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Economic Developments in the Wider Black Sea Region



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Summary

The Black Sea region comprises a heterogeneous group of countries: Bulgaria, Romania, Ukraine, Russia, Georgia, Armenia, Azerbaijan, and Turkey. Their economies differ in their size, institutional characteristics and integration perspectives, are facing vastly different problems, and find themselves at different levels of development. The economic performance of the region during the 1990s was highly unstable, and even the countries which were spared from internal conflicts did not fare much better than the rest. However, more recently, the region has enjoyed a fairly rapid economic recovery accompanied by welcome structural changes, although the labour market situation and social conditions in general are still very difficult.

Both the economic heterogeneity of the Black Sea countries and political issues are crucial factors behind the presently rather low level of their regional integration: the latter generally proceeds only to the extent to which it is compatible with the (very unequal) format of these countries' relations with the EU. At the same time, multilateral integration under the auspices of Russia, which, given its economic size, could potentially serve as an alternative 'gravity centre', appears to be for a number of reasons equally problematic. In fact, the geographic trade patterns of the countries involved do not give an impression of the Black Sea region being a distinct trading block per se, and in those cases where important regional trade links do exist (Russia, Ukraine and Turkey), this seems to be explained first of all by these countries' size rather than by the fact that they are part of the Black Sea region.

The outlook for the Black Sea countries is largely positive, with annual GDP growth in excess of 5% in the medium and long run being feasible. Apart from sound economic policies, it is especially the fostering of institutional reforms and the related improvements of the investment climate which will be indispensable for a lasting and sustainable economic development. More decisive steps towards regional and EU economic integration would undoubtedly be beneficial; however, such integration would require significant changes in the stance of regional (and EU) policymakers, a higher level of mutual trust, a solution of 'frozen conflicts', and – last but not least – ultimately hinges on cooperation prospects between Russia and the EU.

Keywords: comparative study, economic development, foreign trade, integration, macroeconomic analysis

JEL classification: O57, O1, F1, F15, E

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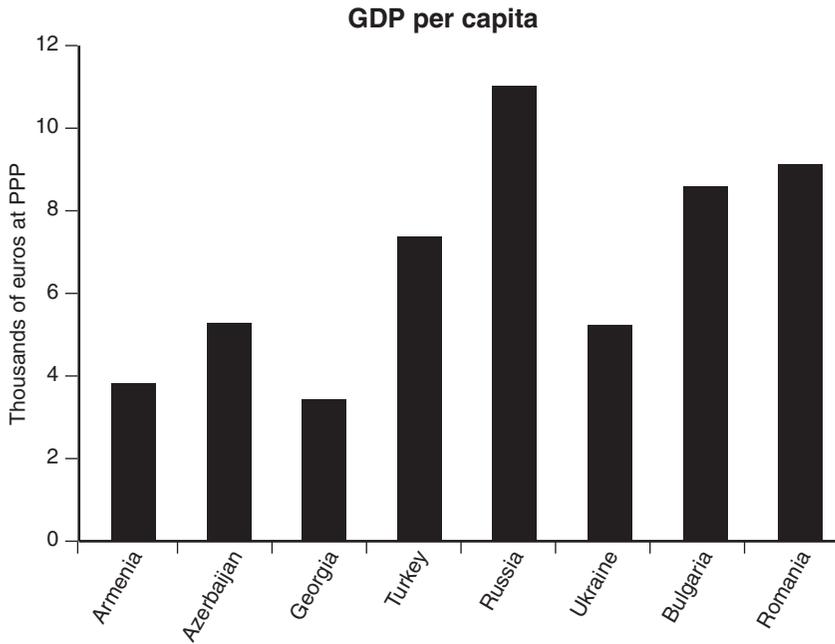
Introduction

