Russia's Search for a Place in Global Trading System

As Russia searches for its place in the global system of trade, what options does it have? An analysis of Russia's trade composition and bilateral relationships with its partners reveals several alternatives that it can use for integrating into global world markets.

RUSSIA'S NATURAL STRENGTHS AND WEAKNESSES

Russia is a country richly endowed with mineral deposits (hydrocarbons, metal ores), renewable resources (forests, water) and fertile land. These natural strengths are somewhat offset by its harsh climate, lack of transportation routes, and an underdeveloped public infrastructure, which has not been historically tailored to the needs of a trading country.

The composition of Russian exports (see Table 1) reveals that this country is globally competitive mostly in products whose value can be attributed to its natural advantages: energy resources (crude oil, gas, coal), timber, diamonds, and non-ferrous metals (platinoids, copper, nickel, and aluminum). These resources account for 45-55 percent of total Russian exports. Semi-processed goods, which stand at 19-23 percent, make up the second most important group. Its composition (motor and heating fuels, iron and steel products, fertilizers and processed wood) shows heavy dependence on the availability of domestic raw materials and cheap energy with low value added. While there is some residual influence of Soviet investment preferences (for example, the Soviet Union developed Siberian gas and oil fields with pipelines leading to external markets), the products of pre-1991 industrial projects do not enter the shortlist of top export groups. The latter observation indicates that modern Russia is able to compete globally only in extraction and rough processing of natural resources.

Table 1. Top 15 Export Product Groups at HS 4 Level by Annual Value of Export for 1997-2006, in million U.S. dollars

Description	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	HS 4
Coal	821	622	436	1,137	1,201	1,151	1,722	2,755	3,756	4,342	2701
Petroleum (crude) oils	14,608	9,456	13,467	23,644	24,563	27,445	36,841	55,099	79,216	96,675	2709
Petroleum oil products	7,836	4,163	5,359	10,712	9,402	11,140	13,927	19,144	33,677	44,218	2710
Gaseous hydrocarbons	15,844	13,407	11,592	16,991	17,882	15,473	17,589	18,621	27,496	42,816	2711
Mineral fertilizers, nitrogenous	1,060	380	296	533	573	544	660	981	1,413	1,510	3102
Fertilizer mixtures in packs of < 10kg	593	667	662	641	633	680	803	1,133	1,278	1,362	3105
Timber	1,026	937	1,204	1,338	1,388	1,648	1,802	2,333	2,856	3,259	4403
Wood sawn, cut lengthwise, processed	654	542	627	733	685	869	1,177	1,510	1,899	2,311	4407
Diamonds, unmounted	1,386	1,353	1,267	1,371	827	1,485	1,742	2,351	2,993	...	7102
Platinum or palladium, unwrought	1,701	2,514	3,218	6,048	5,207	1,807	1,790	1,746	1,830	...	7110
Semi-finished products of iron or non-alloy steel	2,073	1,145	1,421	1,789	1,807	1,897	2,123	4,636	4,752	5,265	7207
Hot-rolled products, iron/steel, width>600mm	1,599	1,590	1,044	1,424	885	1,351	1,621	2,896	3,079	4,355	7208
Refined copper, unwrought	1,126	878	953	1,080	880	711	657	887	1,066	1,711	7403
Unwrought nickel	1,496	1,102	1,217	1,702	1,088	1,720	2,201	3,171	3,548	5,893	7502
Unwrought aluminum	3,798	3,780	3,613	4,142	3,632	2,893	3,318	4,093	4,836	6,803	7601
Memo: total export	85,889	72,276	72,885	103,093	100,653	106,712	133,656	181,634	241,244	301,976	

Source: Comtrade (UNSD, 2006) and FCS (2007) preliminary data for 2006; groups 7102 and 7110 are recalculated using import statistics of recipient countries

Historically, European trade routes dominated the geographical structure of Soviet exports and, as Table 2 indicates, Russia has not done much to diversify its exports since then.

