Some Characteristics of Kaliningrad Region’s Investment Potential

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Lately there has been a substantial increase of interest from scientists and representatives of federal and regional authorities towards Kaliningrad region’s development issues. Pronounced positive tendencies in the development of economy of Russia and its regions, accession of Kaliningrad neighbours, Poland and Lithuania to the European Union, a number of other internal Russian and international factors insistently demand drawing particular attention to researching the possibilities and problems of the Kaliningrad region investment potential.

In this article analysis of traditional notions of the Kaliningrad region’s investment potential is given, investment risk and some disadvantages of such notions are pointed out, the author’s assessment of peculiarities of investment potential that are often underestimated or ignored are given. The conclusion is made that such peculiarities can and must be taken into account by Russian and foreign investors, by regional authorities and all participants of the investment process.

Keywords: investment potential, investment risks, black economy, population’s income, company’s profit.

Introduction

The main scientific problem of this research is the issue of assessing investment attractiveness of the region in the instance of the Kaliningrad region. The object of the research is the investment potential of the Kaliningrad region, characteristics of economic development of the region.

The purpose of the research is to identify and analyse some peculiarities of investment potential that are currently underestimated by participants of the investment process, and often are simply ignored.

Methods of the research are methods of economic analysis, including methods of comparative analysis.

Originality of the proposed approach to assessment of the investment potential of the region is in overcoming of incomplete, hence inaccurate definition of such indicators of investment attractiveness of the region as investment potential and investment risk.

In assessing investment attractiveness of a specific region there are at least two reasons why investment attractiveness of other regions can’t be ignored:

1) Each region has other regions as rivals which compete for investments. It is particularly topical for the Kaliningrad region as its rivals are not only Russian regions, above all regions of the North-Western Federal District (NWFD) of Russia, but also neighbouring regions of Poland and Lithuania.

2) Since understanding comes through comparison, it’s impossible to understand and assess achievements and lost opportunities of the region in creation and development of its investment potential without comparing indicators of this region with indicators of other regions existing in similar conditions for their development.

Therefore, this article examines a number of regions of the North-Western Federal District: Archangelsk, Vologda, Leningrad, Murmansk, Novgorod, Pskov and Kaliningrad regions which have quite many similarities in size of population and economic specialisation.

Consensual assessment of investment attractiveness of the Kaliningrad region

Research in this filed is carried out by the “Expert” magazine consulting team by two indicators: investment potential and investment risks. Investment potential recons in basic macroeconomic characteristics, extent of production factors availability in the area, consumer demand and other indicators, and is made up of eight types of potential: consumer, labour, production, infrastructural, financial, innovation, institutional, natural-resources potential. The aggregate rating of the Kaliningrad region in 2003 is rather high: third place among 7 regions of the NWFD. But in this work we are more interested in investments risk (chances of losing investments and gaining from the) which is determined by seven constituent ratings: legislative, political, economic, financial, social, criminogenic, environmental. By this indicator Kaliningrad is also in the third position (Ivanuk S.M., 2004).

Small weighting factors of financial and legislative constituents and relatively low level of social tension have determined the present good position of the region. At the same time, criminogenic situation is still quite serious and is given a negative assessment by the experts.

Dynamics of investment risk rating among the regions shows that the region with the lowest risk in terms of investments in 1999-2003 was Novgorod region. As for Kaliningrad region, throughout this period its assessment by this indicator was determined by the activities in the field of legislative initiatives. At the same time, aggravation of criminogenic situation and environmental components predetermined worsening of investment risk rating in 2003.

Even though “Expert” is a very authoritative magazine and is staffed with competent experts, the author of this article does not fully share their opinion on evaluation of investment potential and investment risk. Respective as-
essment of these indicators for the Kaliningrad region in our view, are somewhat different from those given on the basis of calculations done by the “Expert” team. This method is very much alike the methods employed by other researchers. Their common weak point is that they do not fully take into account the present economic situation in Russia as a whole, let alone the peculiarities of a specific Russian region. These methods are effectively employed for assessment of investment potential of countries and regions with sustained development of highly-efficient market economy. The situation in Russia is absolutely different so far.