The Black Sea region comprises a number of widely different countries: Bulgaria, Romania, Ukraine, Russia, Georgia, Armenia, Azerbaijan, and Turkey. Their economies differ in size (ranging from Georgia and Armenia, on the one hand, to Turkey and Russia, on the other) as well as in their institutional characteristics and integration perspectives. Bulgaria and Romania joined the EU in 2007; Turkey is a (distant) candidate for EU membership; Georgia and Ukraine aspire to EU membership but are highly unlikely to accede anytime soon; finally, Armenia, Azerbaijan and particularly Russia lack any ambitions to join the EU and have their own vision regarding development and integration prospects. The region is thus affected by the competing interests of the EU (Neighborhood Policy) and Russia, which has her own integration blueprints, basically aiming at the re-integration of the post-Soviet space. An additional dimension of the potentially conflicting interests in the region is its importance as a transit corridor for the energy resources from the Caspian Basin to Europe. Recent EU efforts to diversify energy supplies—in particular to reduce the EU's dependence on Russia, which is now not only a major supplier of natural gas to Europe, but also controls a bulk of transit from the Caspian energy-rich countries (notably Kazakhstan and Turkmenistan),—explain the rising interest in the Black Sea region and the resulting rivalry between the EU and Russia.¹

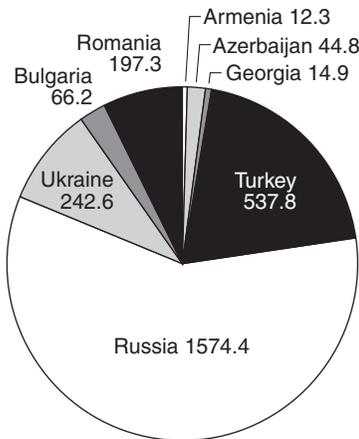
Apart from a similar level of economic (under-) development, a common economic characteristic of these countries is the fact that all have undergone severe economic turmoil over the past two decades,

¹ Energy issues are dealt with in a separate chapter by Gerhard Mangott and Kirsten Westphal, and we do not go into detail in this paper.

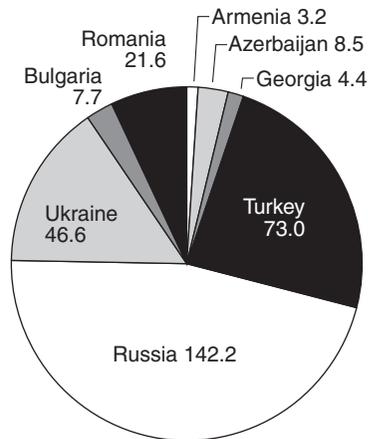
Figure 1 The Black Sea Region: Key Economic Characteristics, 2006



GDP at PPP (billions of euros)



Population (millions)



Source: authors' estimates based on Eurostat and CISSTAT (see Table 1).

Table 1 The Black Sea Region: An Overview of Economic Fundamentals, 2006

	Armenia	Azerbaijan	Georgia	Turkey	Russia	Ukraine	Bulgaria	Romania	MMS-10	EU-15	EU-27
GDP at exchange rates, € billion	5.1	15.8	6.2	318.6	785.8	84.9	25.1	97.2	723.9	10796.3	11539.7
GDP at PPP, € billion	12.3	44.8	15.0	537.8	1574.4	242.6	66.2	197.3	1320.3	10548.1	11907.0
GDP at PPP, EU-27=100	0.10	0.38	0.13	4.5	13.2	2.0	0.6	1.7	11.5	90.6	100.0
GDP per capita at PPP, in €	3830	5280	3450	7370	11070	5200	8600	9140	12700	26370	23520
GDP per capita at PPP, EU-25=100	16	22	15	31	47	22	37	39	52	112	100.0
GDP at constant prices, 1990 (1991)=100	155	150	74	186	101	73	111	120	143	138	139
GDP at constant prices, 2000=100	202	253	156	131	144	155	137	142	131	111	113
Industrial production, real, 1990 (1991)=100	84	78	40	204	77	105	85	82	145	—	127
Industrial production, real, 2000=100	152	223	155	133.2	135	174	161	134	144	—	110
Population—thousands, annual average	3220	8480	4350	72974	142221	46646	7699	21584	102171	390196	493499
Employed persons—LFS, thousands, annual average	1112	3973	1700	22330	68693	20730	3110	9313	42270	171010	213768
Employed persons, in percent of population	34.5	46.9	39.1	30.6	48.3	44.4	40.4	43.1	41.4	43.8	43.3
Unemployment rate—LFS, (%)	7.2	—	13.6	9.9	6.8	6.8	9.0	7.2	10.0	7.9	8.7
General government expenditures, GDP %	19	19	32.4	26.7	31.3	32.6	37.2	32.9	41.8	47.4	47.2
General government revenues, GDP %	18	21	30.7	27.1	39.7	32.0	40.8	31.2	38.4	45.1	44.8
Price level, EU-25=100 (PPP/exchange rate)	35	29	41	63	56	26	37	50	54	102	97
Average gross monthly wages, in €	123	126	110	651	315	164	181	326	765	3211	2755
Average gross monthly wages, EU-27=100	4.5	4.6	4.0	23.3	11.2	5.9	6.5	11.6	27.3	116.6	100.0
Exports of goods (GDP %)	15.7	32.2	12.6	22.7	31.0	36.5	47.7	26.6	46.9	29.6	30.6
Imports of goods (GDP %)	34.3	26.6	46.9	32.9	16.8	41.5	69.2	38.7	51.3	29.9	31.3
Exports of services (GDP %)	—	—	—	6.0	3.2	10.6	15.9	5.7	8.7	8.9	8.9
Imports of services (GDP %)	—	—	—	2.8	4.6	8.6	13.0	5.7	7.5	8.0	8.0
Current account (GDP %)	—	—	-14.9	-7.9	9.8	-1.5	-15.8	-10.3	-5.7	-0.2	-0.5
FDI stock per capita, in €	423	1250	620	822	1160	370	2047	1432	3019	—	—