Table 2. Top 15 Export Destinations Ranked by the Average Annual Value for 1997-2005, in million U.S. dollars

Description	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	HHI 2005	Top product
Germany	6,531	5,721	6,202	9,231	8,376	7,600	6,345	8,768	18,826	24,493	2,843	Crude oil
Netherlands	4,553	3,994	3,673	4,341	4,470	6,935	8,253	14,829	24,482	35,862	3,752	Crude oil
Ukraine	7,240	5,563	4,792	5,024	6,854	6,788	6,266	9,102	12,254	14,979	1,529	Crude oil
Italy	3,564	3,222	3,755	7,255	6,973	7,067	5,788	8,931	18,473	25,111	3,601	Crude oil
Belarus	3,153	4,623	3,767	5,535	5,249	5,922	7,602	11,219	10,186	13,084	1,769	Crude oil
China	3,981	3,200	3,527	5,235	3,878	5,310	7,815	8,376	11,217	15,751	1,209	Crude oil
USA	4,486	5,138	4,714	4,648	2,876	3,026	3,074	5,490	5,115	8,922	906	Iron and steel
Poland	2,515	2,780	2,608	4,452	4,106	3,692	3,719	4,897	8,467	11,479	5,168	Crude oil
Switzerland	3,752	3,256	3,479	3,976	1,473	3,089	3,561	5,158	7,810	12,068	1,001	Oil products
United Kingdom	3,055	3,025	2,886	4,669	3,115	2,944	3,905	4,399	7,578	10,362	1,994	Oil products
Finland	2,774	2,076	2,414	3,104	3,165	2,931	3,727	5,222	7,561	14,377	1,884	Crude oil
Turkey	1,983	1,997	1,631	3,098	3,027	3,136	3,131	5,551	10,381	9,201	1,790	Natural gas
Kazakhstan	2,472	1,967	1,226	2,247	2,671	2,569	3,096	4,507	6,446	8,969	427	Crude oil
Japan	2,935	2,194	2,125	2,763	2,021	1,743	2,250	3,171	3,521	4,670	1,159	Aluminum
France	1,626	1,456	1,218	1,914	1,995	2,381	1,686	2,233	5,402	7,602	2,334	Natural gas
Memo: total export	85,889	72,276	72,885	103,093	100,653	106,712	133,656	181,634	241,244	301,976	1,598	Crude oil

Source: Comtrade (UNSD, 2006) and FCS (2007) preliminary data for 2006; HHI is calculated by the author using 120 main groups (HS 2 and HS 4 for energy and machinery) for 2005.

A closer look at the composition of exports to individual states shows that Western routes are conditioned on trade in hydrocarbons delivered through sea terminals and pipelines. In general, crude oil, oil products and natural gas weigh heavily in total exports. Applying, somewhat loosely, the Herfindahl-Hirschman Index (HHI) of monopolization to Russian trade with individual countries reveals that the HS group 2709 (crude oil) accounts for 40-50 percent of total export, or 1,600-2,500 points on HHI scale, to most states, especially the EU countries. The dominance of crude oil in trade structure illustrates the degree of Russia's reliance on this product. The lack of alternative exportables is particularly evident in Russia's trade with former socialist countries such as Poland. Russia sells a greater variety of products to post-Soviet states (Ukraine, Belarus and Kazakhstan) but even here crude oil is its main staple.

An analysis of trade statistics reveals several facts. First, the composition of Russia's exports indicates that this country is heavily dependent on its natural resources and little on its labor and capital endowments. Second, former Soviet investment in the transportation infrastructure determines Russia's dependence on two groups of trading partners.

The first group comprises European countries, with Turkey – thanks to a gas pipeline that was built in 2005 – as the latest addition. These importers treasure trade with Russia primarily because of their dependence on Russian hydrocarbons. Currently, the growth in energy prices has increased Russia's attraction for the region. However, given that energy prices are volatile, the existing situation seems to be fragile and hardly suggestive of durable Russian-European or Russian-Turkish trade integration. It is a marriage of

convenience, at best.

The second group comprises post-Soviet countries. Here the situation is different. Due to historical circumstances, these states continue to purchase a wide variety of Russian products, which results in relatively low values of HH indices. This is especially characteristic of Kazakhstan. The pattern of trade with Belarus is somewhat distorted, however, leading to high HHI value. The bias is explained by Russian oil companies' delivering crude oil to their refineries in Belarus with the consequent sale of resulting products in the EU.

