round representative of leading countries frequently met to discuss acceptable solutions to this or that issue. Uruguay round and later on negotiations within the framework of the WTO inherited both mechanism and its title regardless of the place these gatherings were organized. It goes without saying that both cases are open to different interpretations. In particular, on might perceive them as certain examples of free riding usually directly linked to provision of public goods. Within this context abovementioned countries get access to international trading rules without contributing any resources to a hard process of their elaboration. In addition to that "green room" consultations arguably help to facilitate decision-making and ultimately promote efficiency of negotiations. At the same time *Bernard Hoekman and Michael Kostecki* (2001, P.61) sensibly

and order, especially if we would treat them not just as an actual existing *condition* but as a *process*. Indeed, for example extension beyond certain reasonable level the number of streets being monitored and protected by individual policeman would *paribus ceteris* inevitably result in growing probability of criminal offences.

[9] Motorway is normally considered to provide a classical example of congestible public good.

[10] "Green room" – is a conference room nearby Director-General's office in rue de Lausanne 154.

claim that many developing countries that were excluded from these gatherings felt that they not being kept properly informed and had no opportunity to express their views. It is not by chance that in recent years certain attempts were made to increase transparency of negotiations with periodical reports on results of "green room" consultations to plenary meetings (*Gallagher,* 2005. P.98-99). Nevertheless, in terms of present discussion regardless of possible interpretations overall conclusion looks straightforward. In its function of forum for negotiations provision the WTO has clear symptoms of so called ***excludible public good***. Theoretically it relates to the situation when certain price or/and another might barrier make non-excludability requirement impracticable. This is precisely what we have in our case.

Third function of the WTO is ***dispute settlement***. They normally reflect the situation when some policy instruments or measures taken by one member-state economically damage (directly or indirectly) another member of the organization or its economic agents. It is commonly recognized that the WTO dispute settlement mechanism proves to be substantial improvement in comparison with its predecessor operating within the framework of GATT. In certain sense this mechanism is unique for the whole system of international economic organizations. At the same time one has to take under consideration that retaliation stipulated by existing international trade rules might be seriously challenged from the point of view of standard economic theory. First of all, it doesn't look as something irreproachable with respect to the target country. Indeed, those economic agents that are actually punished by retaliation neither have done anything wrong by themselves, nor have got any outlawed support from their national government. Secondly, measures under review are largely counter-productive for the imposing country. The point is that they result in some extra defense for the producers who basically do not need it. At the same time national consumers loose in terms of their economic welfare. All this tends to generate various distortions which in turn allow doubting the very possibility to evaluate dispute settlement mechanism as a good. Certain excuse in this case is provided by the fact that retaliation constitutes the very last extreme tool. It has to be used only when all foregoing measures have brought no meaningful result.

According to Article III:2 of "Understanding on Rules and Procedures governing the Settlement of Disputes" (*The Legal Texts*. 1999. P.355) "The dispute settlement system of the WTO is a central element in providing security and predictability of the multilateral trading system". In other words, function under discussion is closely and directly linked to the function of implementation, administration and operation of the Agreements. The former basically creates additional guarantees for successful realization of the latter. Under the circumstances one is really tempted to draw a parallel between these functions with respect to ***non-rivalry*** criterion. Indeed, wouldn't it be logical enough to suggest that in case of substantial increase in a number of member-states applying for dispute settlement some kind of a "traffic-jam" might arise[11]? Evidences accumulated for more than ten years of the WTO performance do not provide any meaningful support to hypothesis of reaching (say nothing of exceeding) dispute settlement system physical capacities. At the same time, mechanism appears to be relatively time-consuming. All respective procedures (including hearings of appeals from panel cases) might legitimately take up to 15 months. Does this type of time-frame really fit the notion of "prompt settlement" stipulated in Article III:3 of "Understanding on Rules and Procedures governing the Settlement of Disputes" (*The Legal Texts*. 1999. P.355)? Certain vagueness both in terms of requirement to implement recommendations and rulings and interpretation of "reasonable period of time"[12] probably also should be taken into account. Meanwhile, even regardless of last consideration in average it took 34 months (instead of 15) to settle a dispute within the framework of the WTO (*Trofimenko,* 2008. P.87). At current stage of research[13] author of the present paper would prefer to refrain from any straightforward final conclusion with respect to the issue. At least from a formal point of view assuming sufficient amount of resources needed to establish any necessary number of panels working in parallel with each other as well as being in accordance with presumption of innocence principle, one might claim that dispute settlement mechanism in general conforms to ***non-rivalry*** criterion.
In case of ***non-excludability*** criterion situation appears to be the following. With respect to forum for negotiations provision existence of some barriers preventing substantial amount of the WTO members from actual participation in the process has been already mentioned. Similarly, involvement in dispute settlement procedures also requires certain financial and intellectual resources. Many developing countries and practically all LDCs do not have these resources. Available statistics clearly illustrate that. For example, by the end of September 2007, 369 disputes were

[11] Situation here largely depends upon time-span. In a short- and a medium-run high efficiency of the dispute settlement mechanism might tend to stimulate growing number of applications and hence increase probability of abovementioned "traffic-jam". In contrast to that, in a long-run high efficiency of dispute settlement mechanism should promote discipline among participants of international trade; convince them that benefits of being law-obedient are higher than possible gains of violation.

[12] Article XXI:3 of "Understanding on Rules and Procedures governing the Settlement of Disputes" in particular runs: "If it is impracticable to comply immediately with the recommendations and rulings, the Member concerned shall have a reasonable period of time in which to do so". The Article also includes criteria to define duration of this period stipulating that it "should not exceed 15 months". On the other hand, that time may be extended "depending upon particular circumstances" (*The Legal Texts*. 1999. P.368-69).

[13] More profound analysis has to take under consideration the fact than for the period of 1995-2006 number of official complains varied from 12 to 50 (*Leitner, K and S. Lester.* 2007. P. 166). Under the circumstances it looks expedient to investigate whether any correlation exists between amount of complains and duration of dispute settlement.

registered in the WTO (*Update of WTO Dispute Settlement Cases*). For all that developing countries tend to initiate disputes much more seldom than developed ones (*Leitner, K and S. Lester.*P.167). As for LDCs they have done this just once – in 2004 Bangladesh has complained against anti-dumping measures applied by India on batteries (*Dispute DS306*). The fact that in order to enjoy advantages of the WTO dispute settlement system individual member-state has to bear certain costs might be interpreted in different ways. Approach elaborated by Joseph Stiglitz in his famous article "Knowledge as a Global Public Good" is of obvious relevance here. In particular, he distinguishes a good *per se* from a service of providing an access to it. According to Stiglitz, this service, firstly, could be supplied by private economic agent who would charge the clients; secondly, even being perceived as additional expenses for the consumer price under review does not change public nature of a good. With all respect to above-mentioned opinion, author of the present paper can't share it. Indeed, classical interpretation of a public good assumes not just formal but actual, real possibility for everyone to consume it without any special efforts and preconditions. For example, signals of lighthouse are seen by each and every vessel sailing by. That is why neither *de-jure* nor *de-facto* barriers can be introduced to limit an access to these signals[14]. In case of the WTO dispute settlement system situation is different. Under the circumstances function under discussion has clear symptoms of ***excludible public good.***

Fourth function of the WTO is known as ***trade policy review***. This actually means comprehensive information support of modern international trade system, making it more transparent and open. Trade policy review mechanism aims "to contribute to improved adherence by all Members to rules, disciplines and commitments made under the Multilateral Trade Agreements" (*The Legal Texts*. 1999. P.380). In other words, organization itself perceives this function as a complementary one with respect to implementation, administration and operation of the Agreements. At the same time reviews should not be directly used for the purpose of dispute settlement or coercion to new commitments. The fact that timing of reviews differs from country to country[15], can hardly be treated as a display of favouritism or discrimination. In general, in author's opinion this function basically conforms to both ***non-excludability*** and ***non-rivalry*** criteria. At last, fifth function of the WTO named in Marrakesh Agreement is ***achieving coherence in global economic policy-making***. It assumes collaboration with other international institutions, first and foremost International Monetary Fund and World Bank. This type of collaboration nowadays is not just advisable but clearly necessary due to several reasons. In particular they are increasing controversial interrelations between various forms of international economic co-operation and the fact that many international organizations (frequently overlapping with each over) are currently involved in elaboration and implementation of global economic policy. Certain legal and organizational prerequisites to coordinate activities of global regulators already exist. For example, Article XV:6 of GATT-1994 links together WTO and IMF. Any member of the former must within a stipulated time become a member of the latter or (in case of failing to do that) "enter into a special exchange agreement" with all WTO member-states (*The Legal Texts*. 1999. P.444).

It goes without saying that in real terms above-mentioned collaboration does not go smoothly. In particular, there are some evidences of explicit competition between international institutions trying to secure for themselves leading role in dealing with this or that global problem. Nevertheless, this by no means signifies competition for the results of coherent global economic policy making between WTO members. On the contrary, the author would argue that regarding this function both public goods criteria are successfully met. Now let us summarize the results of carried out analysis. They are depicted in Table 1.

Table 1. Conformity of the WTO functions with pure public good criteria

Functions Criteria	Implementation and administration of the Agreements	Forum for negotiations	Dispute settlement	Trade policy review	Coherence in global economic policy-making
Non-excludability	yes	no	no	yes	yes
Non-rivalry	No	yes	yes	yes	yes

Conclusion

Four following points might conclude our discussion.

Firstly, norms and rules of the WTO, which at the moment constitutes foundations of the modern international trading system in general, **do not conform to pure public good criteria**. In case of three out of five World Trade Organization functions there are clear features of either congestible public good (implementation and administration of the Agreements) or excludable public good (forum for negotiations provision and dispute settlement). Meanwhile, these are key, crucial functions. Secondly, assuming that pure

[14] Applying Stiglitz logic one has to imagine a very special type of lighthouse being switched on, firstly, only for a short period of time and, secondly, without any regularity at all. Under the circumstances private middleman could charge captains certain price for information on lighthouse working-minutes schedule. As for the signals *per se*, they would be supplied on a free basis.

[15] In case of four leading trading nations (at the moment – EU, USA, Japan and China) reviews have to be done on biannual basis. Next sixteen international traders must be reviewed once in four years, the rest – once in six years. Finally, for LDCs extension might be applied. (*WTO Annual Report 2005*. P.57).

public good is hardly more that abstract theoretical notion assessment of the **WTO rules** in line with other **GPGs** appears to be totally legitimate. Thirdly, **formal non-conformity** of the WTO rules with pure public good criteria results from the fact that also in its **content** rules under review have certain features of congestible public good as well as of excludable public good. This rather demonstrates integrity than dichotomy of the modern international trading system claimed by Ronald Mendoza and other like-minded persons. Hence, any attempts to improve WTO performance should probably take above-mentioned under consideration. Fourthly, **public choice theory** provides **promising and stimulating framework** for the analysis of global governance in general, international trading system in particular.

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The South-Eastern Balkans as a Common Economic Space: Comparison of Business Environments

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Abstract

Located in the South-eastern Balkans Bulgaria, Greece, Macedonia, Romania, Serbia and Turkey have had quite different historical and socio-economical paths after the collapse of the Ottoman Empire more than a century ago. Based on an extensive comparison of various statistics and indicators this article argues that their contemporary economic and business landscapes represent significantly more homogeneous environment than one may expect. Then it reviews the intra-regional trade and investments flows and argues that the potential for regional integration is gaining momentum but still remains significantly underutilized.

***Keywords*:** South-eastern Balkans, business environment, economic indicators, regional development
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1. Introduction

The South-eastern Balkans is an interesting region in terms of its historic, political and economic developments. Being portrayed mostly in negative features the Balkans and the corresponding term "balkanization". "Balkanization" is a geopolitical term originally used to describe the process of fragmentation or division of a region into smaller regions that are often hostile or non-cooperative with each other. The term has arisen from the Balkan conflicts in the 20th century. Geographically the Balkans is also quite imprecise term. Sometimes one may see Albania, Slovenia or Moldova being included among the Balkan countries. Especially after the wars following the Yugoslavian disintegration some authors used to call the Balkans the countries in former Yugoslavia. The European Union itself started using the term South-eastern Europe which is equally imprecise as it also excludes several regions that rightly belong to this geographic description. That is why it is worth specifying that in this article South-Eastern Balkans refers to Bulgaria, Greece, Macedonia, Romania, Serbia and Turkey. Being at the heart of the Balkans these countries share some turbulent and distinctively different history. For several centuries they all belonged to the Ottoman Empire before fighting for their independence and gaining it in the late 19 century. Their newly gained independences hardly contributed towards peaceful coexistence and drive for regional integration. In several Balkan wars in the beginning of the 20th century these countries fought fiercely with each other. The cold war brought division again – Bulgaria and Romania were left in the Soviet sphere of influence and soon became Soviet satellites. Turkey and Greece had some experience with military regimes while Serbia and Macedonia chose some middle way of neither socialist nor capitalist country united in the Yugoslav federation. The end of the 20th century brought more changes and in 1981 Greece became a member of the European Economic Community. By 1990 the socialist system collapsed in Bulgaria and Romania and Yugoslavia started rapidly disintegrating. As of 2007 the south-eastern Balkans represent an interesting group of neighbouring countries: Bulgaria, Greece and Romania being EU members, Turkey and Macedonia being in accession negotiations with the European Union and Serbia hoping one day soon to start similar process of accession negotiations.

This article pursues two objectives. One is to investigate the impact of these historically different paths on the

general economic and business environment in the region. The second is to analyze regional trade and investment patterns and interpret what their values and dynamics may say about the level of regional economic integration. The article objectives define its structure that consists of two parts. It starts with an attempt to build a comparison of economic indicators that must demonstrate how different these countries became in terms of their economies and business landscapes after more that 120 years of different historical paths. The second part focuses on the regional economic integration whose level of development is again determined through analyzing the figures reflecting intra regional trade and investments.

2. Comparing basic economic indicators

This paragraph investigates how big are the differences between the countries in the region based on comparing various economic indicators. The article tries to choose a standard set of indicators such as GDP, inflation, unemployment, Foreign Direct Investments /FDI/, trade balance and foreign debts. While these parameters may not provide a complete picture they may serve well in seeking to answer the question if the region represents more homogeneous or heterogeneous economic space. As it could be seen in Table 1 in terms of GDP volume the regional economic power houses are Greece and Turkey. Turkey's GDP as of 2006 was approximately 30% bigger than the one of Greece while The Greek GDP is more than twice bigger than the Romanian GDP while the Romanian GDP was some 3,6 times bigger than the one of Bulgaria. Considering the great variations of size of their populations it is certainly worth transferring the GDP figures into GDP per capita. In that case as demonstrated in Table 1a the situation changes.

Table 1: GDP in current prices in 1996 - 2006, US$ bln

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	9.9	10.4	12.9	13.0	12.6	13.6	15.6	20.0	24.3	26.7	30.6
FYR Macedonia	4.4	3.7	3.6	3.7	3.6	3.4	3.8	4.6	5.4	5.8	6.3*
Romania	35.3	35.2	42.1	35.7	37.1	40.2	45.8	59.5	75.5	98.6	121.9
Serbia	n/a	n/a	n/a	n/a	9.0	11.8	15.8	20.3	24.5	26.2	31.6
Turkey	178.1	186.1	197.6	181.7	198.2	143.1	183.0	240.6	302.6	362.5	392.4*
Greece	156.5	152.9	153.8	158.3	146.6	150.5	170.9	222.3	264.5	284.2	307.7*

Source: IMF, 2007 / * estimate

The ultimate leader in this case appears to be Greece having almost 5 times better results than the second best Romania and Turkey. On this basis one may conclude that indeed that there is a great discrepancy between the oldest EU member among them Greece and the rest. Still these figures should be treated with great caution as they certainly do not account the grey sector of the economy in the countries in question.

Table 1a. GDP per capita in current prices 1996 – 2006, USD

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	1,204	1,270	1,585	1,612	1,581	1,713	1,979	2,560	3,135	3,462	3,995
FYR Macedonia	2,236	1,883	1,798	1,836	1,783	1,705	1,864	2,285	2,648	2,836	3,059*
Romania	1,566	1,567	1,886	1,608	1,676	1,825	2,088	2,721	3,464	4,539	5,633
Serbia	n/a	n/a	2,127	1,476	1,193	1,567	2,111	2,718	3,285	3,511*	4,220*
Turkey	2,887	3,008	3,175	2,876	2,995	2,126	2,675	3,463	4,289	5,062	5,408*
Greece	14,571	14,140	14,138	14,485	13,353	13,659	15,473	20,075	23,832	25,560	27,610*

Source: IMF, 2007 / * estimate

The grey economy is a significant problem for Greece but is even more rampantly present in the other countries in the region. For instance in 2003 in Bulgaria 55% of the companies employing less than 100 employees and 4,5% of the companies employing more than 1000 employees do not report 26-50% of their turnover. 87,5% of the companies employing less than 100 employees and 25% of the companies employing more than 1000 employees do not report 11-25% of their turnover (*Vitosha Research, 2003*). As of 2003 in Romania the income from the informal economy amounted to about 22,7% (*Albu, 2003*). It is not very different situation in Serbia – the Serbian GDP in reality could be as much as some 35% bigger (*Marinkovic, 2004*). The situation in Greece is not much better and according to the IMF its large and probably expanding informal economy is estimated at 30-40% of GDP. The informal economy in Greece

is 5-10% of GDP larger than in other southern European countries. This reflects ineffective administrative controls and enforcement mechanisms, over-regulation -especially in the labour market—and relatively high tax rates (*IMF, 2006*). The above figures do not attempt to analyze the sources and exact size of the informal economy in the selected countries but to demonstrate that in reality their GDP is somewhat higher than the official statistics would indicate. The differences in GDP per capita are however much smaller if one uses the IMF developed measurement in international dollars[1] as it is shown in Table 1b. Again it is interesting to observe that while Greece is the undisputed leader the difference between Greece and the rest is considerably smaller. Furthermore while the Greek growth rate in the last two years is between 6 and 7% the corresponding figures for Romania and Bulgaria are between 8 and 10%.