In order to reason his opinion one should first of all, present his vision of peculiarities of Kaliningrad region’s economic development as a whole. Particular attention deserves foreign investments issue.

Basic industries of industrial specialisation are food, energy, engineering, metal processing and wood industries, woodworking industry and pulp and paper industry, which comprise around 60% of total production volume made in the region. However, the dominant position is kept by food industry – 35.8% of total industrial production in the region, which is represented by fishery, milk, butter and cheese, meat, baking, confectionary, margarine, fruit-canning, and yeast enterprises. At the regional level chemical and petrochemical, light, flour-milling and feed mill, medical, printing industrial sectors and construction materials industries are also represented. Disintegration of the Soviet Union and transition to the market economy determined substantial structural reconstruction of Kaliningrad regional economy. Currently, in Kaliningrad region there are around 34 thousand legal entities (table 1) and around 60 thousand private entrepreneurs.

Table 1
Branch structure of Kaliningrad region
As of 01.01.2004

<table>
<thead>
<tr>
<th>Economic sectors</th>
<th>Number of objects of economic activities</th>
<th>Percentage in the total number of enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>3725</td>
<td>11</td>
</tr>
<tr>
<td>Industrial</td>
<td>4601</td>
<td>14</td>
</tr>
<tr>
<td>Transport</td>
<td>1459</td>
<td>4</td>
</tr>
<tr>
<td>Construction</td>
<td>3089</td>
<td>9</td>
</tr>
<tr>
<td>Trade and catering</td>
<td>12261</td>
<td>36</td>
</tr>
<tr>
<td>Other</td>
<td>8803</td>
<td>26</td>
</tr>
<tr>
<td>Total</td>
<td>33938</td>
<td>100</td>
</tr>
</tbody>
</table>

At that, the main burden of forming the budget of all levels is shouldered by 80 enterprises, the largest of which are “Lukoil-Kaliningradmorneft” Ltd., FGUP “Kaliningradskaya Zheleznyaya Doroga”, “Yantarenegro” JSC, “Kaliningradnefteproduct” Ltd., “Avtotor” JSC, “Gazoil” JSC, “Morskoi torgovyi port” JSC, “Baltskij” JSC, “Tsepruss” JSC.

In parallel with a sharp decline of a number of productions (fishing and sea products, manufacture of lifting train carriages, searchlights, etc.) new types of production emerged are developing rapidly (assembling of cars, TVs, vacuum cleaners and domestic fridges).

On the whole, structural reconstruction of Kaliningrad region’s economy has been going harder than in many other regions and in Russia as a whole. At the same time, the need for such reconstruction in Kaliningrad region is much greater than in other Russian regions.

Not accidentally the downturn of the region’s economy was more severe. For instance, in 1998 industrial production was only 29% of the 1990 level (the same indicator in Russia – 46%). Agricultural production – 46% of the 1990 level (56% in Russia).

As shown in previous works (Sberedgev N.A., 2002, 2004) the role and importance of production sphere has diminished. The importance of non-production sphere, above all of trade of goods produced outside Kaliningrad region, has grown.

Particular attention deserves the development of small entrepreneurship during these difficult years.

As of 01.01.2004 in Kaliningrad region there were around 70 thousand subjects of small entrepreneurship: 5.6 thousand small businesses and around 60 thousand individual private entrepreneurs without legal entity status.

As statistics show, the number of small enterprises grew by 12% in 2003 as compared to 2002. There is sustained increase in the number of small enterprises in construction, communication and transport, i.e. in the sectors which have been developing dynamically in the region. Besides this, there is a marked increase in the number of enterprises in trade and public catering (44.6% of the total number).

In 2003 small enterprises manufactured goods and rendered services for an amount of 21.3 billion roubles. Specific weight of manufactured goods and rendered services by small enterprises is 28% of Gross Regional Product (GRP).

Capital investment in small enterprises in 2003 was more than six times of the 2002 level.