Finally, Russia is a significant exporter of certain non-energy products to some countries outside Europe and the post-Soviet space, such as Japan, the U.S. and China. The slow growth in the export of non-staple products beyond traditional markets suggests that Russia searches for ways to diversify its trade, yet at this point it would be premature to say that it is succeeding.

RUSSIA'S "ORBIT OF GRAVITATION"

Oftentimes, in order to define the strength of countries' bilateral relationships, economists use the so-called 'gravity model' of trade. The model represents an economic analog of the Newtonian theory of gravitation and assumes trade to be positively related to countries' economic "weight," which is measured by the gross domestic product (GDP), and is negatively related to some measure of "distance" between countries' ceteris paribus. Since the concept of distance is undetermined (it includes all potential trade costs, including transportation expenses), it is expedient to use the inverted form of the model, with distance represented as an unknown parameter. The distance (Dist) is computed as the product of the countries' GDPs divided by the product of their export and import, or

$$Dist_{ij} = \frac{GDP_i \cdot GDP_j}{Ex_{ij} \cdot Ex_{ji}}$$

Then, a "short" distance reveals partner countries with which a state trades relatively more intensely than with other partner countries of similar economic "weight."

Table 3 shows that the intensity of Russian trade is the highest with several post-Soviet countries and some European states. This confirms the above observation that Russia belongs to two trade groups – the post-Soviet core and the EU. The gravity test also provides additional information, in particular, that the post-Soviet core comprises Russia, Ukraine, Belarus and Kazakhstan. Among EU countries, Finland shows the strongest link, with Germany, the Netherlands and Italy rapidly approaching the level of Russia-Finland trade integration. On the other hand, the Baltic States and Moldova are slowly drifting away from Russia. Table 3 covers a rather long period, but it does not include data on the recent growth in trade between Russia and such non-European countries as Turkey and China.

Since the unit of account for "distance" is not insightful, it would be appropriate to compare the data shown in Table 3 with information available for other countries. Globally, the shortest "distance" in 2005 was registered between the pairs Singapore-Malaysia, Belgium-Netherlands and the U.S.-Canada, which have values ranging between 50 and 250. Thus, the shortest "distance" between Russia and Belarus is far behind the values shown by global leaders in trade integration. To achieve a similar level, Russia and Belarus should expand

their trade turnover – which currently stands at $20 billion – to total $45-105 billion. Still, Russia-Belarus cooperation is comparable with that of Spain and Portugal (1,285 and 1,272 respectively in 2005), or Australia and New Zealand (2,261 and 2,549).

Table 3. Fifteen Top Countries Showing "Attraction" to Russia According to Gravity Equation*

Description	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Average for 1997-2006
Belarus	3,340	1,734	3,432	2,466	2,809	2,826	2,146	1,370	2,054	1,507	2,368
Ukraine	5,901	8,840	14,549	11,690	9,955	13,583	13,072	8,255	6,254	4,462	9,656
Kazakhstan	7,986	13,863	33,751	14,755	18,808	23,545	19,383	11,335	10,139	6,780	16,035
Finland	19,131	39,619	49,962	46,346	38,061	38,908	28,290	18,703	11,942	7,905	29,227
Germany	40,563	55,113	74,353	63,840	53,150	55,542	60,254	38,355	22,977	9,764	47,391
Moldova	16,187	27,544	77,318	85,150	67,725	98,482	132,836	102,505	75,613	72,381	75,574
Lithuania	39,264	72,926	183,700	104,544	101,080	81,039	74,441	52,364	35,895	30,162	77,542
Netherlands	60,914	92,203	151,980	142,413	134,997	75,665	59,673	34,851	17,263	9,227	77,913
Poland	86,126	102,102	215,653	126,960	115,233	109,486	90,565	60,461	38,670	22,821	96,208
Estonia	74,300	138,563	228,171	124,284	134,734	115,829	156,534	115,819	71,880	45,932	120,603
Italy	124,209	196,277	294,110	172,566	144,227	118,161	149,449	83,422	41,091	20,350	134,386
Hungary	56,271	107,889	228,906	138,319	157,255	163,663	231,292	164,929	77,312	26,147	135,198
Latvia	35,763	86,466	161,970	129,316	208,059	239,707	212,843	163,472	143,761	82,093	145,845
Switzerland	81,823	113,551	165,445	194,070	413,712	208,145	154,487	101,543	56,157	26,759	151,069
Uzbekistan	33,412	96,741	295,299	216,358	213,190	334,768	263,450	149,111	108,096	63,720	177,409
Total	5,783	10,376	16,839	12,785	11,962	11,461	8,557	5,672	3,794	2,653	8,990