Table 1b. GDP (PPP) per capita in 1996 – 2006, international dollars

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	5,193	5,024	5,320	5,558	6,026	6,466	6,948	7,494	8,188	8,949	9,799*
FYR Macedonia	5,058	5,195	5,404	5,695	6,060	5,905	6,043	6,331	6,763	7,221	7,707*
Romania	6,089	5,847	5,655	5,698	5,974	6,496	6,974	7,521	8,417	9,056	9,869*
Serbia	n/a	n/a	n/a	n/a	4,212	4,541	4,831	5,067	5,711	6,248*	6,771*
Turkey	5,890	6,418	6,651	6,333	6,632	6,178	6,677	7,101	7,834	8,539	9,107*
Greece	14,650	15,332	15,932	16,634	17,682	18,957	19,967	21,309	22,891	24,399	25,975

Source: IMF, 2007 / * estimate

As shown in Table 2 when it comes to inflationary pressures, with the exception of Greece and Macedonia, all other countries had to address the problem of high inflation during the last 10 years. Recently it seems there is single digit inflation with the exception of Serbia.

Table 2. Inflation rate in consumer prices 1996 – 2005, annual % change

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	123.0	1,061	18.8	2.6	8.2	7.5	5.8	2.3	6.1	5.0	7.3
FYR Macedonia	2.3	2.6	1.4	-2.7	5.8	4.8	2.2	1.4	0.1	0.5	3.2
Romania	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9.0	6.6
Serbia	n/a	n/a	30.0	41.1	70.0	91.8	19.5	11.7	10.1	17.3	12.7
Turkey	80.3	85.8	84.6	64.9	54.9	54.4	45.0	21.6	8.6	8.2	9.6
Greece	7.8	3.7	4.5	2.1	2.9	3.7	3.9	3.4	3.0	3.5	3.3

Source: IMF, 2007

The unemployment figures are perhaps one of the indicators that clearly show the serious problems that Macedonia and Serbia currently experience. In the absence of other reliable indicators unemployment could be very useful in analyzing in what phase is exactly the economy concerning its structural reform. Table 3 may confirm that Serbia and Macedonia are either still reaching for bottom or just starting their bottom up movement. The rest of the countries show somewhat similar unemployment levels with Romania having considerably lower figures for 2005 and 2006. These results could be interpreted positively as the exception of Serbia and Macedonia the other countries experienced significant structural changes in their economies that resulted in much higher levels of unemployment at the end of the 1990s.

Table 3. Unemployment rate in 1996 – 2006, % of labour force

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	11.1	14.0	2.2	13.8	18.1	17.5	17.4	14.3	12.7	11.5	9.6
FYR Macedonia	31.9	36.0	34.5	32.4	32.2	30.9	31.9	36.7	37.2	37.3	36.0
Romania	7.3	7.3	9.2	11.3	11.2	9.0	10.2	7.6	6.8	5.8	5.4
Serbia	n/a	n/a	n/a	n/a	13.26	13.36	14.47	16.00	19.53	21.8	21.6
Turkey	n/a	n/a	n/a	n/a	5.2	6.8	8.9	9.3	9.0	8.8	8.4
Greece	8.0	8.3	10.3	12.0	11.2	10.6	10.3	9.7	10.5	9.9	8.9

Sources: Deutsche Bank Research, National Bank of Macedonia, Eurostat, Serbian Statistical Office

[1] The **international dollar** is a hypothetical unit of currency that has the same purchasing power that the U.S. dollar has in the United States.

Figure 4 and 4a illustrate the external debt of the countries in the region. In terms of foreign debt as percentage of GDP it is Serbia and Bulgaria that look on shaky grounds with Turkey not far behind. Still in terms of foreign debt to exports ratio for 2005 it is Greece that looks the most worrying case followed by Serbia and Turkey. World Bank and IMF hold that "a country can be said to achieve external debt sustainability if it can meet its current and future external debt service obligations in full, without recourse to debt rescheduling or the accumulation of arrears and without compromising growth." According to the International Monetary Fund and the World Bank external debt sustainability approximates a net present value (NPV) of external public debt down to about 150% of a country's exports or 250% of a country's revenues (*IMF & World Bank, 2001*).

Table 4. External debt in 1996 – 2005, US$ bln

External Debt										USD Bn
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Turkey	79,38	84,24	96,26	103,13	118,50	113,56	130,16	145,00	162,26	170,59
Greece	34,20	33,00	50,90	53,40	56,80	60,40	63,40	65,83	69,43	75,18
Macedonia	1,17	1,13	1,47	1,50	1,55	1,49	1,64	1,84	2,08	2,28
Serbia	13,3	10,7	10,9	10,4	10,8	11,1	11,2	13,6	12,9	14,3
Romania	9.0	10.5	11.3	10.5	11.6	13.9	17.3	22.5	28.9	37.0
Bulgaria	9,60	9,80	10,30	9,10	9,00	10,29	10,63	10,80	15,90	15,50

Source: Author's compilation (see references)

Table 4a. External debt's share in GDP and exports in 2005, %

	External debt as a % of GDP	Export earnings	External debt to exports ratio (%)
Turkey	47,3%	72,5	235
Greece	34,2%	18,5	406
Macedonia	43,0%	2,1	111
Serbia[1]	74,5%	4,6	311
Romania	38,1%	27,7	134
Bulgaria	57,3	11,7	133

Source: Author's compilation (see references)

Table 4a shows that while in terms of external debt to exports ratio Greece seems to be in dire straights together with Serbia and Turkey it will be Bulgaria and Serbia for which the external debt is over 50% of their GDP. Another worrying indicator could be the persistent trend of having negative foreign trade balances. Undoubtedly as shown in Figure 5 all selected countries are running a negative trade balance – even more concerning is its trend to become bigger every year. That may be quite indicative of their general economic competitiveness but also reflects the fact that with the exception of Romania none of these countries possesses significant resources of oil and natural gas and thus has to face their constantly growing international prices.

Table 5. Foreign trade balance in 1996 – 2006, US$ bln

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	0.2	0.4	-0.4	-1.1	-1.2	-1.6	-1.7	-2.6	-3.7	-5.4	-6.7
FYR Macedonia	-0.3	-0.4	-0.5	-0.5	-0.7	-0.5	-0.8	-0.9	-1.1	-1.1	-1.3
Greece	n/a	n/a	-15,4	-14,5	-17,9	-17,9	-17.9	-23.9	-29.7	-34.7	-15,4
Romania	2.5	-2.0	-2.6	-1.1	-1.7	-3.0	-2.6	-4.5	-6.7	-9.6	-14.8
Serbia	n/a	-1.5	-1.1	-1.1	-1.4	-2.1	-3.1	-3.8	-6.3	-5.3	-6.3
Turkey	-10.6	-15.4	-14.2	-10.4	-22.4	-4.5	-8.4	-14.0	-23.9	-33.5	-39.9

Sources: Deutsche Bank Research, National Bank of Macedonia, National Bank of Serbia, Kokkalis Program

This negative trend of running foreign trade balances is somewhat balanced by a constant inflow in the amount of foreign direct investments the selected countries manage to attract. Table 6 and 6a demonstrate the dynamics and the volumes of incoming FDIs for a period of 10 years between 1996 and 2005. It seems that in terms of absolute volume Turkey is the biggest country recipient of FDI with some total of US$21,9 billion.

[1] Excluding Kosovo and Montenegro.

Table 6. Foreign Direct Investments in 1996 – 2005, US$ mln

FDI										USD mn	
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Turkey	722	805	940	783	982	3352	1137	1752	2847	8600	21920
Greece	1058	984	71	567	1083	1560	50,3	585	1088	1197	8243,3
Macedonia	11	30	128	32	175	441	78	94	156	97	1242
Serbia	0,00	740	113	112	25	125	475	1360	969	1481	5400
Romania	265	1 224	2040	1007	1051	1154	1080	1946	3035	5500	17078
Bulgaria	256	636	620	819	1002	813	905	3443	2488	2300	12377

Source: Author's compilation (see references)

In terms of FDI per capita it appears that Bulgaria outperforms the others being almost two times ahead of the second best Greece and Romania. It is worth noting that in terms of FDI per capita the results of Serbia and Macedonia are not far from the results of Greece and Romania. Especially considering that the former two are still in the more "emerging" phase being emerging economies.

Table 6a. Foreign Direct Investments per capita (accumulated) in 1996 – 2005

FDI per capita in USD	
	1996-2005
Turkey	311
Greece	771
Macedonia	605
Serbia	574
Romania	766
Bulgaria	1491

Source: Author's compilation (see references)

The provided above economic indicators may support the somewhat surprising thesis that for all their different history with its political and economic consequences the countries in the South-Eastern Balkans appear to be not dramatically different in their overall level of economic development. After more than 25 years of EU membership and being one of the biggest recipients of EU financial support for most of this period Greece is the country that could be distinguished as the region's richest economy. Still in many respects such as presence of grey economy, trade balance deficits and external debts the observed countries seem to have similar problems. In a region known for its strong national sentiments and rivalries such an observation might be not accepted. Still from point of view of a potential investor in many respects the region looks to be rather homogenous economic area in terms of both advantages and shortcomings. It is for politicians and decision makers in the region to decide if to turn this into an advantage by positioning a region as a large economic space with similar business environment and underdeveloped markets that offer promising business opportunities. Or they will prefer to choose rather different path of strong relations with the EU while keeping a distance between each other.

3. Intra regional trade and investments

3.1. Business environment

The previous chapter demonstrated that the countries in the South-eastern Balkans have somewhat comparable if not exactly similar economic indicators. Such similarity comes as a surprise in the light of their very different historic backgrounds and corresponding differences in socio-economic developments. This chapter continues the research by pursuing two objectives. One is to highlight that in terms of their competitiveness and the factors that determine it, the selected countries are even more similar and face basically identical challenges. The second is through analyzing the intra-regional trade and investment flows to demonstrate that regional integration has some tremendous potential for future development that may certainly boost economic competitiveness at both regional and national level. Speaking of business climates it is interesting to observe that again there is little difference between national and regional business environments. That is especially intriguing if account for the little regional rivalries and sensitivities that make it insulting for the average Greek to be compared with a Turk or a Bulgarian or for the average Bulgarian to be compared with a Romanian or a Turk etc. For all these self perceptions the business environment in general is quite similar. Table 7 shows the Transparency International Corruption perception indexes for 1996 - 2006.

Table 7. Corruption Perception Index 1996 – 2006 (10 highly clean – 0 highly corrupted)

Corruption Perceptions Index	2006 score	2005 score	2004 score	2003 score	2002 score	2001 score	2000 score	1999 score	1998 score	1997 score	1996 score
Turkey	3,8	3,5	3,2	3,1	3,2	3,6	3,8	3,6	3,4	3,21	3,54
Greece	4,4	4,3	4,3	4,3	4,2	4,2	4,9	4,9	4,9	5,35	5,01
Macedonia	2,7	2,7	2,7	2,3				3,3			
Serbia	3	2,8	2,7	2,3			1,3	2	3		
Romania	3,1	3	2,9	2,8	2,6	2,8	2,9	3,3	3	3,44	
Bulgaria	4	4	4,1	3,9	4	3,9	3,5	3,3	2,9		

Source: TI, 2006

Table 8. Ease of doing business

Ease of...	Turkey		Greece		Macedonia		Serbia		Romania		Bulgaria	
	2006 rank	2005 rank	2006 rank	2005 rank	2006 rank	2005 rank	2006 rank	2005 rank	2006 rank	2005 rank	2006 rank	2005 rank
Doing Business	***91***	***84***	***109***	***111***	***92***	***94***	***68***	***95***	***49***	***71***	***54***	***59***
Starting a Business	53	47	140	134	76	129	60	43	7	6	85	91
Dealing with Licenses	148	145	55	53	86	75	157	158	116	98	140	144
Employing Workers	146	148	166	166	117	116	73	43	101	134	100	106
Registering Property	54	48	94	146	87	75	110	104	114	115	65	66
Getting Credit	65	59	83	76	48	41	33	96	48	41	33	41
Protecting Investors	60	58	156	156	83	81	60	58	33	43	33	33
Paying Taxes	65	61	108	100	79	74	64	65	131	142	107	104
Trading Across Borders	79	69	123	119	127	123	51	142	35	121	104	95
Enforcing Contracts	70	69	48	48	72	99	76	74	45	44	52	52
Closing a Business	138	137	34	33	123	118	103	100	108	112	64	66

Source: The World Bank, 2006

Table 8a. Comparing the ease of doing business in detail

2006	Turkey	Greece	Macedonia	Serbia	Romania	Bulgaria
Starting a Business						
Procedures (number)	8	15	10	10	5	9
Time (days)	9	38	18	18	11	32
Cost (% of income per capita)	26,8	24,2	7,4	10,2	4,4	7,9
Min. capital (% of income per capita)	18,7	116,0	112,0	7,6	0,0	91,3
Dealing with Licenses						
Procedures (number)	32	17	18	20	17	22
Time (days)	232	176	222	211	242	226
Cost (% of income per capita)	150,2	68,8	89,8	1946,7	332,6	270,5
Employing Workers						
Difficulty of Hiring Index	56	44	61	33	33	50
Rigidity of Hours Index	60	80	60	40	80	80
Difficulty of Firing Index	30	50	40	40	40	10
Rigidity of Employment Index	49	58	54	38	51	47
Hiring cost (% of salary)	21,6	31,2	32,5	17,9	33,3	30,1
Firing costs (weeks of wages)	94,7	69,3	21,7	27,3	3,0	8,7
Registering Property						
Procedures (number)	8	12	6	6	8	9
Time (days)	9	23	98	111	150	19
Cost (% of property value)	3,2	3,8	3,5	5,4	1,9	2,3
Getting Credit						
Legal Rights Index	3	3	6	5	4	6
Credit Information Index	5	4	3	5	5	4
Public registry coverage (% adults)	6,7	0,0	2,1	0,1	2,6	20,7
Protecting Investors						
Disclosure Index	8	1	5	7	9	10
Director Liability Index	4	3	6	6	5	1
Shareholder Suits Index	4	5	4	3	4	7
Investor Protection Index	5,3	3,0	5	5,3	6	6
Paying Taxes						
Payments (number)	18	33	54	41	89	27
Time (hours)	254	204	96	168	198	616
Total tax rate (% profit)	46,3	60,2	43,5	38,9	48,9	40,7
Trading Across Borders						
Documents for export (number)	9	7	10	6	4	7
Time for export (days)	20	29	32	11	14	26
Cost to export (US$ per container)	513	1 328	1 070	1 240	1 300	1 233
Documents for import (number)	13	11	10	8	4	10
Time for import (days)	25	34	35	12	14	25
Cost to import (US$ per container)	735	1 443	1 070	1 440	1 200	1 201
Enforcing Contracts						
Procedures (number)	34	22	27	33	43	34
Time (days)	420	730	385	635	335	440
Cost (% of debt)	17,4	12,7	32,8	12,7	10,7	14,0
Closing a Business						
Time (years)	5,9	2	3,7	2,7	4,6	3,3
Cost (% of estate)	7,0	9,0	28,0	23,0	9,0	9,0
Recovery rate (cents on the dollar)	9,8	46,3	15,5	22,6	19,9	34,4

Source: The World Bank, 2006

While all countries demonstrate a tendency to limit the level of corruption all of them remain in the group that is below the average (the average being 5). Still trying to find differences the countries could be divided in two groups: the better scoring are Greece, Bulgaria and Turkey ranked correspondingly in 2006 as 54th, 57th and 60th and group two of the worst doing Romania, Serbia and Macedonia ranked as 84th, 90th and 105th (*TI, 2006*). Another way to compare the national business climates in the region is to use the World Bank "ease of doing business" parameters. As shown Table 8 the selected countries appear to have a more diversified profile. Interestingly enough the country leaders are Romania and Bulgaria with Greece having the worst score. One possible explanation is that Romania and Bulgaria are just coming from major restructuring of their economies and thus have had bigger impetus for reforms. Greece on the other hand may be described as a more "laid back" on reforms as it had stronger and more solid economy together with significant and constant inflow of EU funding. Thus the need for reforms and improvements in the general business environment could have been underestimated by both policy makers and the general public. On the other hand it should be noted that the rankings are quite dynamic as in only one year Romania improved from 71st to 49th place or Serbia moved from 95th to 68th. Tables 8 and 8a underline not only the apparent absence of tangible significant differences in the national business environments but also point to the fact that boosting the national competitiveness in most cases requires facing similar problems and applying similar remedies.