At present, the overall number of employed in small business sector is 35% of the total number of working population, which is not less than 200 thousand of Kaliningrad residents. 84% of small enterprises are concentrated in Kaliningrad.

Contribution of small entrepreneurship constitutes at least 15% of the regional budget revenues.

Basic activities are trade and public catering, industry, construction. The same as in the rest of Russia. But there are obvious differences. For example, percentage of entrepreneurs involved in industrial production in Kaliningrad is larger, and percentage of those busy in trade and catering is lower. By the way, the latter have sharply decreased in number in 2002.

Speaking of small entrepreneurship one can’t omit the fact that its distinctive feature in Kaliningrad is a high percentage of “shadow” sector. By different estimates this sector accounts for 30% to 50% of real turnover in small entrepreneurship. (Matochkin Yu.S., Zhdanov V.P.).

Foreign investments in Kaliningrad region’s economy

Activities of foreign investors in Kaliningrad region have a relatively long history. First relatively large-scale investment started coming in the region in 1992. Since then foreign investments are object of close attention of representatives of authorities and numerous independent researchers.
Investments from abroad come into Kaliningrad in an extremely erratic manner.

In our opinion, there are several reasons for such instability. First of all, strong dependence of the region on the situation in the Russian economy. Practically all projects being implemented in the region are aimed at the Russian market, therefore even small changes there inevitably trigger changes in plans of foreign investors. This is supplemented by the existing structure of foreign investments, which are mainly represented by highly-liquid investments (commodity and short-term credits generally intended for servicing current external trade transactions).

Other reason for fluctuations is the permanent instability of the Special Economic Zone (CEZ) regime from the day it was initiated to the present. Since customs privileges of CEZ is one of few arguments in favour of investing in the Kaliningrad region, any threat of their abolition in the situation when the region has no other competitive advantages has a serious impact on the region’s attractiveness in the eyes of foreign and native investors.

Significant fluctuations in the volume of incoming foreign investments are predetermined also by small size of the regional investment market. Therefore, implementation in the region of one or two relatively large-scale investment projects brings substantial changes into the dynamics and structure of foreign investments.

Until recently foreign investments played no significant role in the investment activities in the territory of Kaliningrad region. In 1995-2001 average annual incoming direct investments/total capital investments ratio was less than 10%, and only in 2003 it has exceeded 15% of the total volume of investments into the non-financial sector of the regional economy.

However, despite rather high growth rate in foreign investments the region is still behind many other Russian regions. For instance, by the beginning of last year the region accounted for less than 0.04% of total accumulated foreign investments in the Russian regions. At the same time, in the course of the last several years the share of the region in the country’s GDP was around 0.5%, and in industrial production – around 0.4%. By the volume of foreign investment the region holds 32-34 place among Russian regions, and one of the last places among regions of the NWFD (Investments in the Kaliningrad region, 2004).

An important indicator of foreign investments showing their importance in the economic activities is their division by the type of participation in the investment process. The existing structure of investment of foreign capital in Kaliningrad region is not optimal from the point of view of supporting the development of production potential of the regional economy. According to the state statistics, regional “accumulated” investments are in half represented by trade capital (trade and other credits). Such investments, as a rule, are directed into short-term assets with short turnover period and are characterised by high withdrawal rate (e.g., in 2003 67% of “other investments” in the region were withdrawn).

Servicing trade operations primarily, these types of investments have practically no contribution into modernisation and development of the region’s economy.

Particularity of the Kaliningrad economy is the utterly small specific weight of portfolio foreign investments. On average in Russia their share in total foreign investments is 27%, while in Kaliningrad – slightly over 1% (in 2003 the amount of investment in shares and securities of Kaliningrad companies was 0.5 thousand US dollars). This is an evidence of backwardness of the regional stock market and still low investment attractiveness of securities emitted by Kaliningrad companies.