* The "distance" is calculated as the product of a partner's and Russia's GDPs at PPP prices divided by the product of the countries' value of bilateral exports, in billion U.S. dollars.

Source: IMF (2006) and CIA World Factbook (various issues) for national GDP at PPP prices; Comtrade (UNSD, 2006) and FCS (2007) preliminary data for 2006 for Russian export and import; author's calculations.

The gravity model can be used to chart the borders of actual or potential unions of trading countries, which are often construed similarly to "hub and spikes" structures commonly used in the optimization of transport routes. Large countries and popular city-states play the leading role in forming a hub through which member countries of such a union – potentially informal – pass trade flows in multilateral trade. For example, it comes as no surprise that the U.S., having the highest "gravitational mass," dominates in NAFTA, while the other members, Canada and Mexico, trade between themselves predominantly via the "hub." Germany is the center of gravity for several Central European countries (Austria, Italy, Switzerland, Poland and Hungary), but the structure of this union is more complex. The German hub overlaps with a smaller center, Belgium, which shows a "shorter" distance to France, Luxembourg and the Netherlands. Sweden dominates in Northern Europe where it draws such countries as Norway, Finland and Denmark into the Scandinavian group. Singapore stands as the main destination for trade routes within ASEAN. Similarly, the United Arab Emirates finds itself the center of the Middle East group of countries.

Russia generates a weaker gravitational power than the top trade leaders but, nevertheless, it has sufficient "mass" to attract Eurasian states. Apart from Belarus, Ukraine and Kazakhstan, which definitely belong to its orbit, Uzbekistan and Turkmenistan weakly gravitate toward Russia. In their turn, Kazakhstan and Uzbekistan are local centers of attraction for Kyrgyzstan and Tajikistan respectively, while Ukraine is the local center for Moldova. Thus, all of these post-Soviet states form a chain that connects them to a potential

Eurasian union.

The Caucasian republics conspicuously fall out of the above picture. Georgia, Armenia and Azerbaijan form a separate group that is only weakly attached to the outside world. Azerbaijan shows the greatest "gravitational mass" among the three and some outward pull toward Turkmenistan. Russia's presence in Transcaucasia is "somewhat visible" due to the transit of Central Asian gas and export of electricity.

Similarly, the Baltic countries form a compact group on Russia's western border, but their cohesion is one degree stronger than that existing between the Caucasian countries. Here, the chain connection among Lithuania, Latvia and Estonia leads to Finland, which, in its turn, belongs to the orbit of Sweden. The pulling attraction of Lithuania – the most distant country in the group – to the southern centers (Poland and Belarus) is about equal, but these countries do not generate trade flows sufficient to compete with the Nordic direction of Lithuanian orientation.

RUSSIAN OPTIONS IN GLOBAL INTEGRATION

If one ignores specific sectors where domestic producers achieve global clout due to the uniqueness of their position (for example, in titanium alloys used in aviation or palladium for car manufacturing), Russian trade integration involves two groups of partners: Europe and post-Soviet states. However, the two groups differ in export and import structures and, consequently, provide dissimilar forms for such integration.