A more detailed survey of the business climate is provided in Table 8b as shown above, which also demonstrates that the disparities within the region are not really that big. Still several parameters show that for all the general similarities sometimes there could be significant differences. In terms of the costs of dealing with licenses measured in % of the income per capita the difference between Greece and Serbia is more than 25 times! Registering property in Romania takes 7 times longer than in Greece and paying taxes in Bulgaria takes 3 times more than in Greece. Then interestingly enough enforcing a contact takes less than a year in Romania but roughly 2 years in Greece.

Table 9. Growth Competitiveness Index and Rankings in 2004 – 2006

Competitiveness	Turkey			Greece			Macedonia			Serbia			Romania			Bulgaria		
	2006	2005	2004	2006	2005	2004	2006	2005	2004	2006	2005	2004	2006	2005	2004	2006	2005	2004
Growth Competitiveness Index	4,14	3,68	3,82	4,33	4,26	4,56	3,86	3,26	3,34	3,69	3,38	3,23	4,02	3,67	3,86	3,96	3,83	3,98
Rank	59	66	66	47	46	37	80	85	84	87	80	89	68	67	63	72	58	59
Category	Medium			Medium			Low			Low			Medium			Medium		

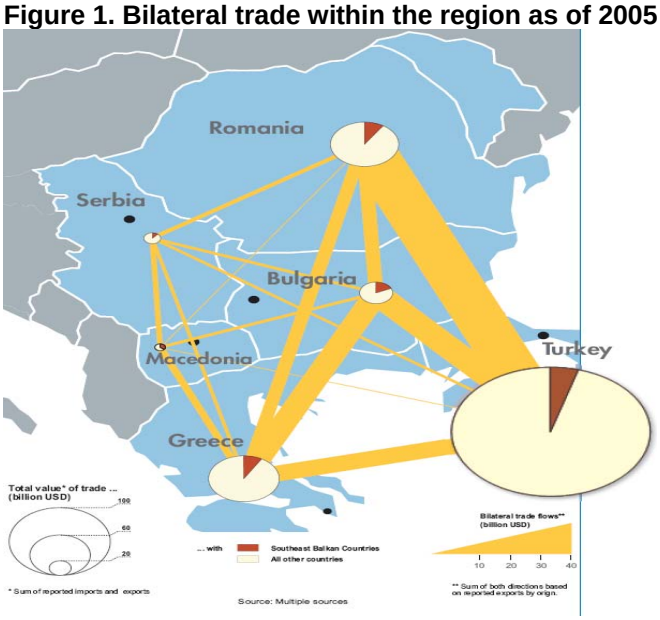
Source: (WEF, 2006)

3.2. Intra-regional trade and investments

The listed above similarities in general economic indicator and business environments basically put similar constraints to the national competitiveness of each country in the selected region and one may argue may require similar remedies. It is very interesting that the tremendously different history after the disintegration of the Ottoman Empire and different paths in their socio - political developments did not have greater impact on their overall economic development and business environments. There is however one very negative consequences stemming from the historical heritage of the region after the collapse of the Ottoman empire – markedly low level of regional integration in general and economic integration in particular.

Speaking of trade it could be very indicative to look at the small share regional trade has in the total foreign trade of each of the selected countries as shown in in the figure it becomes clear that Turkey is a regional trade power house and particularly in its bilateral trade with the other most populous country in the region – Romania. The statistics also clearly suggest the currently negligible share and impact of Serbia and Macedonia on the intra-regional trade. Former Yugoslavia has had very thin links with its then Soviet block neighbours. Being one of the leaders among the non-allied countries Yugoslavia was neither seeking nor actively promoting such trade and investment links. The Yugoslav wars and the embargo during that period only exacerbated the problem as the country missed the reforms carried in other countries in the former socialist block and the consecutive interest of international investors.

Figure 1. Bilateral trade within the region as of 2005



Source: Author's compilation (see references)

Table 10. Bilateral trade in 1995, 2000 and 2005, US$ mln

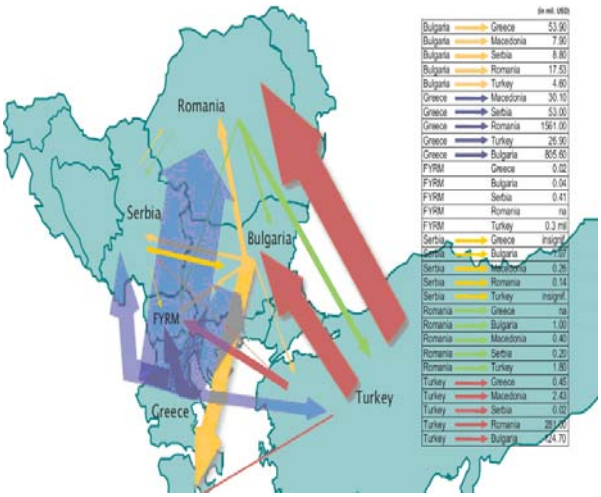
		Turkey	Greece	Macedoni	Serbia	Romania
Greece	1995	410,63				
	2000	868,54				
	2005	1851,50				
Macedonia	1995	126,83	43,07			
	2000	118,24	285,71			
	2005	21,45	609,76			
Serbia	1995	50,50	na	245,85		
	2000	146,10	207,00	525,46		
	2005	261,55	278,47	428,37		
Romania	1995	669,83	363,00	30,17	31,00	
	2000	999,75	696,00	15,14	180,00	
	2005	4068,78	1075,00	69,10	404,28	
Bulgaria	1995	585,20	620,00	511,98	81,00	148,00
	2000	718,34	694,90	124,58	397,70	317,50
	2005	2368,91	2032,92	310,43	295,90	1130,35

Source: Author's compilation (see references)

While the intra-regional trade flows remain unimpressive their dynamics brings optimism and as Table 10 demonstrates in the course of the last ten years the trade growth could be measured in times rather than in percentage points. Especially spectacular is the growth of bilateral trade between Turkey and Bulgaria and Romania. Still these results are far from satisfactory especially if compare them with the regional cooperation of a more successful region in the Baltic Sea. In passing by it is worth making a brief comparison with intra-regional trade in another European region, namely the Baltic Sea region. The bilateral trade between Sweden and Latvia (total population of 11,3 million people) in 2005 was some US$880 million (*LCSB, 2007*)). The bilateral trade between Estonia and Latvia (total population 3,6 million) in 2005 was some US$1,2 billion (*InvestInEstonia, 2007*). That may suggest that in the South-eastern Balkans there is definitely some more growth potential.

While Turkey and Greece have the lead in being the biggest and the most affluent regional trading partners in terms of intra-regional investments it is undisputedly Greece that plays the role of the leading regional investor as illustrated in Figure 2. While Figure 2 shows the 2004 results only it is indicative of the main sources and directions of investments in the Southeast Balkans. The investment power house appears to be Greece and to lesser extent Turkey. The biggest recipients of neighbourhood investments are Romania and Bulgaria. For the period of 1992-2006 Greece appears to be the third biggest investor in the Bulgarian economy accounting for some US$1,8 billion. For the same period the Turkish investments in Bulgaria stayed at some modest US$243 million (*InvestBG, 2007*). By the end of 2005 Greece invested in the Romanian economy some €1,9 billion or about 9% of the total while Turkey invested €412 million or some 2% of the total *(NBR, 2006*). Again a worth noting fact is the absence of significant investment in Serbia in general and in any investments in Serbia from Turkey. Same holds truth when it comes to their mutual trade relations.

Figure 2. Bilateral investments in the region in 2004



Source: Author's compilation (see references)

4. Conclusions

This article had as a main purpose to make an extensive comparison of the countries in the Southeast Balkans with a particular accent on their business climate and intra-regional trade and investment patterns. Managing to compile and present a comparison of various economic indicators the paper succeeded to present a comparative portrait of the country's economies and their development in the period of 1996-2005. The very absence of sources enabling faster and easier collection and assessment of such data is in itself an indication of the low priority assigned to regional integration and economic development. The conducted comparison reaches several important and somewhat unexpected conclusions. Firstly, despite their significantly different socio-political developments in the last 100 years Bulgaria, Greece, Macedonia, Romania, Serbia and Turkey seem to represent in many aspects common economic space – in the level of their overall economic development, in the similar problems their economies face and in the basically similar levels of growth competitiveness. Secondly their intra-regional trade and investment patterns would suggest that the possibilities for regional integration and economic growth are underutilized at best. Another interesting conclusion that can be drawn from the article has to do with the future EU enlargement. Speaking of an economic integration within the region it must be highlighted that Turkey seem to be fairly well integrated player on a regional level. Turkey is undoubtedly a local trade powerhouse and an active investor in the economies of the newest EU members Bulgaria and Romania. As the Turkish relations with Greece will presumably continue their improvement mutual trade and investments will accelerate bringing more economic development for both countries.

Serbia and Macedonia remain to be the most passive players in the intra-regional trade and investments. That has to deal with the ongoing restructuring of the Macedonian economy exacerbated by its ethnic conflicts of 2000 and the continuous political flux in Serbia worsened by the Serbia – EU differences over the future of the Kosovo region. Still the growing inclusion of the two in the regional economic integration will certainly provide a growth momentum for all players in the process. To a large extent it is a question of the normalization of the relations between Serbia and the EU but is a cause worth the lobbying efforts of the EU member states in the region. What is needed is continuous effort to foster more regional cooperation with a particular accent on mutual trade and investments. The article manages to document the insufficient levels of the latter. There are plenty of examples and inconsistencies. Companies fail to use each other market potentials and step by step become regional champions with global ambitious. More intensive regional cooperation will certainly create more competition and thus enable the general competitiveness of the region as a whole.

The present situation suggests for wider and deeper economic integration that includes more of cooperation at every single level be it institutional, entrepreneurial, academia etc. In that respect the region can learn a great deal from the Baltic Rim economies and their generally fairly successful way of cooperation at various levels. This is precisely where further research should have an enormous value for both decision makers and business practitioners in the region. A more detailed comparison between regional integration patterns in the Southeast Balkans and the Baltic Sea countries may certainly bring in the picture best practices and tangible policy recommendations. They may not only boost the regional and national competitiveness in Southeast Balkans but also significantly contribute for the political stability and cooperation between countries that for more than a century did not have a chance to work together.

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Russia's Innovation Policy in 2000s

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Abstract

Russia's economic structure is distinctly different from that of most European countries with its predominance of large companies, concentration on mining and heavy industry, and lack of high-tech consumer goods industries. The large Russian corporations in the natural resource sectors have enough resources to get access to foreign technology that they lack. Companies in traditional Russian high-tech industries (aerospace, defence, machine building) that have inherited technologies at the world frontier now are capable of maintaining their superiority with strong support from the government. International comparisons and benchmarking of national innovation system and policy mix show that generally Russia is moving toward European type of innovation policy and it hardly produced the needed results.

***Keywords*:** R&D, national system of innovation, innovation policy
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Introduction

The transition from a centrally-planned economy towards a market economy has been a rough ride for the Russian Federation, to say the least. Economic production declined sharply during the 1990s, culminating in a major financial crisis in 1998. Under these circumstances, the budget support for R&D dramatically declined during the 1990s as did the number of scientists, and the little attention has been paid to innovation by the government. However, in the 2000s the economy recovered (not the least due to high oil prices). Recent economic indicators for Russia, particularly GDP and industrial growth, employment trends, netto export as a % of GDP look rather impressive and are better than corresponding comparable to EU countries. The oil and gas sector has provided a solid contribution to this economic success, but also other sectors, such as construction, trade and services sectors perform pretty well too. But the overall Russian economic performance is low by international standards. Labour productivity per person employed in Russian economy stands at only 37% of the EU and is slightly decreasing. Now there is a growing awareness that the innovative capacity of the country has been neglected and that it requires a major overhaul and adaptation towards a market economy setting and global trends. The aim of the Russia's midterm innovation policy was formulated as follows: "…the formation of a balanced sector of R&D and effective innovation system providing for technology modernization of economy and competitiveness…". In practice it means growing Federal support for R&D in strategic industries, as well as the volume of public procurements, reforming research sector and direct support for R&D infrastructure.

General economic context for innovation activity

Despite impressive growth in GDP and industrial production, as well as investments in fixed capital the quality of such growth reveals the existence of certain problems in the competitiveness of the country. Relatively low level of GDP per capita and even lower level of labour productivity demonstrate the deep economic problems: technological decline in much of the manufacturing, agriculture and service industries; slow modernization due to relatively low industrial investment and innovation activity (both foreign and domestic). The significant growth of the Russian economy was mainly achieved by raising the rate of production of the oil, gas and mining industries, including their export, and in

many respects owing to favourable foreign market conditions for primary goods. The high rate of growth occurs also in industries that have no direct competition with import products, first of all in the construction, trade and services sectors (Development Center, 2006). We observe the most active investment processes in low tech industries: mining and primary metals production, infrastructure sector and services (table 1). All technologically advanced industries such as machines and equipment including carmakers, aerospace and defence, invest several time less than mining or transport and communication. And table 2 shows that this heavily invested industries are primary exporters while import of machine and equipment is the major article of Russia's import.

Table 1: Capital investment, by selected industries*, 2006-2008, annual growth, %

	2006	2007	2008 (1 Q)	Value $ bil -2007
1. Transport and communications	5,2	8,2	12,5	43,7
2. Mining	22,2	19,1	0,6	29,9
3. Retail and financial services	4,5	18,3	7,7	20,7
4. Power stations	2,2	30,0	35,3	15,1
5. Primary metals	12,8	-0,2	12,3	6,2
6. Machine building (all sub-industries)	13,2	16,6	35,2	4,1

*Ranked by the value of capital investment in 2007
Sources: www.rosstat.org and www.dcenter.ru accessed 25.07.08

Table 2: Export-import structure by major commodity groups, 2006-2008, %

	2006	2007	2008 (April)
Export			
Fuel and energy products	65,8	64,4	67,5
Primary metals	13,7	14,2	12,6
Machines and equipment	5,5	5,3	5,4
Chemical products	5,4	5,8	6,8
Import			
Machines and equipment	48,1	51,4	53,5
Chemical products	16,2	14,0	14,2
Food and agricultural products	15,6	13,7	12,4

Sources: based on data of *Russia's Economic Survey* on www.dcenter.ru

Compared to the European Union, Russia's economic structure is relatively biased towards mining and heavy industry. The overall picture is that Russia increasingly exports low-tech raw materials and imports high-tech industrial equipment and consumer goods. The latter very much reflects a missed opportunity by the Russian innovation system. There are some special features in the market orientation of the most economically important industries. Despite a massive privatization of government enterprises during the 1990s, there are still a number of industries (like defence, aerospace, and atomic energy) in which government ownership is predominant and most likely will remain so. The logic of government ownership in these industries is that the government is the primary client for these industries – they produce *government goods*. Innovation in these industries depends heavily, if not exclusively on government R&D. In other words, the old central planning mode of innovation is still dominating this part of the economy. The Federal Agency on Industry, for example, coordinates all military-related industries, including their S&T policy. The Russian Space Agency (Roskosmos) and the Federal Agency for Atomic Energy (Rosatom) perform similar tasks for respectively the aerospace and aviation industry and the atomic energy industry.

There are other industries in which government ownership still dominates and that is in natural monopolies, such as railways, post, telephone, electricity, and water. During the 1990s, all these state monopolies have been transformed into commercial businesses (many of them were run like ministerial departments in the past), but with the government still as the principal or only shareholder. However, in several of these industries the government has started to sell its shares. This is in line with developments in Europe, where many countries have started to break up natural monopolies. The idea being that by introducing competition, efficiency in the production will be enhanced greatly. Breaking up natural monopolies, however, is not an easy task. The most influential business leaders and corporations in Russia are connected with oil, gas, basic metals and other mineral products. Companies in these industries are usually not very knowledge-intensive and demonstrate a low level of demand for R&D projects and innovative ideas in Russia. Russian companies, being relatively young as private enterprises, are more engaged in the financial restructuring of their core business and tend to rely on foreign multinationals as a source of new technology and equipment for drilling, reservoir monitoring and transportation. In terms of their innovation mode they are rather "*technology adopters*" and innovate primarily by adopting innovations developed by other firms or organizations. For example, Gazprom, created out of the former USSR Gas Industry Ministry, is the world's largest producer of natural gas and also Russia's largest company. Gazprom inherited from the Gas Industry Ministry a whole set of R&D institutes and design bureaux, both in Moscow and in all the regions with drilling and extraction sites. The company has about 4,000 staff in R&D related activities, of which 25% are professors and doctors of sciences. The maximum R&D budget of Gazprom, achieved in 2004 was RR 2.76 billion (or nearly US$ 100 million), of which RR 1.82 billion was spent on in-house R&D (Fig.1). It means that

the R&D/sales ratio of Gazprom fluctuated somewhat, but generally it has been more or less in line with the technologically advanced oil and gas industry's average in Europe (0.3%), but below that of the oil and gas industry in the USA (more that 0.5). See figure on Gazprom in figures 2003-2007 at www.gazprom.com.

