EU enlargement: A new era in Latvian-Russian economic relations?

Alf Vanags
Baltic International Centre for Economic Policy Studies (BICEPS)

Introduction

The EU enlargement that takes place on 1st May 2004 will usher in a completely new framework for Latvian-Russian economic relations, perhaps even a new era This new framework will be defined by two related characteristics:

- Latvia will adopt the EU common external tariff and adhere to the EU's common commercial policy
- Latvia will be integrated fully (eventually) into the EU Single Market

The aim of this presentation is to explore the implications of these changes for Latvian- Russian economic relations. This must also be seen in the context of the development of Russia's own international economic relations eg Russia's path to the WTO

The current situation

In order to set the scene it is helpful to set out some basic facts about the current economic situation between Russia and the Baltic states and Latvia in particular. The key areas are trade and foreign investment.

Trade

The emphasis of Latvian policy makers in recent years has been on the re-orientation of Latvian trade towards the EU. Thus Russia is accounts for just 5.9% of Latvian exports and is the origin 8.8% of Latvian imports. Nevertheless, in 2002 the Russian Federation was in fourth place among Latvia's most important trading partners after Germany, Lithuania and Sweden. Moreover, after the slowdown generated by the Russian crisis Latvian Russian trade has been growing.

A key feature of the existing trade pattern is the trade imbalance between Russia and all three Baltic states and the asymmetric commodity composition. Thus the level Latvian imports from Russia is about 2.5 the level of exports, generating a bilateral Latvian trade deficit (Russian surplus) of over 250m USD. As to commodity composition imports from Russia are dominated by fuels, while the most important export commodity is food products.

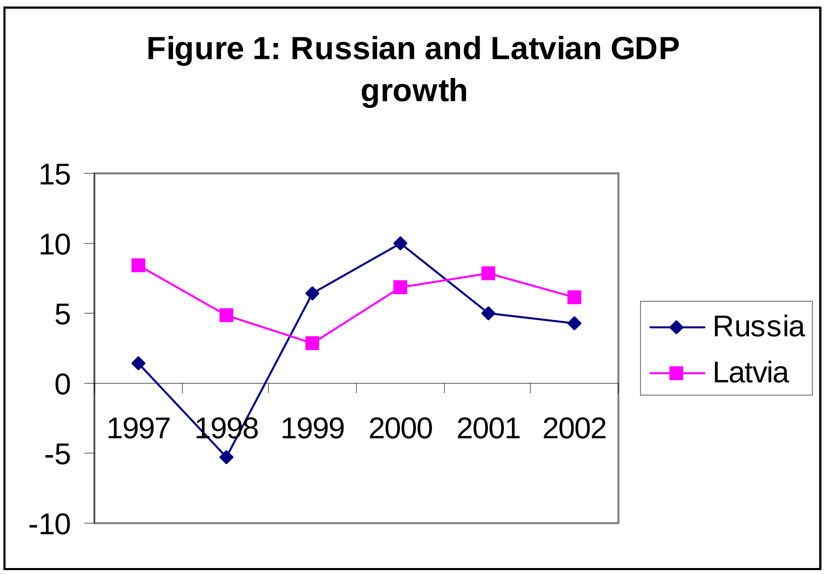
In addition to goods trade Latvia is important for Russia because of its role in transit. Russia does not have a common border with Germany – its largest trade partner. Hence the Baltic states as well as Poland are used as transit countries to access the core of the European Union. This trade is also important for the Baltic countries – transit trade is estimated to generate between 8 and 9 percent of GDP for Latvia (somewhat less for Estonia and Lithuania).

Foreign direct investment

Foreign direct investment often follows trade. Thus Germany and Sweden are first and third among trade partners and second and first among sources of foreign direct investment (FDI). Russia is fourth among trade partners but in 7th place as a source of FDI. This is not entirely surprising – much FDI into Latvia has been to provide services such as banking, supermarkets, hotels etc which either did not exist in the previous system or suffered from quality deficiencies. Thus it is natural that these services should be taken over by foreign investors from the West. Russian FDI is however important in certain specific sectors eg the downstream operators in the the provision of natural resources or in the transit business.