Option 1: EU-Russian integration. The lack of products other than energy weakens European interest in Russia as a partner. For most EU countries, Russia is simply an energy supplier. Consequently, many EU members limit their vision of Russian-European integration to the sector of energy and, desirably, without cross-sectoral linkages. Virtual disengagement is particularly popular among East-European states that are still resentful of former Soviet dominance. At the same time, while minimizing imports from Russia, these countries find themselves to be heavily dependent on hydrocarbon deliveries from this country. For example, Poland and Lithuania have extremely high HHI scores for import of crude oil (9,446 and 9,903), implying that Russia is practically their only supplier. Unsurprisingly, these countries demand that Russia sign the Energy Charter to ensure unrestricted access of Central Asian producers to its pipelines and, preferably, admit European producers to its oil and gas fields. However, such a proposition is not acceptable for Russia as it reduces its export and transit revenues. Other European importers are less concerned with Russian energy clout as they have diversified networks of suppliers. For example, German HHI in crude oil equals 1,672, with its largest supplier, Russia, accounting for 30 percent of the import. Thus, while Poland is bent on hard bargaining with Russia, Germany can afford a more accommodative stance if Russia reciprocates in other areas. Meanwhile, Russia resolutely shows no inclination to sign the Charter, which is understandable given its heavy dependence on hydrocarbon trade.

Currently, the EU-Russian dialog on deepening trade relationship seems to be stalled on two counts: first, Russia is unwilling to compromise on the energy front as it is its only trump card in trade negotiations and, second, the EU lacks consensus on negotiating anything else but energy. Under current circumstances, talks between Russia and separate EU members may prove to be more fruitful and, at least initially, to sustain momentum in integration. Two countries, Germany and Finland, now serve as major points that connect Russia economically to the EU: Germany provides a potential link to the Central European

cluster of business activity and Finland links Russia to the Nordic group.

Let us consider what would happen if the EU lets its members define the speed of eastward integration individually. Germany and Finland are already disproportionably involved in bilateral trade and they will choose fast integration. However, given that trade between them and Russia is disproportionate, a concessionary quid pro quo approach cannot work if economic sectors are treated separately. Thus, to agree on concessions, several sectors should be involved simultaneously. This constraint rules out the possibility of natural integration that takes place on the level of individual enterprises and requires government interference to coordinate the process. Let us consider what mutual concessions might look like.

Both German and Finnish companies export a large amount of machinery and electronics to Russia. The latter reciprocates predominantly with energy products. These three sectors can form the core of integration activity, particularly through mergers and acquisitions, but also with direct investment in new assets. The economic benefits of such integration – the economy of scale gains – are obvious; yet to become politically feasible the parties should agree on the national division of such gains. Since Russian machinery and electronics makers do not wield political clout compared with the national energy lobby (Gazprom or Rosneft), and German and Finnish energy companies do not have serious interests in oil and gas extraction, it is expedient to condition Russian energy expansion westward on German and Finnish access to Russian machinery or mobile telephony markets. The resulting expansion of mutual trade can be large: for example, if Germany and Finland raise their level of integration with Russia to the current level of Germany's integration with Poland, total Russo-German and Finnish turnover will rise to $82 and $20 billion respectively from current $41 and $15 billion.

Facts indicate that some German, Finnish and Russian companies have identified the potential of this strategy. German carmaker Volkswagen has announced plans to develop a €400 million technopark in Kaluga. AMD has sold its Dresden microchip facility for estimated $250-300 million to Russian company Angstrem in Zelenograd. A mulled merger of telecommunication assets of Russia's Altimo and the Swedish-Finnish concern TeliaSonera would be a step in a direction that the Russian government is likely to approve. However, the process of integration is proceeding in a haphazard way as other moves lack an inter-sectoral quid pro quo approach. Moreover, they may provoke discord because they resemble foreign attempts at hostile takeovers. Russia has been right not to demand a place on the EADS corporate board as it has little to add to the EADS value at the moment. European companies seem to be less sensitive to such considerations. Siemens, for example, attempted to get a controlling stake at the main Russian power plant maker Silovye Mashiny. This raised Russian suspicions that this firm was attempting to define its domestic energy renovation program. Similarly, it transpired recently that Finnish utility Fortum might not be allowed to take a controlling stake in the St. Petersburg-based generating company OGT-1 for strategic reasons.

The observation above shows that attempts at unsolicited cross-border mergers are self-defeating in the long run because they provoke economic nationalism, which seems to be incompatible with true partnership. Responding to popular pressure, the political authorities deign to protect the jewels of the domestic economies; their destiny is to be guarded jealously. In order to progress, the sides should be willing to compromise on their dominance in those sectors where their comparative advantages are indisputable. After all, the total of bilateral gains is what matters most, while the national distribution of gains can

be adjusted through further negotiations.