R&D system and innovation

The level of gross domestic expenditure on R&D in the government and business enterprise sectors in 1990s has been dramatically decreased in comparison with Soviet times. Within the overall government budget, expenditure on R&D and innovation contracted sharply in the middle of the 1990s, mainly because of cuts in military R&D, which was the basis of the innovation system in the USSR. In 1998, the share of total (civilian and defence) R&D expenditures in the federal budget reached its lowest point of 2.22% (compared to 5.72 % in 1993) and has grown since then to 4.04% of the federal budget in 2004. In the beginning of 2000s R&D and innovation expenditures were slowly increasing relative to GND up to 2003 and after that have not increased, on the contrary they have even decreased in 2003-2005 (table 3). Civil part of R&D expenditures is growing up what may be considered as positive trend but business input to national R&D support has been diminished while this indicator is not high by international standards. Historically Russia as part of the former Soviet Union has been characterised by the well developed system of public R&D institutes. According to the official statistics, their number is slightly decreasing and in 2006 there was 3622 R&D entities in the Russian Federation. The prevailing type of R&D organization (2040 or almost two-thirds of the total number) is the R&D institute or (more or less) independent unit, not directly connected to a particular industry. These institutes are more focused on *technology push* than *demand pull* projects.

The Russian Academy of Sciences is the largest and most prominent research organization in the country and comprises 451 research institutes. In addition, there are several sectoral academies of sciences, but only two of them are actively engaged in R&D, namely: (a) the Russian Academy of Medical Sciences (66 institutes); and (b) the Russian Academy of Agriculture (297 institutes). The mandate of all these academies is to conduct fundamental research, but they also conduct some applied research. Russian universities do not play much of a role in R&D. Only some 40% of the higher education institutes in Russia are actually involved in R&D. Funding for R&D at universities comes primarily from competitive funding schemes and research contracts with industry and government. Financial and human resources in the higher education R&D sector comprise no more than 5% of the national total. Intermediary organizations such as technology transfer centres, business incubators, and technology parks that aim to bridge the divide between public research organizations and the business community has been developing with the strong government support. The short history of these organizations in Russia starts with the establishment of technology parks, followed by the introduction of Innovation and Technology Centres (ITCs) in 1996, and that of Technology Transfer Centres (TTCs) in 2003. Technoparks and ITC have been organized mainly in close relationship with universities and other higher education institutions. They both focused on the development rather than the commercialization of S&T achievements and hence proved unsuccessful in stimulating entrepreneurial activity. At the same time, however, one has to realize that the relative importance of SMEs in the Russian economy is of a completely different order than in Europe. Hence the demand coming from the SME sector for scientific support tends to be relatively weak.

Table 3: Main Indicators of R&D and Innovation Activity, 2000-2006

	2000	2001	2002	2003	2004	2005	2006
R&D/ GDP, %	1,05	1,18	1,25	1,28	1,15	1,07	1,07
Civil R&D/ GDP, %	0,23	0,26	0,28	0,31	0,28	0,36	0,36
Business R&D/national R&D, %	32,9	32,5	32,5	31,5	31,4	30,0	28,8
R&D personnel, thous	887,7	885,6	870,9	858,5	839,3	813,2	807,1
R&D personnel per 10000 employed in economy	217	219	223	226	230	228	223
R&D organizations, total number	4099	4037	3906	3797	3656	3566	3622
-private R&D organizations	388	450	456	434	420	422	505
-higher education R&D org-s	390	368	390	393	402	406	417
Share of innovative enterprises in manufacturing, %	10,6	9,6	9,8	10,3	10,5	9,3	9,4
Share of innovative enterprises in ICT industries, %	12,1	12,2	13,5	14,3	14,7	15,3	12,5
Russian patents granted to domestic inventors, number	14444	13779	15140	20621	19123	19447	19138

Sources: *Indicatory nauki: 2008* (*R&D indicators: 2008*). RF Ministry of Education and Science. Moscow. 2008. In Russian.

Most Russian businesses have no clear innovation strategy and are not used to investing in their own R&D capacity. At present the Russian business sector invests substantially less in R&D than their counterparts in Western economies. In part, this is due to the structure of the Russian economy with its predominance of relatively low-tech industries such as mining. Hence there is a need to restructure Russia's economy towards more knowledge-intensive industries. But, even when comparing directly with similar industries abroad (e.g., the automobile industry), Russian industries usually invest substantially less in R&D. In order to withstand competition in international as well as (increasingly open) local markets, Russian industries have to substantially increase their investment in R&D and develop and strengthen their own R&D capacity. This does not mean that the government should reduce its research efforts, as it has its own role to play, but there needs to be a shift in the balance of research effort towards the business sector over the medium- to long-term. In order to achieve this, financial incentives should be introduced to promote investment in R&D by the business sector.

The all national survey of innovation activity, based on the Oslo manual methodology, shows that on average less than 10% of the Russian manufacturing companies pursued some kind of innovation activity in 2006 (table 3). That compares with 25-30% in European countries. Innovation activity in information and communication industries is higher than average and slightly growing in 2000s but decreased in 2006. Higher rates were shown by independent Russian surveys that used a wider definition of innovation. According to the Russian Economic Barometer (an analytical unit affiliated with the Institute of World Economy and International Relations, RAS) 77% of the companies polled in 200-2005 could show instances of innovation using such a definition: 31% of them commissioned new equipment, 17% introduced new technologies, and 29% did both. This represents an improvement from 1997, when the result was 51%. A similar poll in 2003 by experts of the Moscow Carnegie Centre and Institute for the Transition Economy gave similar results: the innovation rate was 84%, of which purchase of new equipment was 53% and the adoption of new technology was 31%. The respondents mentioned increase of profit and market share, and reduction in costs as main goals of innovation. Factors stimulating innovative activity were competition from imports, development of the financial system in the company's region, and quality of corporate governance. Main obstacles to innovation were financial and credit difficulties and lack of support from federal and regional budgets. Domestic competition and export opportunities were not major determinants of innovation.

Small and medium-sized enterprises (SMEs) are very important as the engine of innovation in many EU countries. In Russia, the total number of SMEs in general and those involved in high-tech industries in particular remains very much insufficient. Moreover, the number of SMEs is declining in some industries. The most cited reason is that the business/innovation infrastructure – tax, capital and financial markets, administrative barriers –inhibits the emergence of a vibrant SME sector.

Objectives and Instruments of National Innovation Policy
Government innovation policy objectives and targets are formulated in several official conceptual and program documents issued in 2002-2006. The necessity of shifting to innovation-based economy was stressed in several policy documents, first of all "The Basis of the Russian Federation's Policy in the Sphere of Science and Technology Development by the year 2010 and Further Perspective"(The Basis, 2002). The main issues of that document were developed in "The Main Directions of the Russian Federation Policy in the Development of NIS by the year 2010"(The main directions, 2005). The following indicators are proposed: the growth of R&D expenditure up to 2,5% of GDP and the growth of non budget expenditure up to 70% by 2015; the growth of researchers younger than 39 years old up to 36% by 2016; the growth of patent activity (coefficient of innovation activity) up to 5,5% by 2016, share of innovative production in industrial production and sales – up to 18%, in exports – up to 15%, the growth of innovative enterprises - up to 20%, annual growth of innovation SMEs up to 120 by 2016 (The Strategy, 2006). Although the government has declared a need to create favourable climate for innovation, the actual innovation policy measures implemented are mainly aimed at specific support actions and are largely based on direct support of R&D and innovation activity.

The necessity to stimulate innovations is also stressed in several Federal goal oriented and industrial strategies. The most important are "The Energy Strategy of Russia up to 2020", "Federal Space program", "Development of Civil Aviation Technology", and "The Strategies for Development of the Russian Chemical and Petrochemical Industry up to 2015". When a comparison is made of this policy documents, the same list of innovation policy instruments tends to be seen. They represent mostly a combination of innovation climate measures and sector specific measures: stimulating industry's demand for R&D results and high technology, providing a more effective IPR regime; creation of stimuli for innovations at SMEs, support of innovative infrastructure, and promotion of cooperation networks. For example, the main goal of the Space Program in the innovation area is to consolidate positions in the development of space technology and strengthen Russian space technology potential, play an active role in international cooperation, and increase the Russian share of R&D in development of space apparatus.

The Defence Ministry apparently did not participate in the innovation policy formulation process, which reflects the separate status of the defence R&D and industry within the Russian innovation system and economy.

This is somewhat peculiar, as at the same time there is a lot of talk of dual purpose technology and the military scientific and industrial complex being considered an important source of innovation for the rest of the (civilian) economy. The Russian Government traditionally gives a lot of attention to identifying R&D and innovation priorities. Following the experience of several developed countries, the Russian government elaborated a list of critical technologies as the basis for selecting S&T priorities. The first list approved by the Government in 1996 comprised of 70 critical technologies. A new revised list of 52 critical technologies was approved by the President of the Russian Federation in 2002, giving it substantially higher importance. Nevertheless it was criticised as being too long and too similar to foreign priorities. In 2006 the list was cut to 35 technologies. The selected priority technologies receive federal support within the Federal Goal-Oriented S&T Programmes.

The Russian Federation has made major progress in putting the principle regulatory functions in place that are of relevance to innovation (such as IPR and antimonopoly), but their implementation still seems to be problematic. For example, despite the fact that piracy and other kinds of IPR violations is widespread, the capacity of courts to deal with IPR disputes is minimal. Moreover, there is a lot of discussion and confusion with regard to who owns the IPR when the research on which the invention is based has been funded by the State. Antimonopoly measures have become increasingly important in a world that is dominated by large corporations. Monopolies tend to become lazy innovators and hence the need to keep monopolistic tendencies under control. Again, the problem is not that there is no anti-monopoly legislation in Russia, but a lack of experience and capacity to execute the law. Rules and regulations (such as IPR, antimonopoly, fair competition, bankruptcy, and technical standards to name a few relevant to innovation) are usually not looked at from the point of view of how they impact innovation processes. However, they do matter, and often very critically, in the sense that they can make or break innovations and innovative businesses. A better awareness as well as a better understanding of these issues is important.

In the light of our analysis, it would be useful to compare the Russian measure set adopted in 2000s with the Lisbon guidelines (exhibit 1). It gives the impression that the set is spread along all the directions. However, closer inspection of the content of each measure reveals that most measures involve a large component of direct government support in the form of subsidies or public procurement. In general, however, it may be said that the current policy mix, where it is used, is the result of retargeting of policy strategies. At the same time, in general, the government continues to favour specific measures. It is only at initial stage of discussion on the possibility to introduce more general innovation climate measures. Before 2006 there was no serious discussion about introduction of innovation climate measures.

Exhibit 1: Russia's policy measures relevant to Lisbon guidelines n°8 and 15.3

Lisbon guidelines n°8 – Innovation	Title of measure in Russia
1. improvements in innovation support services, in particular for dissemination and technology transfer	Creation of technical-promotional special economic zones Creation of technology park in high tech Co-financing of R&D at small innovative enterprises Decree on temporary import tariff for some sorts of technical equipment Reform of Technical Regulations – Technical Regulation Act, 2002
2. the creation and development of innovation poles, networks and incubators bringing together universities, research institutions and enterprises, including at regional and local level, helping to bridge the technology gap between regions	Creation of technical-promotional special economic zones Federal Goal-Oriented Program "E-Russia"(2002-2010) Creation of technology park in high tech Support of R&D at start-up innovative companies – program START
3. the encouragement of cross-border knowledge transfer, including from foreign direct investment	Creation of technical-promotional special economic zones Creation of technology park in high tech Creation of Russian venture company Creation of the open joint-stock company "Russian Investment Fund of Information and Communication Technologies" Federal Goal-Oriented Program "National Technological Basis" for 2007-2011 years Federal Goal-Oriented Program "Development of civil aviation technology in Russia in 2002-2010 and till 2015"
4. encouraging public procurement of innovative products and services	Federal Goal-Oriented Program "National Technological Basis" for 2007-2011 years Federal Goal-Oriented Program "R&D in Priority Directions of

	Development of Science-Technological Complex of Russia in 2007-2012” Federal Space Program for 2006-2015 years Federal Goal-Oriented Program “E-Russia”(2002-2010) Federal Goal-Oriented Program “Development of civil aviation technology in Russia in 2002-2010 and till 2015” Federal Goal-Oriented Program “Ecology and Natural Resources of Russia for 2002-2010 years Draft Plan of Measures for Light Industries Development for the period 2006-2008 years
5. better access to domestic and international finance	Creation of Russian venture company Federal Goal-Oriented Program “National Technological Basis” for 2007-2011 years Federal Goal-Oriented Program “R&D in Priority Directions of Development of Science-Technological Complex of Russia in 2007-2012” Creation of the open joint-stock company “Russian Investment Fund of Information and Communication Technologies” Federal Goal-Oriented Program “Development of civil aviation technology in Russia in 2002-2010 and till 2015” Draft Plan of Measures for Light Industries Development for the period 2006-2008 years
6. efficient and affordable means to enforce intellectual property rights	Control over the legal protection of the results of civilian R&D created under budgetary expense
Lisbon guidelines n°15 – Entrepreneurship and SMEs	Title of measure
3. Strengthen the innovative potential of SMEs	Co-financing of R&D at small innovative enterprises Support of R&D at start-up innovative companies – program START Tax remissions for organizations working in information technologies

Source: Ivanova N., Dejina I. et all. Policy Trends and Appraisal Report. Russia. 2007. INNO-Policy TrendChart.

Policy Benchmarking

During the 1990s a lot of progress has been made in Russia in the area of R&D statistics development and in improving standards according to international rules. International comparison of R&D resources and innovation activity has become the responsibility of several analytical bodies inside the Ministries and related institutes and in Russian Academy of Sciences. Russian R&D statistics are presented now in corresponding databases of leading international organizations, including the OECD and World Bank. A growing number of international expert teams are engaged in analytical projects implemented in different Russian regions for studying their innovation systems and innovation policy. The author of this article has been deeply involved in two projects devoted to comparative analyses of innovation processes with European experts (Ivanova N. Roseboom J., 2006; Ivanova N., Dejina I. et all, 2007). Here we cite just the three most important benchmarking studies (available in English) which were initiated by the Russian Government, or in cooperation with it, during 2005-2006. In 2005, Russian Ministry of Education and Science requested a German TACIS expert team for the assessment of the draft “Strategy of the Russian Federation to Develop Science and Innovations until 2010”. The assessment of the German experts was intended solely for in-house consideration of the MES. But later it was published as a public deliverable of the project.

The overall assessment of the Russian strategy was positive “altogether, the German group of experts considers the strategy to be the right approach for developing a modern Russian system of innovation.” (Tacis, 2005). They also elaborated a set of recommendations for improving the Strategy. For example, general innovation policy recommendations underline such points like:

- increase focus on creating a pro-innovation legal framework, increase incentives for innovative business start-ups and the infrastructure for commercialisation findings and marketable products;
- reappraise the objective of state controls for assessing the success of individual innovation promotion measures provided at several points in the strategic design; tried and tested international evaluation instruments could be applied here;
- ensure that state innovation policy covering the research landscape should provide a clear allocation of tasks for the budgeted types of institute;
- strengthen the innovative capacity of the executing agencies and foundations for promoting research;
- set up national laboratories to profile institute primarily intended to engage in applied research and development.

In the "Economic Survey of the Russian Federation: Sustaining growth in the Russian Federation: key challenges. OECD. 2006", Russian and foreign experts involved in the survey of innovation policy, concluded that Russia can do much to make innovation policies more effective. Russia's innovation potential is considerable but its innovation performance remains disappointing. Realising this potential will require further steps to create a healthy, open business environment, as well as steps to stimulate greater private R&D and strengthen the domestic IPR regime. Reform of the large but inefficient public science sector could make it more responsive to business needs and more dynamic as an engine of knowledge creation. Specific innovation-promotion schemes, like special zones or technoparks, should be limited in scope, carefully targeted and rigorously assessed in order to avoid deadweight losses and market distortions. The OECD experts believe that the potential of public science sector is enormous but it badly needs to be reorganised towards reducing the number of direct recipients of budgetary R&D funds, shifting to project-based rather than institutional financing and pursuing the commercialisation of the results of their research (OECD, 2006).

In the background paper for that report (Gianella, C. and W. Tompson, 2007) the authors put special attention to the new targeted innovation initiatives – Special economic zones and Russian Venture Corporation (RVC). The government is well aware of the risks related with the SEZ activity and has attempted, in drafting the SEZ legislation, to provide safeguards against the kinds of abuses seen in the 1990s. So the legislative procedure for establishing zones is competitive and requires lower-level governments wishing to create such zones to make significant commitments of their own; they can no longer use special zones simply to extract resources from the federal budget, conclude the authors. Government support for VC also raise an issue of moral hazard, and the track record of state-owned or –managed VC funds in most countries is not very good. But the authors believe that Russia's approach looks more promising than some, particularly as the new innovation strategy explicitly states that the RVC's resources are to be allocated on a competitive basis and that the state's share in the new VC funds will decline over time.

The (World Bank, 2006) paper contains a chapter on innovation entitled «Fostering an innovation economy in Russia". There the experts evaluate positively the current high priority of the Russian Government to promote economic diversification, develop competitive industries outside of the resource sectors, and cultivate a knowledge-based or "innovation" economy. But the general assessment of innovation policy measures is rather controversial. The experts consider that the emerging strategy represents a certain shift in emphasis away from the classical liberal economic objectives of creating a level playing field for private initiatives and entrepreneurship, and toward "industrial" or "regional" policy where the objective, on the contrary, is to create special conditions for the priority development of certain sectors, regions, or firms. The logic behind this strategy is the perception that market forces alone are pushing Russia down a path of resource dependence and low international competitiveness, and that government intervention is required to remedy this problem.