The largest countries-investors into Kaliningrad region’s economy are Cyprus, Poland, Lithuania, Germany and Great Britain. By early 2003 they accounted for 77% of accumulated investments. And in total, these 7 leading countries account for 84% of foreign investment in the region. Other 16% are divided among 39 countries, and volume of accumulated investments in 14 of them did not reach 100 thousand US dollars. In 2003 investments in the amount not exceeding 2 million US dollars came from seven countries, and a 5 million US dollars threshold was overcome by only 2 countries (Cyprus and Germany).

Existing technological structure of foreign investments does little to support modernisation and renovation processes in the regional economy. According to statistical data, the bulk of investments by foreigners go to supplies of materials and machinery and distribution spheres (78% of capital foreign investments in 2003), all industrial sectors account for 16%, virtually all investments intended for industrial production went to machine-building and metalworking enterprises. All other sectors put together got slightly more than 1% of foreign capital investments.

Foreign capital investments are primarily intended for procurement of cars, machinery, equipment and inventory. The share of this group of assets in the total volume of foreign capital investments is 98%. In 2003 foreign investors made no spending to buy land or property.

By the beginning of 2004 implementation of several dozens of investment projects with participation of foreign, including Lithuanian, capital has been in progress in the Kaliningrad region.

Income of Kaliningrad residents

Economic development and changes in the quality of life of the population are closely interconnected and interdependent processes. On the one hand, without development of economy of a region and a country as a whole it’s impossible to solve the problem of improving the quality of life population of the region, of the country, on the other hand, improvement in well-being of people, and not just individuals or “elite” groups, stimulates economic growth. The issue of level and quality of life of region’s and country’s population directly connected to the issue of investment attractiveness. Unfortunately, the situation in Russia in this respect is rather difficult, as professor Yu.A. Shpachenkov points out (Yu.A. Shpachenkov).

The situation with income of the population remains quite bad. While in pre-crisis 1997 income of the people constituted 46% of the 1990 level, in 2000 it went down to 38%.

According to the Institute of Socio-Economic Issues 15% of the richest population in Russia accumulate 85% of all savings, 57% of monetary income and 92% of income from property. In essence, there are two Russias – Russia of the rich and Russia of the poor, too different
from each other to be compared.

As L. Abalkin, Director of the Institute of Economics of the Russian Academy of Sciences points out, the gap in the income of the poor and the rich in Russia is catastrophic. Even so, this gap is constantly increasing. In 1998 the ratio was 1 to 13.8. In the first half of 2004 it was 1 to 15. From the point of view of social security this ratio should not exceed 1 to 8. Otherwise it can trigger a rise of tensions in the society and, probably most importantly, loss of trust to the authorities (L. Abalkin, 2002).

A number of experts (Sedov A., 2002) believe that the real gap is even wider: 18-20 times. This is on average in Russia, the situation in the regions is rather diverse. Table 2 shows the change in share of the population with income lower than the cost of living in some regions of the NWFD.

Table 2

<table>
<thead>
<tr>
<th>Regions</th>
<th>Share of population with income lower than the cost of living, as percentage of the total population</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
</tr>
<tr>
<td>Arhangel's</td>
<td>24.8 (6)</td>
</tr>
<tr>
<td>Vologda</td>
<td>18.9 (3)</td>
</tr>
<tr>
<td>Leningrad</td>
<td>24.3 (4)</td>
</tr>
<tr>
<td>Murmansk</td>
<td>16.8 (1)</td>
</tr>
<tr>
<td>Novgorod</td>
<td>17.8 (2)</td>
</tr>
<tr>
<td>Pskov</td>
<td>27.4 (7)</td>
</tr>
<tr>
<td>Kaliningrad</td>
<td>24.5 (5)</td>
</tr>
</tbody>
</table>

Note: the number in brackets is the position held by a region in respective year

The average per capita income / cost of living ratio in the Kaliningrad region is higher than in the rest of Russia; in 2001 in the Kaliningrad region this ratio was 1.24 (1.91 in the rest of Russia), and in 2003 it was 2.09 (2.06 in the rest of Russia). At that, the percentage of people living beyond the poverty line in Kaliningrad region is much larger than in Russia as a whole. In other words, the gap between the rich and the poor here is even wider, than in the rest of Russia. (Sberegael N.A., 2004). This is largely conditioned by the level of “shadow” economy in Kaliningrad region.