Interstate negotiations can enhance the process on two counts. First, inter-state agreements reduce the risk of opportunistic behavior of national companies. Second, government intervention solves the potential problem of market failure due to the unequal distribution of integration gains. To achieve Pareto-style efficiency, governments redistribute gains from winners to losers. For example, the Russian government may find it expedient to compensate losses or invest in the public infrastructure, supporting local machinery producers using additional energy revenue. Finally, governments – notably that of Russia – can be tasked with the objective of reducing red tape and other obstacles to order to fill formal agreements on real partnerships. It is an open secret, documented in many surveys, that the business environment in Russia contrasts negatively in comparison with conditions that German or Finnish enterprises face at home. The feeling of alienation that this difference creates makes formal pledges of cooperation ring hollow.

Option 2: Eurasian economic union. In another geographic area, the Eurasian space, Russia remains the local center of gravity for a number of countries. Moreover, because Russian and other Eurasian markets have been historically intertwined, there is strong demand for a wide range of goods produced locally. Thus, regional integration has sufficient momentum to develop into a full-fledged joint market.

Five countries – Russia, Belarus, Ukraine, Kazakhstan, and, to a lesser degree, Uzbekistan – form the core of the group. The core attracts smaller European countries (Moldova) and Central Asian states (Kyrgyzstan, Turkmenistan and Tajikistan) that have attraction to the union. The longevity and strength of such a union depends on the net benefits that its members derive, such as gains from utilizing economy of scale, which are particularly large for capital-intensive industries, and greater bargaining power that the would-be group would have vis-?-vis the rest of the world. To realize the latter (redistributive) benefit, the countries need to coordinate their moves in dealing with outside consumers and producers. A greater coordination, while not necessarily increasing global efficiency, empowers the prospective bloc to charge higher prices on their wares and to purchase imports cheaper than when they are competing against one another.

Given the existing structure of Russian trade with other post-Soviet countries, the energy sector takes the central stage in integration efforts. However, to become an engine of inter-state cooperation, several hurdles should be overcome. The first problem involves the unequal energy pricing at home and abroad that provides implicit subsidies to domestic energy consumers but distorts the nature of integration. The sorry state of the Russia-Belarus "single economic space" is a case in point. Being separate countries in everything but energy pricing, Belarusian enterprises received Russian oil and gas subsidies of about $4 billion in 2006. Naturally, Minsk realized that it received all perks and no obligations from the "union" and refused to go further. When Russia expressed its displeasure and suggested to re-introduce a customs border between the two countries at the end of 2006, a full-fledged trade war broke out, destroying the minimal goodwill that still existed between the two countries. Similar discontent is now brewing in Kazakhstan, which argues it cannot get the "fair" price for its gas, which is sold at the Russian border at almost Russian (subsidized) domestic prices. Another complication concerns Western energy majors, which signed production-sharing agreements (PSAs) with the former Soviet republics at the dawn of their independence. Russia was the first to stop this practice (currently Russia has only three PSAs projects, retained under pressure, which are to be brought in line with Russian general legislation), but Kazakhstan still relies, albeit with increasing reluctance, on foreign

partners in what many see as PSAs deals. Since PSAs are not renegotiable in principle, regional integration in the energy sector cannot proceed without gaining the consent of foreign energy companies.

Both problems are technically solvable if there is goodwill. To prevent conflicts associated with the distribution of energy gains within the union, the future members can swap stakes in national oil and gas companies. This may be calculated by the amount that matches their relative contribution in the joint development and transit of energy resources, minus subsidies they receive due to lower domestic prices. Furthermore, to facilitate the process of bargaining and monitoring, prospective members can establish a 'coordination and conflict resolution energy committee' similar to the International Energy Agency (IEA) that comprises 26 OECD countries. Coincidentally, such an organization, in charge of streamlining national practices that inhibit regional energy cooperation, can provide a "Eurasian" solution to the problem of stalled negotiations regarding the Energy Charter of 1994. If Eurasian oil and gas producers and transit countries agree on a common stance, their voice is more likely to be heard by the IEA.