The state might play a specific role in stimulating innovation activity through programs such as matching grants or participation in private venture funds, the World Bank experts believe. The experience of other countries in this area strongly suggests that an innovation economy thrives primarily on dynamic decentralized processes in the context of fierce international competition. While Russia has made some progress in creating such an environment during 15 years of economic transition, this agenda remains highly incomplete. Furthermore, recent trends toward greater centralization and expanding government participation in the economy could even hinder future progress in this area. The vision of such a Russian "national economic model" may be consistent with a continued resource-oriented path of development, but it is unlikely to deliver much success in developing a highly competitive or innovation economy in Russia, conclude the authors of the report. Learning from abroad mainly takes place through rather ad hoc mechanisms, such as:

- reading relevant reports published by e.g. the OECD, the European Commission or World Bank;
- short stays abroad aimed at gaining insights into how innovation policies are formulated, organized and implemented in other countries;
- participation at relevant international conferences;
- participation in and cooperation with transnational organizations and networks.

Generally speaking, international benchmarking is very important part of Russia's innovation policy formation and monitoring. Learning from foreign experience is growing but it is not yet a standard activity of responsible Government's Ministries. A new approach was demonstrated recently by the Ministry of Economy and Trade (now the Ministry of Economy) during the creation of the Russian Venture Company. They invited the CEOs of innovation funds in Finland and Israel to become members of its Board of Directors. The problem is that Russia' system of innovation is too much different from the best western one and foreign experience has to be much more carefully used in rather different economic and institutional context.

Conclusion

During 2000s the Russian Federation has made a lot of progress in the formulation of innovation policy and in the creation of an innovation governance system (legal base development, growing number of Ministries engaged in innovation policy, learning from abroad in priority setting and monitoring of innovations). Russia

still has tremendous potential in certain leading research and innovation industries. However, the efficient use of vast natural resources on the international market is possibly one of the main challenges posed for Russia's technology intensive industries and its ability to commercialise research findings into marketable products. Russian research remains attractive as attested by different international expert panels and supporting organizations.

In general there is a high level of enthusiasm in the departments and Ministries that are responsible for innovation policy development, in particular in the Ministries of Trade and Industry, Education and Research, and several local Governments. Still, the governance system faces some serious problems when it comes to bridging the gap between political visions and ambitions on the one hand and the implementation of those visions on the other. A comprehensive innovation policy involving a large number of Ministries requires that these different cultures absorb the common vision of the innovation policy . Russian innovation policy is still based on a more linear, research-centred ideology. Ministries who are not used to this way of thinking may find it hard to contribute to this policy in a meaningful way, especially as these have other overreaching objectives that might collide with the ones presented by the innovation policy. In order to improve the overall functioning of the Russian innovation system, the Russian Government should adopt a more pro-active innovation policy. A major challenge for the Russian innovation policy is to redefine the responsibilities of the various actors within the system in the light of a more dynamic and open market economy and develop new ways of interaction among them. The greatest challenge here is to induce a stronger participation by the Russian business sector in the whole innovation process, including that of conducting research. A healthy business environment may be considered a precondition for boosting innovation activities. Russian innovation policy should therefore be carefully designed, with a balance between general and targeted measures. Monitoring and evaluation is another bottleneck of the Russian innovation policy. While the innovation policy should give the innovation system a sense of direction, it should, once translated into a concrete and detailed action plan, be complemented by the specially designed evaluation system in order to check whether the system is evolving in the right direction and introduce corrective action where necessary.

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Financial Convergence Development: Case of Russia

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Abstract

Financial convergence and a financial conglomeration as various sectors of the capital market diffusion become one of the central elements of the contemporary financial system. There are three basic forms of financial conglomerates: bankassurance, assurfinance, allfinance, meaning transition from product-oriented to client-oriented strategy of the integrated financial products sales. The process of financial convergence in Russia compared to the developed countries is concentrated not in the financial, but in the oil and gas, extracting, mining and metallurgical, transport complexes, which survived as natural monopolies after 90-th reforms. High level of transaction costs, total mistrust to opaque transactions in the market, instability of state regulation, etc. promoted development of various forms of association of the Russian enterprises as large vertically - integrated companies and financial conglomerates.

***Keywords*:** Financial Convergence Development, Russia, Financial Conglomeration

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Introduction

Introduction

One of the new phenomena raised by globalization process and liberalization of financial markets appeared to be new forms of financial integration and/or financial convergence. Beginning from the 90-th Russia started to develop new institutional form of financial-industrial integration unknown for its economy. These institutions were named (FIG) Financial-Industrial Group later on transferred into (VINC) Vertically-Integrated National Companies or (IBG) Integrated Business Groups which were characterized by certain peculiarities compared to Western analogues.

Literature review

"Financial convergence" as the process of wiping out boarders between different parts of financial system concerns all types of assimilation or diffusion between financial services suppliers and integrated demand on these services. Economic literature mainstream have evolved the analysis of financial convergence and its different institutional forms – bankassurance, assurfinance and all finance - (Van den Berghe, L.A.A. and Verweire, K. (1998)). Institutionally financial convergence led to the relatively new form of international financial business organisation "financial conglomerate", defined as a group of companies under the unique control. The exclusive activities of the financial conglomerate is linked to the financial services provision at least in one of three main sectors - banking, insurance and investment happening through the process of homogenisation (Skipper, Jr., H.D.(1982)). The financial sector integration resulted assimilation of financial services which have product-oriented nature directed to the complex financial product development. In this case a firm traditionally acting in one sector starts to mix different sectors products. Combination of bank, insurance, investment activities leads to cross-selling, packaged products sales, modular-sales and hence to the fully integrated solution. Annuities, unit-linked, catastrophe options, bonds, equity puts; standby letter

of credit proposing different finite risk transfer mechanisms joining bank, insurance service and securities trade(Van den Berghe, L.A.A. and Verweire, K. (1998)). The growth of financial conglomerate diversification strategy in Belgium and the Netherlands was analyzed by Verweire, K. (1999) in the USA by Saunders, A. and Walter, I. (1994). The term "diversification" appeared on the peak of economic research after the paper of Rumelt R.P. (1974) and his successors Ramanujam, V. And Varadarajan, P. (1989). There were a lot of papers dedicated to the practice of state regulation of financial convergence process particularly insurance industry. (Atamtchuk G.V. (2001)), Klein R.W. (1991) and other authors.

Whither Banks could be leading institutes of financial convergence in Russia?

The contemporary stage of financial markets development in the developed countries is characterised by financial convergence, financial conglomeration following different managerial strategies under the influence of bank's leading role, demographic and customer's preferences changes and other factors. The main factors of bank's leading role as institutes of financial convergence in the world economy's developed countries are the following:

Corrosion of particular banks' intermediary role in financial transactions. Traditionally through the market economy formation banks were core institutes of financial system. In the 90-th of the XX c. biggest financial-industrial companies started to substitute banks with the help of their own in-side financing issuing bonds and securities accompanied by outflow of deposits to the new financial products, proposed by TNC. In Russia there is no corrosion process of the role of the banks as a main financial intermediary due to the fact that the former centrally-planned economy was financed from the budget through the unique State Bank and after the 90-th the newly born two-leveled system was too far weak to credit economic development, individuals and enterprises in crisis. The aggregate Russian banking system capital is only 45% of GDP and should be as twice as big – 80% of GDP.

Banks' daughter's company's creation for different financial services provision (leasing, consumers' credit, financial engineering, and insurance broker's and consultancy services) reflected the process of financial convergence start in developed countries.

Banks solvency requirements strengthening. It resulted the decrease of banks transactions profitability and increase of different non-banks transactions (different securities sales, futures, options, suretyship, consultancy services, etc.) Banks started to search new sources of profit acting as brokers and agents of insurance companies which benefited from this due to the use of banks distribution channels and reducing costs of marketing and sales – hence acquiring economies of scale. Insurance companies were not inspired to financial convergence until banks converted into their competitors starting to organize insurance companies of their own caused by the similarity of banks and insurance life-products

Demographic shifts. Beginning from 1980-the, the rates of demographic growth decreased crucially and duration of life increased resulting aging population and retired pensionists growth compared to the working population causing changes in the social and state pension system and welfare state concept "pay as you go" principle crisis (Natalia Kuznetsova, Natalia Drosdova, Eds (1998). It is impossible nowadays for the retired person to keep the same level of the working people income based on the state pension provision. Hence those groups of population are inspired to take part in the additional non-state pension schemes. (Lafferty Business Research (1991). In Russia the same processes of demographic shifts are going on accompanied by the crash of the state pension and social security system. So we see the necessity of the catching up period of the new social security model creation.

Consumers demand shift and saving restructuring. Due to the welfare increase pension savings raised as well resulting success of long-term financial products (unit-linked, index-linked, mutual and investment funds management). This type of evolution shows liaison between financial conglomeration of bank, insurance (due to the life products spread) investment sectors with pension funds. The pension schemes reforming and two financial crises of 1992 and 1998 in Russia resulted the mistrust to the state social security system and passive fatalistic attitudes of the population to the current events and new feeling of un-protection and crash of the system of values characteristic for the Soviet period. Financial convergence process stimulated banks to propose additional financial services: life policies, index-linked policies, simple pension schemes, etc. Banks sales of insurance products led to the new strategy of bank realized through the following variants:

- Bank could produce insurance products through insurance daughter company either affiliate. In this case the bank is appeared to be the carrier of risk determined by the nature of insurance.
- Bank could propose insurance products of its insurance partner through joint venture.
- Bank could limit its activities by the insurance agents or brokers services.

The analysis shows that in Russian banks started to sell insurance products according to the mode of cross-sale limiting its activities to the brokers and agent's services provision. The process of bankassurance formation in Russia is supposed to be on the first stage of development. In 2005 there is only one really functioning bankassurance group – Ingosstrach-Autobank, which includes two banks: Ingosstrach-Souz and VDNH Bank. There are a set of strong insurance companies that could be a future basis for the bankassurance group formation:

- Insurance company SOGAS, insurance company Gasprommedstrach and

Gasprombank. All these companies are parts of FIG GASPROM;
- Trust and Investment bank and insurance company “UKOS-Garant”, in which oil company UKOS is a biggest client;
- insurance company Interros-Soglasije and Rosbank, servicing (FIG) Financial-Industrial Group - Interros;
- Voennij (military) bank and Voenno-strakhovaja Company created on the basis of “East-European investment Bank".

We could point out the following forms of rather expensive financial product integration in the Russian young financial market through the transition from product-to to client-oriented strategy. One of the simplest forms of bundling – insurance policies sale to natural persons through banks. According to the banker’s management opinion the integrated financial product should be as simple and transparent for the customer as possible. From the other hand the sale of these type of product should have “active” and mass consumer’s demand. There is no such demand in Russia excluding third party motor liability in non-life and ritual services insurance in life products. Second form— banks product includes insurance services. For example, getting a plastic bank card is accompanied by insurance policy sale. Russian banks comprehend the benefits form the accident, medical and technical assistance insurance policies sales for traveling clients who simultaneously open international credit and debit plastic cards. Third form —deposit interest rate management, when a part of money could be used by the client for different insurance policies buying (pension schemes, medical insurance, etc.). The bank proposes accident insurance policy as a gift to the bank deposit. It is considered by insurance company’s management as a declaration because it is proposed for a short-term basis and is used for marketing purpose. Forth form — credit programs for legal and natural persons, accompanied by mortgage insurance. Credit and suretyship insurance accompanied by the life policy is quite beneficial for the bank stabilizing the banks’ credit portfolio. Banks give a chance to their own captive insurance companies to benefit on mortgage insurance products. Fifth form— insurance deposit. Client depositing money at the bank has accident insurance with the sum insured equal to the deposit sum[1].

Banks and insurance companies in Russia still are crossed over the limited segments of the product line. Insurance companies have a lot of problems that could be solved partly with the bankassurance group formation: low capitalization, absence of large distributor’s chains, and underdevelopment of product lines.

The process of financial convergence in developed countries involves not only banks but insurance companies, investment and pension funds, etc. The new institutional form of financial convergence appears – financial conglomerate developing in a number of different functional structures. In spite of the fact that Russia is a part of the world financial market and the process of financial convergence is going on in the country it has its own peculiarities and problems. Historical background of the (FIG) financial-industrial group’s development through the Soviet and reforming Russia’s period. Underdevelopment of the modern Russian financial market: banks, insurance, securities firms, investment and pension funds sectors, different forms and classification of Russian undertakings integration. Non-perfection and lack of legislation dedicated to financial conglomerates. Historical background of the financial-industrial group’s development through the Soviet and Russia’s transitional period. The organizational structure peculiarity of the Soviet-Russian industry – a number of large industrial enterprises which are large-scaled according to the gross output, fixed capital and a quantity of employees. Transition from centrally planned to the market economy was accompanied by the inner and outer business environment change, raising of the problem of survival, processes of auctioning, privatizing, mergers and acquisition. Those shifts are the factors of (VINC) vertically-integrated companies and financial conglomerates formation.

In the USSR numerous attempts of overcoming the negative consequences of departmental dissociation were undertaken - committees and a bureau were created purposing the co-ordination of technologically connected branch activities (for example Power-energetically Complex, chemistry-forest complex and so forth). One of last attempts of reorganisation of large-scale industry within the framework of the USSR was creation of (MNTC) multi-branch scientific and technical complexes and the state concerns. Within the framework of the given stage of transformation during 1988 -1991 such state concerns, as - "Gazprom", «Norris Nickel», "Nefteotdacha", "LangepasUrajKogalimneft" and a number of others have been created. Distinctive features of the created state concerns were:
- Horizontal integration of technologically connected branches and manufactures within the framework and under aegis of one head quarters structure of management;
- Wide territorial scope of technologically connected kinds of activity.

Two basic stages in the development of these state companies could be figured out:

[1] There were a lot of non- successful attempts to create “financial supermarket” in Russia. Failure of these efforts could be explained by the absence of the program and concept of financial conglomerate joining bank and insurance company and by non-compatible actions of both institutes. There should exist a whole system of interactive policies directed to the client hooking into the net of financial supermarket with a positive image. Besides the traditional participants this system could include tourist firms, lawyers, creation of complex client-oriented services, personnel training. These projects are lagging behind due to the lack of customer’s financial culture. See also: Andrew Donskikh. (2005) Whether Russians need financial supermarkets// Bankovskoje delo v Moskve N3(123).

1. ***Formal***- connected with the transformation and transfer of capital of technologically connected branches and manufactures to the newly born head quarters structures of management;
2. ***Economic***- formation of new economic principles and rules of interaction and coordination - inside these concerns, and outside of them in connection with an external world (including not only consumers of their production, but the state as a whole - on federal and regional levels).

The last stage proceeds till now. Since 1992 - the beginning of large-scale and comprehensive privatization - the new phase in formation of the large companies and industrial - financial conglomerates began. On the one hand, in a number of sectors of economy - first of all in oil-and-gas sector - auctioning and privatization were accompanied by simultaneous formation of large vertically - integrated companies, and on the other hand, auctioning has created an opportunity for the further association within the framework of the uniform property of large share holdings of technologically connected branches and manufactures. Last circumstance has caused a new wave of financial and industrial conglomerates creation. A significant role in formation of the Russian industry "new image» was played by the state policy which declared the raising role of large financial and industrial groups in the economic development of the country. The institutional development of corporate sector main tendencies in the beginning of XXI century in Russia was:
Consolidation of the property rights,

- Proceeding processes of the share capital concentration,
- Associations of the enterprises and reorganization of already created Business - groups (holdings),

Inter and multi-branch expansion.
The modern veiled structure of the property was created, in particular, in raw-material branches and has been caused by a basic dilemma born in the beginning of 2000-Th. On the one hand, "partnership" within the framework of each large group has actually developed, and it was required to make structure of the property and the income more legally transparent. On the other hand, their legalization would result significant financial losses (taxes, etc.), and risks growth in sphere of property rights owing to the existing blanks of the Russian legislation. The following logic step of institutional development was the creation of offshore holdings (in order to prevent the additional taxation in Russia), where owners ("partners") could hide behind the group of complex legal structures through holding. All organizational circuits became quasi-legal, i.e. formally not contradicting to the legislation, except two cases: 1) permanent infringement of the antitrust law (by estimations, not less than 20 % of transactions) and 2) transfer pricing (as a way of capital export although legal regulation does not exist here).

The achieved level of concentration of the joint-stock property in Russia is not very essential compared to some countries of the Eastern and Central Europe; however the process of the share capital concentration develops intensively. Within the framework of the economic policy directed to the development of large financial and industrial groups a number of laws and the legal norms providing achievement of above consolidation of material and financial flows has been accepted. The legislation of Russia conducting the consolidated balance and the uniform accounting reports of financial and industrial groups (FIG) members was authorized, that assumed the centralized taxation on the consolidated balance in a place of registration of the company's headquarters.

The process of the largest Russian companies' reorganization began in 90-Th. The basic and positive tendency was the transition from diversified holdings and conglomerates (actually analogues to Korean chebolies), typical for 1990-th, to more controlled and structured forms of corporate groups. This process is marked almost obviously in oil and metallurgical branches, but similar tendencies became characteristic for chemical, the food-processing industry, civil aircraft construction, for some sectors of (MIC) Military-Industrial Complex (though in the MIC long-term attempts of creation or, more precisely, restoration of vertically integrated structures "from above" were not successful) and other branches. Criteria of formation of such structures (compared to former financial and industrial groups (FIG) in the 1990-th has changed as follows:
Technological, financial and economic expediency of connection of new assets (enterprises) acquiring;

- higher level of the corporate control over affiliated structures (75 % and are higher);
- Organizational - legal transformation (including mergers, acquisitioning the frameworks of holdings, transition to the uniform form of stock in holdings, etc.).