The significance of the Russian economy for Latvia

In absolute GDP terms the Russian economy is quite small – certainly much smaller than the EU as a whole and about the same size as the Netherlands. However, this does not reflect the underlying influence of Russia on the Baltics. Whether we like it or not, the health of the Russian economy is very important for the Baltic economies in general and Latvia in particular. This is vividly illustrated in Figure 1 below which shows the development of Latvian and Russian GDP since 1997 (ie growth as compared with the year before). The two graphs have a common pattern with Russian GDP growth leading Latvian. This is also logically the direction of influence. The impact of the Russian crisis is clear as are the turning points in subsequent years.



What happens after EU enlargement?

As noted in the introduction after accession Latvia will adopt the common EU external tariff and the EU commercial policy and will eventually become a full member of the EU single market. These changes will have effects on both trade and factor movements. In the latter case most particularly on FDI.

Trade

The impact of EU accession on Latvian/Russian trade will come from two effects. One is the change in tariffs from the current Latvian tariffs to the EU common external tariff. This effect has been investigated by Vanags (2001) a computable general equilibrium model of the Latvian economy and as far as trade with Russia is concerned there is expected to be a small amount of trade diversion ie diversion of trade from low cost Russian sources to higher cost EU sources. However, the impact is likely to amount about 0.13% of Latvian GDP. Basically negligible for Latvia and negligible for Russia

However, a second, more serious, effect might come from the fact that Russian trade with Latvia and the other Baltic countries will be subject to EU anti-dumping rules. This could have serious effects in particular sectors eg steel.

Nevertheless, on the whole it is unlikely that there will be major trade effects either on Russia or the Baltic countries arising from the EU enlargement in May.

FDI

More significant effects may be expected to arise with FDI, especially Russian outward FDI. The transition countries are just starting to become foreign investors and Russia is by far the most important player, making up almost three quarters of the outgoing investment from the former eastern block. Russian foreign investment amounted to USD 3284 million in 2002 and the aggregate Russian FDI stock totaled over USD 18 billion in 2002. Russian outward FDI took off in 1997 reaching over USD 3 billion and has been been in the range between USD 1.2 and 3.2 billion annually since then. The annual average for the previous decade was only USD 94 million. See Svedberg et al (2003) for more details. The exact amount of Russian foreign investment is uncertain but it is very likely to be substantially larger than indicated above as capital flight is not included in the FDI statistics and it is estimated to account for as much as USD 20 billion a year from Russia. Moreover, the statistics does not include a number of other transactions that could be identified as foreign investment. In 2000, un- or misregistered Russian FDI outflows may have been more than USD 14 billion.

So Russia is an important and growing source of FDI, especially to the Baltic region. EU accession is likely to enhance the attraction of the Baltic states as a destination for Russian FDI. Since Latvia and the other Baltic countries will now be part of the EU market Russian businesses wishing to access the EU market will now be able to do so from the Baltic countries. Language, geography and culture all suggest that Latvia and the other Baltic countries will provide Russia with an attractive platform for entering the EU market. This will be especially enhanced as Russian manufacturing eventually develops and seeks EU markets.

Changed relationships?

For understandable reasons Latvian/Russian political and commercial relations in the 1990s have had some problems. The EU enlargement offers the prospect of a radical change. In commercial terms there will be Russian/EU relations and bilateral Latvian/Russian commercial relations will de facto no longer exist. Whatever the Russian Federation achieves in terms of signing separate partnership agreements with each of the new EU member states, in practice the terms of such agreements will have to be the same. It will no longer be possible for Russia to trade on different terms with Latvia as compared with say Lithuania, or for that matter Germany. This is all to the good and bodes well for the mutual development of Russian Latvian commercial relations.

References

Vanags A (2001) “ Measuring the impact of Latvian EU accession” *Baltic Economic Trends* 2001(4)

Svedberg M, Berglof E, Vanags A, and Yudaeva. K (2003) *EU enlargement: implications for trade growth and investment in the Baltic Sea Region*, SITE November 2003