Apart from multilateral agreement on energy, Russia may initiate a series of bilateral integration projects. This particularly concerns the iron and steel sector where Russian and Ukrainian interests intersect; both countries are large steel exporters and competitors on the international market. A common agreement to combine efforts in domestic projects, such as the construction of trunk pipelines, and matching export plans, will provide for greater specialization within the countries. These steps will increase aggregate profits for both countries, however, at the present time, the two countries are moving in opposite directions. The accumulated force of mutual distrust pushes Russia to substitute Ukrainian steel products: for example, it initiates the construction of several mills that produce large-diameter pipes. If implemented, these plans will drive the large Ukrainian producer, Khartsyzsk Pipe Mill, out of the Russian market with great losses for the latter. To prevent such mutually destructive trade wars, both countries need to reach a common agreement on cooperation in the area, which is vital for the development of a common Eurasian steel market.

Cooperation in agriculture and agriculture-related industries offers another field where the interests of the five countries overlap enough to warrant a negotiation. Russia, Ukraine and Kazakhstan are significant exporters of grain, while Belarus and Ukraine have strong positions in dairy products. In addition, Belarus has retained its agricultural machinery plants whose output – tractors and trucks – found a ready market within the former Soviet Union. All these states want to revitalize their agro-industrial sectors, but their plans remain uncoordinated at the moment. These internal plans can be enhanced if complemented with interstate agreements on cooperation in agricultural production and trade. Unfortunately, the national authorities continue to rely on confrontational measures aimed at solving short-term problems. This confrontational atmosphere leads to the inefficient use of available resources. For example, it has been reported that after Ukraine introduced export quotas on grain to keep the domestic price of bread low, a significant amount of its crop was destroyed and disposed of to the detriment of national producers.

Food processing is a sector where cross-border mergers allow for the rapid realization of advantages offered by economies of scope. The process is already underway, for example, in the beverage sector where breweries like Baltika (Russia) and Obolon (Ukraine) are large exporters to each country. Other joint projects can involve, for example, large-scale production of pork, poultry, sugar and vegetable oils.

Option 3: Trade with other countries. Russian potential for integration with other countries is limited to individual projects. Currently, Russia offers few products that have international appeal apart from energy. Because such projects have no economy-wide linkages neither for Russia nor its partners, there is little rationale for state activism. Some Russian companies, such as Norilsk Nickel or Rusal, expand aggressively in other countries as they have become "too large" to be content with regional leadership. Given their global clout and expertise, they are able to take initiative on their own. In this situation, the role of the state is reduced to logistic support and mediation among national players.

There are indications that the Russian government understands its role. For example, in October 2006, the Kremlin weighed in favor of a merger among domestic aluminum majors Rusal, Sual and trading firm Glencore from Switzerland after being asked to mediate. The very next month, the Kremlin resolved a commercial conflict among Severstal, Bazel and Renova, which competed for the right to develop the Tavan-Tolgoi coal field in Mongolia. In the latter case, public support was indispensable as the project proceeded within the tentative framework of Russo-Mongolian agreement on state cooperation.

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Ongoing globalization and the logic of economic prosperity prompts Russia to search for ways to realize its comparative advantages in the international division of labor. After the country has completed its economic restructuring and accumulated international reserves and expertise, Russia will continue to grope along, navigating through hidden reefs while exploring tempting possibilities.

Russia today is a staple economy, with mineral and natural resources comprising the largest share of its exports. Energy products dominate trade with many countries, creating a one-sided view of Russia as the pure supplier of oil and gas. Russian imports are more diversified, however, suggesting that there are many possibilities for strategic interaction that other countries can exploit.

Several EU countries have developed relatively strong bilateral links with Russia. Judging by the force of attraction, Germany and Finland are key countries that link Russia to Europe. These links, if enhanced, can introduce Russia to larger integration areas developed in the Nordic and Central Europe. If that happens, EU countries can gain from stronger linkage to Russian energy resources, thereby enhancing their energy security. On the other end, Russia may expect a gradual improvement in the machinery and electronic sectors, benefiting from greater exposure to European technologies.

Russia may also form the backbone of a regional union for several post-Soviet countries. The union can be built by employing multiple channels of cooperation in the energy, steel, and agro-industrial complex.

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