The investigations show, that to the greatest degree it is typical of those groups which "nucleus" was generated still in 1990 - the beginning of 2000th and which have already passed a stage of "primary" reorganization in different forms, having sold non-profile assets (manufactures), having allocated the specialized sub-holdings (with simultaneous consolidation of corresponding assets), having optimized control systems (purposing the establishment of maximum control of management), having achieved the certain level of a transparency and publicity. We suggest taking into account some features of large corporate group's formation in a context of processes of integration in Russia. Formally, from the point of view of different types of integration, the history of corporate group's formation is submitted conglomeratic, vertical and horizontal kinds of associations.

The process **of vertical integration** (in oil, gas, chemical, an iron and steel industry) provides

concentration of extracting and manufacturing production. It is most typical for branches with significant number of technological repartitions and allows maximizing the aggregate income of group due to the control over the technological chain producing the value added (including the "optimization" of taxes and financial flows within the framework of the group). Though there are various points of view on efficiency of vertical integration, we mark the obvious advantage of Russia is connected to the process of redistribution of property. Interception of the control over the supplier or the consumer means a stop of the vertically integrated chain. Cases of "raw" pressure upon competitors or on the shareholder, not wishing to concede the control, are rather numerous (examples with mining production and mining processing comminutes are numerous and famous. We could refer to typical examples of vertical integration of the main oil companies and groups organized in nonferrous metallurgy ("RUSAL", "SUAL", "UGMK"), some holdings in ferrous metallurgy ("Severstal", "Mechel"). The important advantage of conglomeratic investments (investments in non-profile assets) for the mining companies is the opportunity of price fluctuations smoothing. Concerning the Russian groups conditionally named vertically integrated, it is more correct to speak about the mixed forms of integration uniting vertical and conglomeratic forms.

Among the advantages of **horizontal** integration we could note the economy of production and sales costs, reduction of tax payments. Typical examples - some machine-building holdings (for example, «Power machines»), the brewing companies, confectionery holdings and others. Prospects of horizontal integration in the Russian economy are caused, first of all, by the current level and prospects of concentration of the markets in concrete branches. Now the first priority in the field of reorganization, mergers and acquisition of the companies is legal innovations. Improvement of the legislation is still actual. The question of "economic concentration» (in terms of the antimonopoly law) regulation (degree of control) as well as control over activities of actual supervising proprietors (and their managers) which can be carried out to the detriment of other groups of shareholders (the actions connected to dividends, transfer pricing, understating of the export prices, a transfer of assets, tax avoidance, export of the capital, etc.).

Last years a number of large holdings (groups) have started the programs of reorganization directed to the control toughening and consolidation of new assets management. It is possible to figure out two basic directions of such reorganization.

1. *Strategy of assets restructuring* (liquidation and sales of non-profile enterprises) which is characteristic not only for oil branch, but also for the majority large, well-formed groups.
2. *Toughening systems of the administrative and property control* that is typical for final stage of group's expansion process as well as for those groups which are continuing their corporate "construction".

In 2002-2004 the administrative models diversification process of the largest groups starts. There are three basic models of management:

1) Financial (an opportunity wide business diversification, investment functions, non-interference to industrial activity of business - units, the statement of budgets and investment programs of basic business - units, criterion of profile - business is high profitability of the invested capital);
2) Operational (mono-business, directive - functional management of operations);
3) Variants of strategic planning and control (presence of a business - nucleus, non-interference to operational activity, functions of corporate strategy definition, submission of financial activity to strategic tasks, the basic criterion business-profile - development of a business - nucleus and other business - units in aggregate giving a synergy effect).

Whatever is the chosen management model of the large group *standards of the operative management organization were already formed.* Those are two basic features typical for them:

1) Unlimited bureaucratization of the lowest and middle management (detailed rules, standardization and formalization of decision-making (especially financial) procedures, over-complicated procedures of the decision-making coordination, etc.);
2) The major decision-making is made by the main partners

Through the last 5 years integrated business - group is the most widespread concept in the economic literature used for a designation of associations of the holding type enterprises. The concept (IBG) «the integrated business - group» has arisen gradually, having transformed from concept of (FIG) financial-industrial group. Initially FIG is the legal concept formally concerning to both shareholders and top managers in a mode on-line without any excessive procedures. In many developed countries the boom of the developing markets resulted leading positions of financial conglomerates, which pushed aside competitors. However in Russia there is a special situation in financial sector. The integrated business - groups (or business - communities) - rather new concept to the Russian economic science and practice - means the group of non- financial and financial enterprises connected by personal, operational and professional relations, providing the mutual control (cross possession of shares, consolidation of financial flows, etc.) In economic sense (this view is shared by many experts) acquisition of one bank by another starts from the control package purchase. An operational experience of bank holdings and groups confirms such view figuring

out a number of banks - independent legal persons - is « the unique person in the market ».

There is a difference of definition of IBG and FIG, even in a broad sense. IBG does not provide obligatory occurrence of financial institute into the group. Then the concept of (IIG) integrated industrial group - began to be used. IIG can consist of the enterprises of industrial sphere and, accordingly, supposes absence of bank or other enterprises of financial - credit sphere. All associations of the enterprises of holding type concern to the integrated business - groups: vertically integrated, horizontally integrated, mixed, and diversified. The association of holding type is named either concerns (in the Russian economic and legislative literature) when there is a technological connections between the enterprises which are included in association, or conglomerates - when there is no interconnection between enterprises.
The situation in Russia is far from an ideal when we are talking about associated business-group management from the point of existing economic and legal situation. The ideal situation for business - group's management is a concurrence of economic sense of business - groups to their legal registration. In practice, economic (scientific-theoretical) comprehension, legal (according to laws) and practical (used for concrete actions) understanding of IBG in Russia do not coincide. It is a result of legal regulation imperfection and the mess created by discrepancy of legal and economic classifications of associations of the enterprises. We focus on economic and legal classification of associations of the enterprises, paying special attention to the Russian financial-industrial groups. FIG - the phenomenon which was born in the heads of academics, and consequently there are many discrepancies at attempt to join legal concept of FIG with economic comprehension of the integrated business - groups.

Underdevelopment of the modern Russian financial market

The general results of 2001-2007 Russian financial market development show out the main issues of the Russian financial market underdevelopment and instability: Lack of assets and not-working mechanism of institutional investments development. The main financial resources in the developed countries are provided by investment funds which are supposed to be institutional investors. In Russia the indicator of non-state pension funds assets per capita is equal $36 and investment fund assets per capita is $28 (compared to Hungary $1000 and $600 adequately). 100 companies from "Top 500" according to The *Financial Times rating* are banks keeping $4 trln. Of assets compared to $2 trln of oil and gas companies. The contemporary capitalization of 6 Russian top banks is only $64 bill. That is 8% of the aggregate capitalization. Nowadays there is a shortage of liquid banks stocks.
The fast dynamics of the voluntary non-life and in the mandatory insurance – motor-vehicle third-party liability and medical insurance particularly dangerous for the certain insurance undertaking;

- quick growth of commodity goods bank credits;
- slow growth and high interest rate of mortgage credit not adequate to the fast dynamics of dwelling construction and to the demand;
- overheating of PIF investment activities;
- fast dynamics of inside financial transactions of FIG and IBG compared to slow growth of bank crediting;

The Russian financial market is characterized by the regional misbalance... More than 40% of premium income, credit transactions and bank deposits are concentrated in the Central Federal region (including Moscow and Moscow oblast), 15% in The Volga Region and 12% - in the North-Western Region (including St.Petersburg and Leningrad oblast). Under-estimation of banking and insurance as investment and social protection institutes adequate to the absence of financial culture and mistrust into their prudent and fair behaviour on the part of the population, not ready to form active social and psychological mode of society's behaviour. Absence of professional dialogue between insurance, banks, investment, pension funds with the consumers of financial services; Underdevelopment of financial science and absence of multi-level system of training and retraining of personal for insurance, banking, investment, pension schemes, for government bodies responsible for social security; Contradictory character of foreign capital participation in the development of the financial market of Russia. Non-perfection and lack of legislation dedicated to financial conglomerates consequences the following processes. Underdeveloped regulation of financial market in Russia is reflected in the imperfection and contradictory character of financial legislation (insurance, banking, investment, non-state pension funds) accompanied by contradictory Tax code.
Absence of financial conglomerates (in June 2007 the Law of FIC was cancelled) legislation (Federal Law "About the cancelling of the Federal Law "(2007). Particularly it is referred to the lack of legal requirements concerning solvency margin of the Russian financial conglomerate or FIG whatever is the institutional origin of it. The most part of the world's large banks becomes financial conglomerates. It causes the new problems for the regulator due the following factors:

- solvency margin requirement for financial conglomerate
- a lot of financial services overcome the "banking authorities "sector but risks stays in the financial system
- one's sector risk could "infect" the other sector

Regulators of different countries with developed financial markets are in the decision making process of these problems. The important legislative initiatives were: 1) US 1999 Act Gram-Leach-Bliley[2] "About financial

[2] Gramm-Leach-Bliley Act canceled the legal restrictions which didn't allow banks, securities firms, insurance companies to act in the near-

modernization" and 2) EU 2002-2007 Directive "About financial conglomerates". The main problems facing the regulator are: methodology of financial conglomerate solvency margin calculation; interaction between different sector's authorities either unique financial authority formation. The goals and tasks of the unique economic and legislative EU community creation were modified according to the worldwide development[3]. This consideration in the world' regulatory practice should be kept in mind considering Russian financial convergence practice.

Concluding remarks

Summing up the consideration of financial convergence and financial conglomerates development in Russia we could figure out the following problems of these processes. The over- significance of the largest industrial enterprises inherited from the Soviet period resulted the chaotic formation of FIC, IBG and IIG which were converted into the "managerial companies" – the cores of the financial market development. The weakness of financial sector development – banking, insurance, investment, securities companies, stock-exchange, etc. and its low capitalization - predetermined that the nucleus of financial convergence were formed not in the financial sphere with the leading role of banks in this process, but in the industrial sector – in the first turn – in the sphere of the so-called natural monopolies – or complexes (oil gas industry, metallurgy, chemical-forest, MIC, railways, avia-cosmos, etc.) with the big share of state control and new legal form of state –holders concerns. Absence of financial conglomerates legislation particularly concerning solvency margin regulation and could-be "risk infection" between institutes involved into the FIG or IIG.

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by businesses permitting the process of financial convergence in the form of US universal financial undertakings.This Act solved the problem of contradiction between US Financial conglomerates formation and Antitrust Law as well as led to the transparency deal between the institutes involved into the conglomerate and the customers. By July 1, 2001, every U.S. financial institution had to notify customers about its policies and practices regarding the protection and disclosure of nonpublic personal information. Customers was given the opportunity to "opt out" of any sharing of information with third parties. If customers don't do anything, their information will be available to the financial institution to use within federal regulatory guidelines. Financial institutions rely on integrated information systems to operate more efficiently on behalf of their customers, thus avoiding the cost of maintaining duplicate systems. Allowing customers to opt out, versus requiring them to opt in to information sharing, is far more practical and efficient and makes better business sense for both the institution and the customer. Although Gramm-Leach-Bliley deals with privacy of financial information, the legislation is really about financial modernization. It removes Depression-era barriers among banks, securities firms and insurance companies, increases competition and is predicted to save U.S. financial consumers $15 billion a year. Responsible information-sharing allows a financial institution to recognize and respond to the individual needs of its customers, provide new product and service information, add competition and keep prices low. Proper use of information can also lead to better fraud detection, improved service at the automatic teller machine, better financial reporting to the customer and more.

[3] The most part of the Russian academics and financial practitioners focus on the EU regulation and history of financial convergence due to the fact that 1) this region is supposed to be the organic part of the Eurasian economic space to which Russia belongs to; 2) EU was the first to develop theory and practice of state and regional regulation of financial conglomerates activities; 3) Russia is facing the financial convergence and financial conglomeration processes and is eager to acquire the experience of the EU regulators. The latter was the main reason of Russian legislation dealing with the financial convergence modification. See: The Federal Law "About financial-industrial groups" (1995); order of the President of the RF 22.06.2007 "About the canceling of the Law "About FIG". See also: Kammel A.D. A proposal for the governance of financial regulation and supervision in Europe// Vierteljahreshefte zur Wirtschaftsforschung.- B., 2005.- J. 74, H.4.- S. 167-187.

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Russian Perception of Europe and its Implications for the Russia-EU Relations

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Abstract

The field of modern international relations is undergoing radical changes, and diplomacy has therefore acquired qualitatively new features. The scope of its activities is expanding to include international cooperation aimed at responding to new global threats and challenges. Diplomacy can only be truly professional and effective, however, when it absorbs new practices into a solid ground of traditions and values tested by historical experience. We believe that politics is about perceptions and Russia's perception of Europe in historical retrospect effects contemporary Russia-EU relations. With a new leadership in the Kremlin, Russia's relations with Europe entered a new phase. This article aims analyzing continuity (historical legacy) and change (a new president in Russia) in a dialogue between Russia and Europe.

***Keywords*:** Russia, Europe, Relations, Medyedev
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Introduction

The field of modern international relations is undergoing radical changes, and diplomacy has therefore acquired qualitatively new features. The scope of its activities is expanding to include international cooperation aimed at responding to new global threats and challenges. Diplomacy can only be truly professional and effective, however, when it absorbs new practices into a solid ground of traditions and values tested by historical experience. We focus on one of four levels of analysis, namely the level of decision-making. We look at the decision-makers' beliefs about the world and their images of others. We believe that politics is about perceptions and Russia's perception of Europe in historical retrospect effects contemporary Russia-EU relations. . Of course, perceptions and more specifically perceptions of other actors (Europe, for instance), are not the only decision-making variables that are important. That two actors have the same perceptions does not guarantee that they will adopt the same response. But as many experts agree, their responses will often be the same, and when they are not. It is normally easy to find causes of the difference. Indeed, the roots of many important disputes about policies lie in different perceptions. In this regard, there several questions to be raised: How do statesmen come to develop their images of self and other? What evidence do they pay more attention to? What makes them perceive treat? What kinds of behavior are most apt to change an established image?

At the risk of over-simplification, there are two broad schools of thought about Russia's future direction. One is that Russia has chosen its course. What we are seeing now is the future. There are not a few analysts within Russia and outside who believe that, having regained strength and self-confidence, Russia has now reverted to a historic model which is fundamentally incompatible with the West: "sovereign" should be interpreted as "separate." Russia has a unique Eurasian character. Its national identity, in part founded on the Orthodox Church, is deeply conservative. It is not attracted by democracy: strong, centralized authoritarian rule is the only way of ensuring order in this vast land

and – as opinion polls show – is widely supported by the people. Stalin remains an admired leader. The country's future success can be built on its huge natural resources (in a resource-hungry world) and traditional strengths in heavy industry, with the State playing the dominant role in the economy. The opposing school of thought is that what we are currently witnessing is a revisionist cycle in a long process of transition. Processes of change are underway which are not yet apparent at the political level – notably the growth of a new middle class, of new and competitive private sector businesses, and the gradual emergence of a generation of young, educated Russians who have been exposed to the outside world in a way that was denied to their parents, and wish to be part of it. It is also argued that the traditionalist model of Russia will not work – that an economy based on gigantic and massively inefficient (indeed value-extracting) state-run industries failed in the 1970s and 1980s, and will fail again. In the recent past, the West assessed Russia's foreign policy in light of Russian history.

The legacy of this past color the relationship. A retrospect is necessary to explain continuity and change in Russia's perception of Europe. The key questions are, how do novelty and continuity interact in the foreign policy of contemporary Russia ? To what extent does its present understanding of national interests correspond to historical traditions, and to what extent does it completely diverge? What historical heritage has Russian diplomacy brought into the twenty-first century? Where is Russia heading under president D.Medvedev?

Russian perception of Europe in historical retrospect

Russia's attitude to the outside world, and to its own identity, has always been complex, and one issue over which Russians have long disagreed centers on the country's relation to Europe. Russia's most densely populated regions lie in Europe and it was in Europe, that in the ninth century, the first state of the eastern Slavs took shape. By the eleventh century, Kievan Rus was a major center of Christian civilization and a hub of European trade and manufacturing. To this day, the bulk of Russian population is concentrated in the western- and southern-European regions of the country. Yet Russia has traditionally seen itself as a Eurasian country with vital trade and security interests in Asia as well as in Europe. Today, even after Russia has lost many of its imperial possessions, two-thirds of Russia's territory and most its natural wealth –oil, gas, timber, and precious metals – lie east of the Ural Mountains.

The Russian historian Vasilii Kluchevskii described Russia's premodern history as a history of 'a country that colonises itself'. That is to say, Russian history is a history of colonization. Russia was a center of the largest land empire history has known. For over four centuries, its territorial expansion averaged seventy square kilometers a day. The fact that Russia was a land empire meant it was never clear where the boundaries were between the metropolis and the colonies, and the inhabitants of the former were governed in much the same way as those of the latter. In the recent past, the West assessed Russia's foreign policy in light of Russian history. As a retired Sovietologist from the U.S. Navy put it in a recent letter to The Economist: "Any scholar of Russia knows that Russian history revolves around long periods of authoritarian rule, broken only by brief periods of chaotic liberalization before a new kind of authoritarian regime comes to power to exploit the nationalistic anti-Western xenophobia of the Russian people."