Notes: **MMS-10**: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia.

PPP: Purchasing power parity—wiiw estimates. **LFS**—Labor Force Survey.

Source: wiiw, AMECO, UNCTAD, EBRD, Eurostat and CISSTAT; authors' estimates.

followed by impressive recovery. However, the dramatic economic decline observed in most countries of the region (except Turkey) over the 1990s, which accompanied their transition from a centrally-planned system to a market economy, left its legacy in the form of a sharp deterioration of living standards. Even more than in the former socialist countries of central Europe, the economic transition of the Black Sea region was marked by a pronounced dismantling of the role of the state, especially when it came to social networks. In addition, the difficult economic situation and the local conflicts resulted in substantial outward and internal migration. In turn, Turkey, which—unlike the rest of the region—did not undergo a systemic change, has been repeatedly prone to financial crises. Despite a largely positive short- and medium-term economic outlook for the region, the longer-term growth sustainability is—apart from purely economic factors—dependent on the resolution of a number of difficult social, political and institutional challenges.

This chapter provides the main economic characteristics of the countries concerned, outlines the sources and barriers to their growth, deals with structural issues, analyzes foreign trade patterns and integration prospects, and concludes with an outlook with respect to the countries' growth prospects and the challenges they are facing. Needless to say, only the key aspects of these problems can be addressed in this short chapter.

Economies of the Black Sea Region in Comparative Perspective

Key Macroeconomic Indicators at a Glance

Figure 1 and Table 1 provide an overview of key economic indicators for the Black Sea countries, comparing these also with the new EU member states from central and eastern Europe (NMS), as well as with the EU as a whole. As can be seen, most economies of the Black Sea region are rather small, and compared to the EU are even tiny:² the Armenian, Azerbaijani, Georgian and Bulgarian economies (measured as GDP at purchasing power parity—PPP) are less than 1 percent

² In fact, the combined GDP of the Black Sea countries (€ 2.7 trillion at PPP in 2006) accounts for around one fifth of that of the EU.

that of the EU. Even Russian GDP—by far the largest in the region—corresponds to just 13 percent of EU GDP. Turkey's GDP is 4.5 percent of EU GDP. The Russian economy clearly dominates within the region, as it accounts for more than half of the Black Sea region's GDP, followed by Turkey (20 percent) and Ukraine (9 percent).

The Black Sea countries together, however, number more than 300 million inhabitants—compared with more than 490 million in the enlarged EU. Hence, the average level of development (measured as per capita GDP at PPP) stands at just one-third that of the EU. Within the region, Georgia and Armenia are the poorest, Russia the richest (with 47 percent of the EU average), while the levels of Azerbaijan, Turkey and Ukraine are similarly close with about 20 percent to 30 percent of the EU average. Thus, all Black Sea countries are poorer than the central European NMS.