“Shadow” economy in Kaliningrad region

Claims of the critical criminal situation in the Kaliningrad region have become traditional. Indeed, for many year statistics have been showing that the crime rate in the Kaliningrad region is the highest among regions of the NWFD and one of the highest in Russia as a whole. At the same time, as a rule, non of the works devoted to this problem considers crucial, critically important specificity of Kaliningrad region’s crime issues.

First of all, it is a very high level of “shadow” economy in the region. Under “shadow” economy in this article we understand “lawful activities of creating value added, which is not registered or taxed, most of which can be defined as concealed labour” (Schneider F., Enste D., 2000). According to estimates by MIA of Russia shadow capital turnover in Russia amounts to 40% of Gross Domestic Product (GDP).

The share of shadow economy in Kaliningrad region is undoubtedly larger than in Russia as a whole. To confirm this it is enough to look at the data on profits and losses of companies operating in main economic sectors. Just one example, trade and public catering – these are almost 100% privately owned enterprises, however according to official statistics 33.8% of them were unprofitable in 2003, and in 2001 the share of unprofitable companies was at the level of 45.1%. This shows the strength and influence of “shadow” economy. The same holds true for other economic sectors of Kaliningrad region. By the estimate of a number of experts (Samson I, Eliseeva I, 2003) Kaliningrad “shadow” economy accounts for 60% to 95% of the official Gross Regional Product (GRP). Therefore, official data regarding sales revenue, value added and profit of profitable companies cannot be taken as credible (Ivanyuk S.M., 2004; Yandiev M., 2004). According to this data, Kaliningrad region is behind all other regions of NWFD save Pskov region by sales revenue per company. By value added per taxpayer and by profit of profitable companies per taxpayer Kaliningrad region holds the fourth position. Credibility of this data is rather questionable.

If we take into account not just “shadow” economy, but also illegal economy, i.e. all types of economic activities prohibited by law, the gap between official statistics and real economic data will turn even wider.

In this regard the findings of professor I. Samson’s and Corresponding Member of the Russian Academy of Science I. Eliseeva’s research are of interest, as they give other definition of “shadow” economy, which, in their view, consists of concealed, informal and illegal economy.

In concealed economy economic activities are undertaken by registered legal entities, which at the same time practice tax evasion, i.e. do not register part of their revenue (for instance, cash received from sales of caught and sold). In informal economy economic activities are carried out by unregistered agents, but the activities are not prohibited by law (private amber processing or tourism activities). Illegal economy comprises all types of economic activities prohibited by law (in Kaliningrad these are: drug handling – 30%, smuggling – 28%, illegal arms and ammunition manufacturing and traffic – 14%, prostitution – 14%, production and sales of alcoholic beverages – 8%, unlicensed gambling – 7%). By the estimates of I. Samson and I. Eliseeva illicit activities account for 30% of Kaliningrad region’s “shadow” economy.

Another important feature of crime and illegal business issue in Kaliningrad region is that, using the language of the underworld, Kaliningrad region is the “red” zone, i.e. the territory of organised crime groups (OCGs). But these groups are not run by leaders of all-Russian and international OCGs, the so-called godfathers. Multiple attempts by leaders of the Russian criminal world to take Kaliningrad OCGs under their control were decisively stopped by law enforcement authorities. As D. Melikov, Deputy Head of Department against Organised Crime of Kaliningrad regional Internal Affairs Administration stated “we have now highlighted main areas in the war against organised crime. And we intend to proceed with our con-
tinuous and tough measures, above all towards the leaders of OCGs. We have a complete list of gangs organisers and leaders, and all of them will be systematically checked on the subject of connection to criminal activities. Therefore they I wouldn’t advise them to expect the life of ease” (I. Orekhov, O. Goncharova, 2005).