Since the era of Peter the Great, Russian diplomacy has undoubtedly looked toward Europe first and foremost. As early as the mid-eighteenth century, Russia actively participated in European affairs. Particularly after the defeat of Napoleon in the early nineteenth century, it became a full member of, and a leading power in, the European "concert." Alexander I suggested that the great powers mutually guarantee the integrity of their borders, and several years later he proposed "simultaneous proportionate disarmament of the European powers," what may be considered the first initiative toward general disarmament in history. Subsequently, in 1899 Russia called for the first Hague Peace Conference, aimed at preserving global peace and, if possible, reducing armaments. Although the "concert" of great powers then was not ready for any true reduction of armaments and military expenditures, the conference played a positive role, establishing a conceptual framework for international negotiations. The importance of this conference became fully apparent only in the second half of the twentieth century when the international community realized the necessity for arms control and disarmament. As a result of the first and second (1907) Hague conferences, fundamental documents on the laws and customs of war on land were signed, agreements that now constitute the basis of one of the most dynamic spheres of international law. Almost a century before the modern epoch of globalization, Fyodor Martens, a prominent Russian diplomat and one of the greatest European authorities in international law, foretold the need for better governance of international relations based on the progressive development and strengthening of international law. As we move from a bipolar to a multipolar world order, the creation of reliable mechanisms to manage global affairs and ensure strategic stability in its broadest sense becomes more urgent than ever before.

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Russians have traditionally seen the West as the 'Other' by comparison with which they have defined themselves. Russians accordingly tended to regard Western Europe with mixed emotions. The famous debate between 'Slavophiles' and 'Westernizers' that began within Russian intelligentsia in the 1840s exemplified this ambivalence. The Westernizers did not deny the intrinsic value of Russia's cultural heritage. But they argued that, if Russia was to overcome its backwardness and realize its potential as a great power,

it must adopt some Western customs and find ways of integrating with the rest of Europe. Otherwise, it would be condemned to isolation, exclusion, and impotence. The Slavophiles, for their part, put the case for Russian exceptionalism, arguing that destiny had fated Russia to follow its own path. While Slavophiles did not reject Western values in themselves, they insisted that Russia's unique combination of semi-Asiatic roots and Orthodox religious heritage could not be reconciled with the individualistic and materialistic values of the Western world. Traditionally, there were many critics to this Western choice. One of the most prominent of them was the famous Russian writer Fedor Dostoevsky who rejected the idea of Europe as the only choice for Russia. In his words,

The price we have had to pay (for this European choice) has consisted of the loss of our spiritual independence, of our unsuccessful policies in Europe, and finally of money – God only knows how much money – which we spent in order to prove to Europe that we were Europeans and not Asiatics.

In 1881 Dostoevsky shared his deep concerns about Europe and its elite that are still acute:

Why can't they believe that we are their friends and good servants, and our whole European mission is to serve Europe and her welfare?... Nay, they cannot place trust in us. The main reason is that they altogether unable to recognize us as theirs.

… In Europe we were hangers-on and slaves, whereas we shall go to Asia as masters. In Europe we were Asiatics, whereas in Asia we, too, are Europeans.

The outstanding Russian diplomat, Chancellor Alexander Gorchakov, who first introduced the notion of Russia's national interests into the foreign policy debates and suggested a valuable alternative to the ongoing debate about the dominant Russia's identity. He stressed that his main objective was to create the best possible external conditions for the liberal domestic reforms initiated by Emperor Alexander II. His memorandum to the czar pointed out that

No matter in what area we undertake to make our suppositions, be it Europe or the East, we arrive at the same conclusion: for the sake of our security and our power in the foreign domain ... as well as in the interests of peace and general balance, the foremost duty of Russia is to complete domestic reforms on which depends the future of Russia and all Slavic people. This is the underlying foundation of our policy.

Gorchakov was well aware that the enormous expanse of Russia, its unique geographic position bridging Europe and Asia, and its relatively insufficient economic development (compared to other leading world powers) called for an active but prudent foreign policy that avoided adventurism. The next Russian emperor, Alexander III, remembered in history as a peacemaker, followed this philosophy strictly. Although his own vision of the internal situation in Russia differed radically from Gorchakov's liberal ideas, Alexander III rejected the idea of "monarchic solidarity" with Germany and Austria–Hungary, choosing a close alliance with republican France instead. Later, Piotr Stolypin—the great reformer who headed the government of Emperor Nicholas II—continued that tradition. Addressing the Russian parliament, Stolypin said,

Give us 20 years of peace—both internally and externally—and you will not recognize Russia.

Unfortunately, the imperial Russia itself did not always heed those appeals. Its presumptuous and adventurous attitude drew it into the tragic war with Japan (1904–1905). A few years later, the fatal course of events in Europe plunged it, together with other European powers, into the fire of World War I that destroyed the Russian empire itself. Before collapse of the Soviet Union, Mikhail Gorbachev introduced idea of a common European house and new political thinking which basically was a European in its core. He has paved the way to peaceful and rapid withdrawal of Soviet troops from Central and Easter Europe by creating conditions for building a big Europe as it is today. There is no need to tell such informed audience that Gorbachev faced an enormous resistance at then Soviet establishment.
Russia's European choice never was an easy business and got universal support in Russia.

The collapse of the Soviet Union in 1991 injected fresh life in this debate, insofar as it forced Russia to choose a new path. Quite a few of Yeltsin's countrymen regretted the dissolution of the Soviet communist system; more lamented the breakup of the USSR itself, and many more were fearful about what would happen next. There was constant muttering about a new *smutnoye vremya*, or 'Time of Troubles', a repetition of the disasters that had befallen the country between the Rurik and Romanov dynasties at the beginning of 17th century. Yeltsin fit this role all too well. His chronic ill health became for his numerous critics and his aggrieved constituents a metaphor for the condition of the state over which he presided. Yeltsin was a leader of the most recent Russian Revolution which was actually three in one: the Russians were trying to transform their country from a totalitarian system to a democracy; from a command economy to a market one; from a multinational empire to a nation-state. Where Russia is heading under Putin and Medvedev? By 2003 'Time of Troubles' was over. That year of 2003 was a turning point in both internal and external policy of Russia. Internally, enormous revenues of petrodollars was the death knell for reform. Externally, it has become increasingly clear since 2003 that the dominant forces in the current Russian leadership have turned against the idea of a "strategic partnership" with the West which, in fact, ceased to exist as a homogeneous actor after American invasion of Iraq. Europe was and to great

extent is still divided over that war. Indeed, Russia did not feel it needs the West: the country was strong enough to pursue a wholly independent policy, did not need to make concessions to Western/American viewpoints, and could dictate its own terms for cooperation, especially in energy sector. The Russian leadership mistrust the motives of the West – a mistrust reawakened by events and Western actions, especially by American-British led war in Iraq, by interpretation of international law regarding independence of Kosovo and by criticism of Russia's (mis) behavior towards Georgia, Ukraine, and Iranian nuclear program. And Russians were angry: there is a bitter feeling that Russia has not been respected, but has been abused, exploited, ignored and made a victim. In Putin's words, "Russia will either be independent and sovereign or will most likely not exist at all." Thus, "respect" is a key point in this debate. Russia "wants its legitimate rights to be respected and its views on major issues to be reckoned with," says one of the leading Russian scholars in IR Alexei Arbatov. For sure, the determining factor will be the economy. But the prosperity generated by high oil and gas prices has merely masked, rather than resolved, the underlying structural weaknesses in the system. Another Russian scholar Dmitrii Trenin believes that *Over time, Russia will acquire more and more rightful owners: from a few dozen today to a few hundred several years from now to hundreds of thousands. Within a generation, having a single master of the land will first become impossible and then unthinkable. The powers of government will have to be separated in reality… Governance and competence are likely to emerge as criteria for grading the political regime and determining its fate. Russia circa 2025 will still not be a democracy, but it will be considerably more liberal and modern. The liberalism that has a chance to prevail in Russia will be economically driven.*

Analyzing a new Foreign Policy concept adopted by President Dmitrii Medvedev in July of 2008, we see that it is already clear that Russia has asserted its sovereignty. No one will be under any illusion about Russia's economic revival and determination to be regarded once more as a significant and independent actor on the international stage. Russia wants to be treated on international arena as an equal partner of both the European Union and the United States. A call for a 'collective leadership' of all leading powers within various frameworks (UN, G-8, BRIC, etc.) is another step forward in Russia's attempt to prevent unilateral policy of the United States. Traditional priority of Russia's foreign policy is the so-called Commonwealth of Independent States and development of integration processes with various institutions emerged after collapse of the Soviet Union. The CIS located both in Europe and Asia provides for both European and Asiatic choice of Russia. It is worth noting that the working model of relations with CIS states for Russia is long ago adopted concept of multi-speed and multi-level integration existed in the European Union. Thus, Russia is taking this model after European Union. A common denominator for deep integration, according to the Concept, will be a common cultural heritage. Having regained a soft power in the newly independent states, Russia will concentrate on strengthening its positions in the region. It appears that Russia more and more is seeking a new active role in European affairs – this time as a provider of 'civilizational compatibility' of Europe taking into account its long-term history of existence as a multinational and multi-confessional state. One of new features of Russia's perception of Europe today is that OSCE is no longer viewed as a dominant pan-European institution. Russia's favorite choice is the Council of Europe whose role should be increased in setting standards in the filed of protection of human rights for all European states. According the Kremlin, the Council of Europe can guarantee elimination of the so-called dividing lines in Europe in the nearest future. As for its relations with the EU, a new tone of Russia is in seeking strategic partnership with Brussels based upon reciprocity and equality. Besides reaching a new Partnership and Cooperation Treaty, Russia wants to achieve a visa-free regime with the more coherent and homogeneous Union. At the same time, Russia believes that the EU will still be the world's richest bloc and Russia's largest trade partner, and will have developed a more cohesive foreign policy.

Another novelty in perception of Europe is that Russia has set hierarchy of its partners in the continent. To the first group, according the Concept, belong Germany, France, Italy, Spain, Finland, Greece, the Netherlands, Norway as well as 'some other states of Western Europe'. Though a main motive of building this group is its adherence to support Russia's innovative sectors of economy, it is clear that priority status is given to those states which are the most cooperative in Russia's project in energy sector. The second group is more vague by being identified as 'Northern Europe', whose importance for Russia stems from common projects within multilateral institutions in Barents-Euroarctic region and Arctic as such. This re-emerged interest to the Arctic again linked with the Russia's aspiration to explore vast energy resources in the region. Relations with the rest of Europe, e.g. Central, East and South-East Europe, must be based upon pragmatism and willingness of each state to co-operate with Russia.

Conclusions

Russia's attitude to the outside world, and to its own identity, has always been complex, and one issue over which Russians have long disagreed centers on the country's relation to Europe. The new Foreign Policy Concept is clear message to the West that Russia is getting stronger but wants to try to prevent a further deterioration in climate. Russia's current agenda with Europe became much more clear and is based on Gorchakov's type perception of national interests. For the first time in post-Soviet history, Russian leadership made it clear that in order to provide its national interests, it is ready to act unilaterally but in accordance with international law.

In place of vague 'strategic partnership' with the EU, Russia is seeking cooperation with Union on specific strategic issues such as energy and innovation. It is obvious that the West (Europe and the United States) must recognize that change in Russia will come from within, and over a long period. Democracy cannot be build overnight. In the countries where it exists, democracy takes many forms, and took hundreds of years to develop. A fair amount of personal freedom has developed in Russia over the past twenty years. Genuine democracy (which is a bottom-up process), not surprisingly, has yet to start – but may well develop over the next 25 to 50 years. It would make better sense for the West to focus on the rule of law, where the Russian government has clearly defined internal and international commitments: implementing them would unarguably be in Russia's best interests, and would provide a much stronger foundation for Russo-Western relations. Russia needs neo-engagement, not neo-containment. The sooner Russia becomes a member of the WTO, the better not only for Russia itself but also for the West.

Russia's inability to break with its past, or its non-western national psychology, had been evident for many years. However, it was the opportunities presented by the oil boom which really put flesh onto the bones of the Kremlin's ambitions. Moscow's cautious faith in its own abilities quickly gave way to over-confidence and euphoria as power and wealth flowed in from the global market in hydrocarbons. It appears that the new Russia won't make concessions − which confuses the Europeans. On one hand, the culture of compromise is deeply rooted in the EU's internal relations; on the other, the Union is unwilling to compromise with external partners. When neither side will back off, you soon create gridlock.

Finally, the next time that Russia and the EU try to get a dialogue going, the principle of "reciprocity" is going to become crucial. This will be a departure from the old style of relations when, in simple terms, both parties launched attacks on the other in an effort to make their point. For many years Brussels attempted to "tie" Russia into EU legislation, reflecting its usual tactic of expansion into Eastern Europe. This met growing resistance from Moscow, which retaliated by closing the doors to investment from abroad, including the EU. Adopting the principle of "reciprocity" would, therefore, offer the chance for both sides to start building relations afresh on the basis of a more constructive and even-handed approach.

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Crucial enablers for Knowledge Transfer between Russia and Western European Co-operations.

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Abstract

Many companies regard international co-operation as a quick and profitable engagement in order to win the global race for innovation, technological and competitive advantage. Beyond growing only quantitatively, however, co-operations or alliance partners should target to commonly create new knowledge as a basis for qualitative growth. The challenge is the successful design and implementation of this process. This task becomes even more challenging when co-operation members transcend national borders and the knowledge transfer is impacted upon by national cultures. The paper presents empirical findings of current research that is being undertaken to explore the impact of national cultures on knowledge transfer between Russian and Central/Eastern European, and Western European co-operations.

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Introduction

The way people learn is, to a large extent, influenced by culture. Eastern educational traditions based more on a hierarchical structure, as it was the case in Communist societies, left a deep impact on the learning approach, e.g. lack of critical thinking, fear of making mistakes, rejection of criticism or copying attitudes (superficial rather than cognitive learning). In the same vein, Reilly (1999) states, that the educational system was characterized by educational uniformity; uniformity of philosophy, control, curriculum, goals and teacher preparation. Contrarily to this type of education, Holmes (2004) describes Western education as Socratic, meaning that the knowledge is produced or generated in an active process of questioning and evaluating believes.

This paper suggests taking the influence of culture on knowledge transfer into account as learning styles depend, according to Guild (2001), on: a) cognition - how people perceive and gain knowledge, b) conceptualization - how people form ideas and think differently, c) affection - people's emotional responses and different values, d) action - simply, people act differently. Some cultures put more emphasis on brain development than others; therefore, different outcomes in ways of learning and thinking can be identified. For example, Germans stress logic and order ideas, information and experiences in a linear, sequential way, while Japanese reject the Western idea of logic. Some cultures favor abstract thinking and conceptualization, while others prefer rote memory and learning. What seems to be universal, however, is that each culture has a reasoning process, but then each manifests the process in its own distinctive way, as underlined by Guild, (2001, p.1): "learners bring their own individual approach, talents and interests to the learning situation".

To understand, cope with and, most importantly, capitalize on the diversity of different cultures many scholars have devoted substantial amounts of time conducting cross-cultural studies, e.g. Hofstede (1980), Adler (2002) or Usunier (2005). However, so far, they are lacking a specific focus on cross-cultural learning

and knowledge transfer methodologies, content and cross-cultural knowledge creation attitudes. Related to those attitudes, the most negative attitude highlighted by the Russian respondents during the research was the structuralistic or, more commonly denominated, the imperialistic attitude. The basic idea behind structuralism is that the process of knowledge transfer flows from the Western part to the Eastern part occurring on a linear or one-way direction completely ignoring cultural differences (Lang and Steger, 2002; Clark and Geppert 2002; and Tsang, 1999). The structuralistic approach may lead to role model and imitative management learning. If the learning process is based on imitation and on pleasing the formal requirements, this will imply, at best, the adoption of new practice (behavioral change achieved by single loop learning). Without any reflection, criticism, appreciation and, most importantly, application of new knowledge no real cognitive change can take place. If it is accepted that international co-operations or strategic alliances should be designed context specific, an additional reflection on the macro-, meso - organizational, and micro individual environment is suggested.

Albeit referring to the entrepreneurial background in Eastern Europe, Kaufmann, Davies and Schmidt (1994) and Kaufmann (1997; 2000) provide a comprehensive reflective gap net resulting from research in Eastern Germany, Belarus and the Czech Republic. The model is based on Thomas (1991) who claimed, that his model can be generalized for the whole of Eastern Europe. As to the macro environment the technological, infrastructure, ecological, legal, cultural, democracy and liberty gap is mentioned. The meso - gaps refer to the productivity, marketing, management, decision making, and capital gap whereas the micro-individual aspects include the motivation, time and experience gap. The model is used in this research as a reflective input. Importantly, the authors referred to the overriding importance of culture, however, on a macro and individual level, in the sense of a loss of values and identity rather than on the organizational or knowledge transfer context. The qualitative and quantitative findings of Kaufmann (1997) imply that entrepreneurial education in Eastern Europe should be differentiated by identity levels depending on the transition choice of either ‘shock therapy’ or ‘gradual approach’. In addition, the general models provided by Kaufmann, Davies and Schmidt (1994) on synergistic education between partners in transition to acquire basic successful system behaviors and the generation of motivation based on which management and marketing education can take place, have also been reviewed as a reflective input. A second identified negative attitude was the knowledge hoarding; the feeling of keeping knowledge as a way to keeping power was very widespread among both Eastern and Western research participants. This represents a major blockage in communication between the partners with detrimental consequences in terms of trust, being of pivotal importance for the success of the cross-cultural co-operation.