Patterns and Sources of Economic Growth

The transformation recession has left deep scars in the region, as an unprecedented economic decline occurred during the late 1980s—early 1990s in all countries except Turkey. The length of the crisis and the trough of the GDP decline varied, however. Armenia reached a turning point already in 1994 (after GDP had declined by almost a half), Georgia in 1995 (its GDP had contracted by nearly two-thirds), and Azerbaijan in 1996 (where the economy had fallen to just 42 percent of the 1991 level). The recession was less severe—though more protracted—in the remaining countries. In Bulgaria, the bottom was reached in 1997 (at 82 percent of the 1991 level), in Russia in 1998 (after a 40 percent GDP loss in the previous years), and in Romania and Ukraine in 1999 (after several ups and downs in Romania and the loss of more than half of GDP in the previous years in Ukraine). In contrast, Turkey enjoyed relatively smooth economic growth during the 1990s, albeit interrupted by brief recessions (in 1994, 1991 and 2001).

As can be seen, the economic development of the region has been highly unstable, and even the countries that were spared from internal conflicts did not fare much better than the rest (e.g. Ukraine). Generally, the five former Soviet republics suffered from a much deeper economic decline than the remaining Black Sea countries, since their transformation recession was accentuated by a disintegration of the

Soviet Union. This resulted in a disruption of traditional economic linkages, which hit the small Caucasus countries particularly hard. In addition, the Caucasus countries—given their geographic location—had more difficulties in re-orienting their economic ties towards Europe and, probably most importantly, were torn apart by severe inter-ethnic conflicts and the episodes of civil war. Thus, their military expenditures absorbed a lion's share of economic resources that could have been alternatively used for financing the badly needed economic restructuring. Besides, the conflicts brought about an extremely unstable environment, not only inhibiting large-scale investment but also creating an obstacle to cross-border trade flows.

The more positive news is that since the late 1990s, the whole region has enjoyed a fairly rapid economic recovery, growth being the fastest in countries that had previously suffered the most (Azerbaijan, Armenia, Georgia, and Ukraine). Since 2000, GDP has more than doubled in Azerbaijan and Armenia, and expanded by more than 50 percent in Georgia and Ukraine. In the remaining Black Sea countries, cumulative economic growth since 2000 has ranged between 30 percent (in Turkey) and 40 percent (in Romania and Russia). Thus, their growth performance is comparable to that of the NMS and, needless to say, has been much better than in western Europe (Tables 1 and 2). Nevertheless, Russia has just barely reached its pre-transition GDP level while Georgia and Ukraine still remain about 25 percent below their peak economic performance from the early 1990s.³

In individual countries, the sources of the recent economic recovery have been quite diverse. Thus, Romania's and Bulgaria's development has been hugely affected by their EU membership prospects, culminating in formal accession in January 2007. This event was the outcome of a long process of economic integration of these two countries into European structures. The anchor of future EU membership and the related reduction of political risks, the sustained reform efforts undertaken by the two countries' governments, particularly the adoption of the accession-related *acquis communautaire*, the long-standing free trade agreements with the EU, and—last but not least—massive

³ These comparisons are highly tentative—not only because of numerous statistical problems. The main issue here is to what extent the predominantly market-oriented output of these countries today can be numerically compared with their output produced under the former system of central planning (obviously, Turkey is once again an exception).

inflows of FDI have facilitated a profound restructuring of the two economies, particularly in the last few years, and enabled them to gain firm niches in the European markets of selected goods such as textiles and, more recently, cars and electric appliances. Thus, Bulgaria and Romania have been broadly following the earlier development path of the more advanced NMS. Besides, they have benefited from substantial transfers from Brussels targeting infrastructure and—since their formal accession in January 2007—are eligible for direct payments to their agricultural producers within the framework of the EU Common Agricultural Policy.

In the three Caucasus countries (Georgia, Armenia and Azerbaijan), economic growth resumed in the mid-1990s, after a certain degree of stability returned to the region following the signing of major cease-fire agreements. Since 1996 at the latest, all three countries have witnessed continuous economic growth—often at two-digit rates and uninterrupted by the Russian financial crisis of 1998. As a result of the dynamic economic performance, Armenia and particularly Azerbaijan have by now surpassed their pre-transition GDP by a wide margin, although Georgia—where the GDP decline over the nineties was the biggest—still has a way to go to reach the 1989 level. However, in all three countries, poverty is still widespread, with so-called ‘internally displaced persons’, i.e. largely war refugees, being the most vulnerable group, often living in temporary housing for years.