By the results of 2003 Germany has taken the lead among Kaliningrad’s foreign trade partners. 360 companies with German capital operate in the region. However, German investors feel themselves being “unwelcome guests”, said Stefan Stein, Head of Representation of Hamburg Chamber of Commerce in Kaliningrad region to Governor Egorov. Mr. Stein believes the inflow of German capital would increase if Kaliningrad officials “mildened the regime”. This relates, above all, to visa problems.

Bureaucratic “conundrums” are not the only obstacle on the way of German capital to the East. According to Mr. Stein’s information, our region doesn’t have the infrastructure essential for investors: it’s impossible to find production facilities, and you can’t build in “the open field” without proper water-, electricity- and gas supplies. Therefore, not only small and medium sized German business will not come here, we can’t expect big business here either. Mr. Stein exemplified this with a recent visit in the region of representatives of such mighty companies as “Bosch”, “Siemens”, “Nestle” which left the region dissatisfied.

The information on the “sharks” of business which “swam away” from our waters was sad for Vladimir Egorov to hear. “If we hadn’t scared these representatives of big business by our conditions, we could have much more than 56 million in dollar investments that we now have”, complained the Governor.

The fact, that no decision is made on the issue of normal organisation of work with potential and real investors, obvious for it’s necessity and advantages, is the testimony not only of the lack of political will expressed by leaders of the regional authorities, but above all of high corruption rate among officials, which are guided by self-interest and are not interested in the order in organisation of work with investors.

Conclusions:

Analysis of specificity of Kaliningrad region’s investment potential allows to come up with the following conclusions:

1. Economy of Kaliningrad region is exposed to the influence of external factors much more than other Russian regions. Therefore, investors believe its pace of overall development and development of separate economic sectors is of much less importance; what’s far more important are estimates, including forecast estimates of external factors, determining the development of Kaliningrad region’s economy (political and economic influence of the European Union as a whole, and Poland and Lithuania in particular, the influence of Belarus). Evaluation of investment potential and investment risk in the instance of Kaliningrad region should give proper weight on the one hand, to the influence of external factors, and on the other hand, to readiness and ability of regional economy and authorities to react to such influences.

2. High, by Russian standards, level of business development in Kaliningrad region must be taken into account when evaluation of investment attractiveness is made. Because, firstly, this indicates that the share of people who adapted to the market economy conditions is larger than in most of the Russian regions; secondly, this is a nutrient medium for a higher crime level, which cannot be coped with by means of law machinery alone.

3. The traditional image of high crime level in the Kaliningrad region is incomplete, as Kaliningrad region is a “red” zone which is a significant competitive advantage, because despite the inflow of Russian capital into the region (primarily of Moscow origin) Kaliningrad organised crime groups are not controlled from the outside, so it’s easier for the law machinery to fight it.

4. The gap in income level between the rich and the poor in Russia is wide, dangerously wide. Unfortunately, such gap in Kaliningrad region is even wider. But while social and political activity of the population is insignificant this situation is not dangerous for investors. Moreover, to some extent it’s favourable for them: real income of rich Kaliningrad residents is higher than the official level, therefore their consumer wants are higher.

5. Very high level of “shadow” economy, noticeably higher than the average Russian level should also be taken into consideration by investors for a number of reasons:

1) This is a nutrient medium for corruption. Not accidentally the regional authorities “can’t” organise at least normal work, let alone effective work with real and potential investors.

2) Investment potential of many Kaliningrad firms, which could be partners or competitors to foreign investors and investors from other Russian regions, is higher than the official estimate.

6. Kaliningrad region is obviously in worse conditions as compared with other Russian regions in terms of efficiency of regional authorities in organising investment process. Unfortunately, changing this situation is a very hard task considering high share of “shadow” economy, respectively high level of corruption, and weakness of local branches of all parties operating in Kaliningrad region.

7. Russian and foreign investors put up their funds before, they are investing now and they will continue investing in the economy of Kaliningrad region. The problem is how to improve investment attractiveness of our region. One of essential conditions for finding a successful solution to this problem is consideration and correct usage by all participants of investment process of the peculiarities of investment potential of Kaliningrad region described in this article.

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16. The language of the article is not edited.

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