A comparative study between Western countries, mainly German speaking countries, and Eastern Countries with a focus on Russia will provide the reader with an understanding of the two opposite views and behaviors related to learning. The knowledge transfer in this study has been analyzed at the dyadic level, meaning focusing on the joint behavior of both parts. Nevertheless, a focus on the behavior of each part, sender-receiver (nodal level) has also been performed to suggest some directions for improving and facilitating the transfer of knowledge at a systematic level focusing on the behavior of a system consisting of providers and seekers.

In order to develop possible solutions and suggestions a critical reflection on own’ behavior and partner’s behavior will shed light on some hidden constraints blocking the learning process of cross-cultural partners, e.g. mistrust, devaluation, reluctance to share, blind obedience, bad learning atmosphere and pride, as well as, to address the paramount importance of changing attitudes related to ethnocentrism, respect for others and the willingness to help the partner to grow e.g. by improving relationship building and trust. All these properties and concepts will lead to the development of a new cross border common identity. In consequence, the transfer of knowledge being rooted in action and social context should become the centre of academic interest. This research focuses on the investigation of factors to get access to and utilize this valuable deposit. Factors such as a shared cognitive code, a shared system of meaning, transfer-mation of knowledge, common experience, and a socialization process, all of them being handled with emotional and cultural intelligence have to be provided for.

2. Methodology

A phenomenological approach is pursued because it tries to understand social realities, which are based on people’s experiences and the meanings attached to them. Post-positivism philosophy was regarded to be the most adequate philosophy to follow because “post-positivist approaches, aim to describe and explore in-depth phenomena from a qualitative perspective” (Crossan, 2003, p.2). Those phenomena refer in this case study, for example, to analyzing social and human interaction, perceiving the influence of the past and sharing tacit knowledge.

2.1 Research Methods and Techniques

The study was conducted in three stages. The first one, secondary research was conducted by a literature review. As to the second one, primary research was qualitatively conducted using the case study method with focus-group, participant observation and in-depth interviews as research techniques, because “all of them are methods that allow the researcher to respond to emerging themes and to the particular characteristics of each of the cases” as stated by Daengbuppha, Hemmington and Wilkes (2006, p.3).

The data collection phase was carried out over a 13 months period from February 2007 to March 2008. The data were collected by in-depth interviews (23), needed to reach theoretical saturation, non-participant and participant observation (7), focus groups (4) and fieldtrips notes in Russia and Austria. Theoretical sampling was used to select the participants.

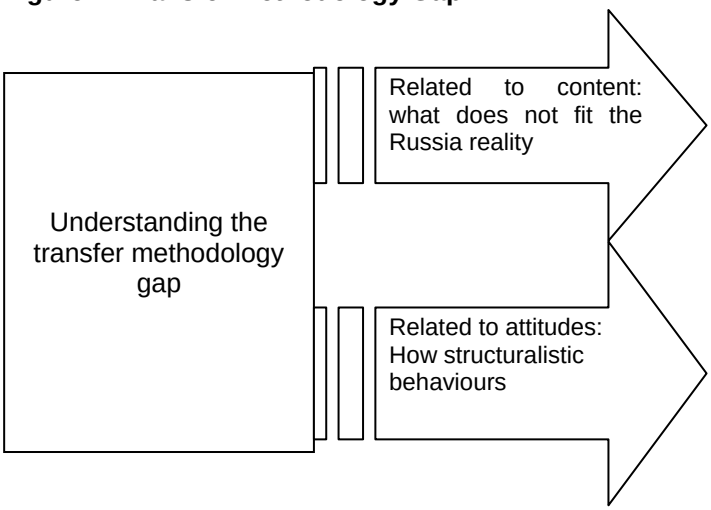
2.2 Data Analysis - Grounded Theory

The grounded theory method of constant comparative analysis according to Glasser and Strauss (1967) and Strauss and Corbin (1990) was used to analyze the gathered data. According to Darkenwald (2005, p.1) grounded theory is "an inductive approach to research that focuses on social interaction and relies heavily on data from interviews and observations to build theory grounded in data rather than to test theory or simply describe empirical phenomena". One of the main goals was the discovery of the participant's main concerns and how they continually try to solve the problems.

3. Findings of the Research

The influence of national culture on the way of learning is causing innumerate problems when transferring and receiving knowledge across borders. This can be seen in the following figure observing that national culture influences on the content as to what to transfer, in order to be accepted and on the attitudes prevailing in the transfer process in order to increase the likelihood for a real cognitive learning of both, the knowledge transmitter and the receiver.

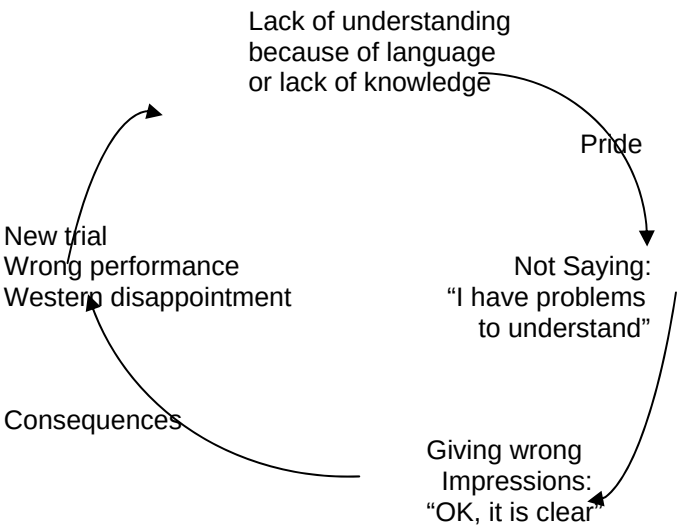
Figure 1: Transfer Methodology Gap



Related to the knowledge content respondent (2) highlighted *"if they think this concept is over-sophisticated and it doesn't fit for Russians, you immediately loose them" (R2)*. This is confirmed by respondent 10 calling in addition for innovative knowledge: *"If Westerners transmit knowledge in Russia, it has to be interesting for the person there, and also new for them. If the content is interesting, they will be interested" (R10).* The second finding relates to the attitudes during the transfer process: *"you see middle aged western managers coming here with their superiority, showing all the background they have, saying I'm a graduate of such and such a School of Management, very self-centered and sure that they bring the light of wisdom. No member of the Russian team will feel happy in the presence of this people. Who likes to listen that you are still living in the stone age?, which is not true" (R2).*

Resulting from the data analysis, two figures have been derived from statements of Eastern/Western interviewees as a way to explain the failures occurring when transferring knowledge. A constant thought and concern for Western interviewees was to understand why Russians couldn't submit reports or accomplish the tasks which were demanded from them according to Western expectations after having visited the Russian partners. After the analysis of the data from the Western part the following 'negative learning circle' arose.

Figure 2: The Western Perspective
The Negative Co-operative Learning Circle

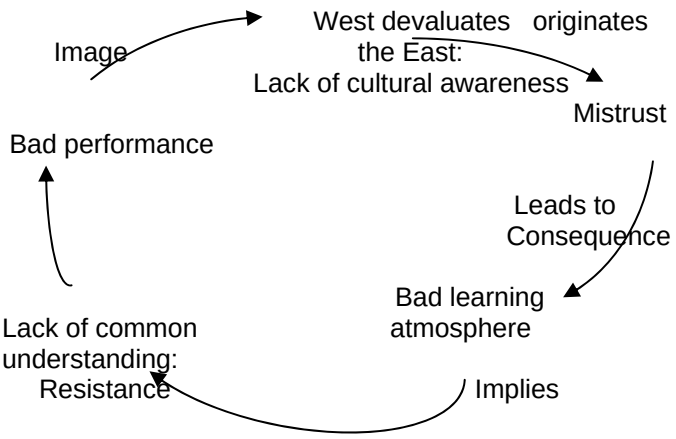


The Westerners mentioned issues related to problems in understanding due to language limitations, misinterpretation, lack of communication flow and also having different levels of knowledge as being important barriers for transmitting knowledge or even for the normal co-operation. Observations have been made related to the Russian pride. They argue that Russians will not admit that they have a problem in understanding, or lacking the knowledge in a specific area or having problems facing criticism. This is reflected in the following statements: *"We are in a meeting, and we have the feeling that there is something going on, we have the impression that people don't like to face problems in a way how we do that in our area" (R13). "If there are just technical instructions they understand because they have a very good technical education, too, but if you try to explain them the strategy behind or a concept, we feel that there are big differences" (R13).* A Russian respondent (9) expressed that *"Criticism is the weakness of the Russians" (R9).* Continuing with the circle (Figure 2), this attitude provides a wrong impression; the Western partner will think that

everything is fine and understood as it was the case with respondent (14): *"after teaching them about new things or regulations of policies, as we know it from our culture, they always said, yes we understood, and it was really not understood, it was far from being accepted"(R14).*

The consequence of this behavior is that after a time of two or three weeks or months after their visit in Russia, Westerners are expecting outcomes to happen. Then they are disappointed with the performance of the Russian partners because they did it in a totally different and un-expected manner, or they just produced 30-40% in comparison to the expected 100%. Respondent (14) tries to explain this situation: "*first, they didn't understand it because of languages, they didn't say sorry I have a problem to understand you because of the language, OK, they said, I have understood. So it was a barrier for them to jump over this and to be honest and to say sorry, but my German or my English is too weak. The other aspect is that they have not accepted it and my conclusion was that these things didn't fit with their understanding".* In a state of confusion and not understanding what went wrong, Western companies try again via telephone calls, email, faxes etc, but, unfortunately, the circle continues to turn.
Continuing with the analysis of the findings from the Russians interviewees, a different perspective arose and an additional negative learning circle was developed.

Figure 3: The Russian Perspective
The Negative Co-operative Learning Circle



Unanimous concerns from the Russian interviews were mainly related to the aspects of attitudes towards knowledge transfer and cultural empathy. The following statements reflect the Western attitudes towards the transfer of knowledge named as structuralistic or imperialistic behavior: *"Yes, the colonial approach, they are humiliating sometimes"(R6)* or: *"that Westerners only teach the Russians is not good. It is related to collective decision making, not to an authoritarian way" (R1).* Pointing to a lack of cultural awareness, the respondents stated that Westerners go to Russia without any cultural preparation. This relates, for example, to knowing something about Russian history or Russian reality: "*they don't do their homework* " (R1-2) referring to a necessary preparation in their home country before traveling to Russia. This preparation does not only relate to macro-economic figures but also to getting to know their partners' achievements and knowledge background. This lack of cultural preparation, ignoring Russian culture, not showing interest in the country or even lacking appreciation originates a climate of mistrust. Consequently, a big gap exists regarding the right learning atmosphere and learning motivation: *"a lecturer from Canada will explain, discuss with you a lot about Canada and, may be, he will not be aware of what is going on in Russia, and for us it is as if this person from Canada doesn't know anything about us, he knows a lot about his own country but for us it is just useless"(R5*). This inefficient learning atmosphere prevents a common understanding and can undermine the learning success. Even more, the resistance to learn and to integrate new knowledge will be blocked by creating defensive routines. Obviously, this Russian behavior will lead to a badly perceived performance and the image will be damaged, so, again, the negative circle will continue turning.

4 Recommendations
The variables facilitating knowledge transfer have been elicited and are presented by the figure below. It has to be explicitly mentioned that the suggested variables apply in the same way and extension to members and organizations in Russia as well as to those in Western Europe, because the solution rests on a reciprocal and interactive learning process. The identified variables are: changing the learning attitudes, emotions in action, time investment for reflection, transfer-mation of methodologies, building on common values, improve and expand teaching skills and increase travel and exchange placements. In order to avoid this learning difficulty, knowledge transmitters should be sensitized about the knowledge receiver's way of learning, meaning to understand the way people think, interpret and acquire knowledge. This should start by exploring the roots of actions. Then, helping partners to bridge this transition from their first culture education methodology to the new dynamics of reciprocal learning. This new dynamics must include knowledge about the innate personality of the knowledge receiver as well as, learning cultural values that affect and trigger the receiver's behaviour. This approach is indicated by respondent 10 referring to the Russian writer

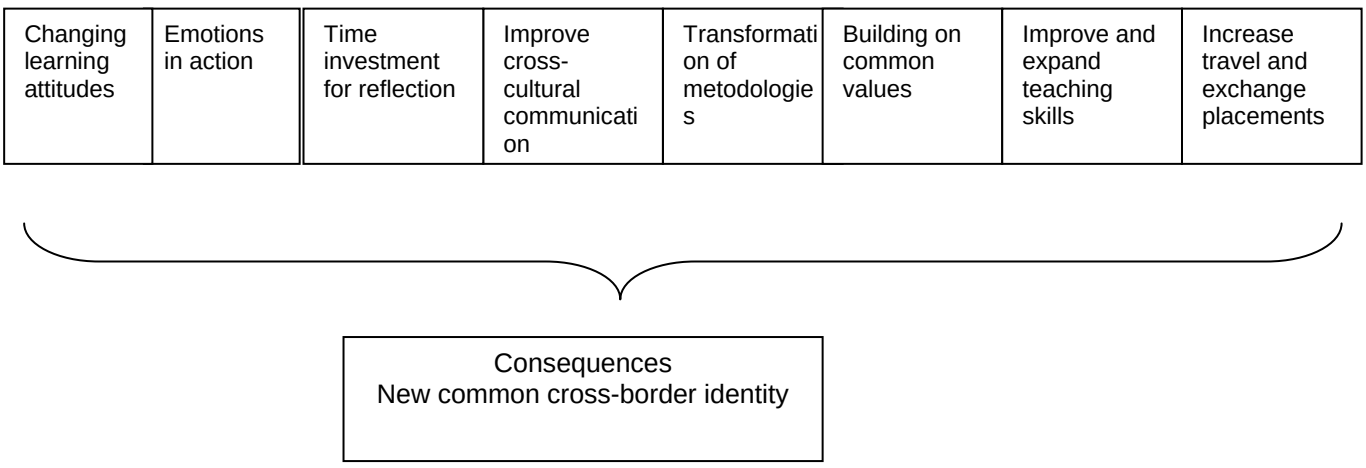
Nikrasow: *"Russia has to be understood, not by observation or perception." (R10).* Perceptions are very often distorted by self-reference criteria or even existing stereotypes, therefore, the best way is by interacting face to face because *"unfortunately these relations don`t work virtually" (R10*) and will help in building up a trustful relationship. Additionally, emotions play an important role when developing new knowledge as underlined by Bagshaw (2000, p.3): "we can not expand knowledge purely with knowledge that already exists. There has to be an input of hunches, guesses and intuition. These come more readily when we open the doors to

emotional reactions". This statement has been widely confirmed by Russian respondents: *"well, emotions are connected with interest and enthusiasm. To pay more attention depends on interest, and how you build interest is connected with emotions" (R1).* She continues: "*emotions helped us to solve a lot of problems in the past...Emotions bring impulse to real life and then can change something".*

Changes on a cognitive and behavioral level can occur when both partners express and exchange their underlying understanding and behavioral norms (integrative learning) (Child and Marcoczy, 1993); Nadle, 1992). This process implies that the knowledge receiver has a receptive attitude to new concepts and practices transmitted by the knowledge sender, and at the same time the knowledge sender is equally open to accept that their approach and ways of thinking and performing might require conceptual and methodological modification in order to fit the local environment. Using an analogy of musicians and the orchestra referring to Eastern and Western partners, Tsang (1999) suggests that each member has to learn a part of the new symphony. The actual concert performance, which is the result of mutual learning, is always a group and not an individual activity. This is in line with Rosen (2000, p.101) regarding integrative learning and innovation as emerging "from the juxtaposition of people, ideas and technology, not from the isolated endeavors of individuals.

The suggested reciprocal and interactive learning calls for a synergistic technique, explicitly synthesizing cultural dimensions into future models of trans-national management education that goes beyond the usual western paradigms and practices as highlighted by Mitry & Bradley (1999), Adler (in Mitry & Bradley, 1999) and Jaeger (in Bolton, 1999). Scholars like Bedward, Jankowicz and Rexworthy (2003) ask for mutual collaboration in the examination, construction or changes of the knowledge and material to be transferred to increase the likelihood of success. This is confirmed by a respondent stating: *"a very important point is having mutual discussions. The time spent for these discussions, for example, and openness and willingness to share knowledge are necessary. If Westerners are ready to spent time and are ready to share, then it can work" (R1)*. Concordantly, Holsapple (2003, p.201) suggests "that the learning processes are intrinsically social and collective and occur not only through the imitation and emulation of individuals, as with teacher-student or master and apprentice, but also because of joint contributions to the understanding of complex problems". Similarly, Liu & Vince (1999) stress that organizational learning is culturally dependent and it is very important to understand the different modes of managing and organizing as well as the respective social and economic background as a basis for engaging effectively in a collaborative process of learning. This is supported by the suggestions of the following respondent: "*We have differences in planning, scheduling, discussion of main points, having different priorities, having different backgrounds. It is no easy to overcome the problem. I think we could prepare ourselves by reading about the other's culture, by being open to each other and by drawing together a common aim" (R1).* The following figure summarizes the methodological recommendations.

Figure 4: Reciprocal and Interactive Learning



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