Economic growth originated from different sources in each country. Growth in Azerbaijan has been driven primarily by the booming export-oriented oil and gas sector. Following the signing of major production-sharing agreements (PSAs) with foreign multinationals,⁴ the start of operation of the vast Azeri-Chirag-Guneshli offshore oil deposit and the launch of a major Baku-Tbilisi-Ceyhan oil pipeline in 2006, oil exports from Azerbaijan have surged, leading to the near-doubling of exports in 2006 alone, as well as impressive GDP growth of 34 percent in 2006 and 25 percent in 2007. Due to the growth in oil revenues the country’s current account registered a huge surplus in 2006 (16 percent of GDP). This was a stark contrast to previous years,

⁴ Although Azerbaijan has a state-owned oil corporation of its own (SOCAR), 70 percent of the country’s oil exports is accounted for by the Azerbaijan International Operating Company (AIOC), including—beside SOCAR—such leading foreign multinationals as British Petroleum, Chevron, Statoil, and ExxonMobil.

which had been characterized by high current account deficits, largely due to FDI-financed imports of equipment for the oil industry. The massive influx of oil-related export revenues has enabled a rapid accumulation of foreign exchange reserves and has boosted the country's fiscal revenues. As a result, wages in the public sector and pensions were raised by about 50 percent, and capital expenditures by a stellar 300 percent. However, the unpleasant side-effect of the increased spending has been a surge in inflation—despite the on-going appreciation of the manat in line with the 'crawling peg' regime (in place since 2006). Currently, oil and natural gas account for about 30 percent of Azerbaijan's exports to the CIS and for some 90 percent to the non-CIS.

In Georgia and Armenia, in contrast, recent economic growth has been due primarily to rising domestic demand, financed largely by loans and transfers from abroad. These transfers have come from the wealthy foreign diaspora (e.g. Armenian diaspora in the United States and France), were part of official assistance (particularly to Georgia by the EU and the United States), or represented remittances from Armenians and Georgians who left their countries in search for better job opportunities, particularly in Russia. Georgia's development has been also greatly affected by the radical liberal reforms implemented after the 'Rose Revolution' of 2004, including *inter alia* the introduction of a flat personal income tax; a large-scale privatization program; reduction of arrears; and abolition of customs duties. The resulting improvement in the business climate led to a surge in private capital inflows, supplemented by foreign investment targeting the construction of two major pipelines: Baku-Tbilisi-Ceyhan (oil) and Baku-Tbilisi-Erzurum (gas). In Armenia, the key engine of growth has been the services sector, particularly construction, which benefited from both FDI and remittances and posted growth rates of some 30 percent over the last few years. In both countries, the massive inflows of foreign exchange induced currency appreciation and thus helped contain inflationary pressures. In addition, the appreciation has contributed decisively to the rising confidence in domestic currencies and hence to the de-dollarization process which, in turn, has fuelled further appreciation.

The reverse side of this macroeconomic stability, however, has been greater external imbalances, as high economic growth has led to a strong demand for imports, such as the imported inputs for the boom-

ing construction sector. As a result, trade deficits have been on the rise, particularly in Georgia. Georgian exports contracted dramatically in 2006 due to trade sanctions imposed by Russia—hitherto Georgia's main trade partner. More broadly, rising trade deficits are a reflection of the structural weakness of these countries' industrial sectors and of their dependence on energy imports, particularly against the background of globally booming energy prices and the current policy of Russia's Gazprom to bring its export prices closer to west European levels.

In Russia and Ukraine, the recovery was initially triggered by the devaluation of their currencies in 1998-1999 following the Russian financial crisis. This opened a window of opportunity, initially for the domestic food-processing industry, but the recovery soon spilled over into other sectors as well. Also, the growth in both countries was helped by the booming world prices for their main export commodities: energy (in Russia) and metals (Ukraine), as well as by a surge in Russian import demand for Ukrainian products. Meanwhile, abundant export-generated revenues have translated into strong domestic demand for both consumer and investment goods, and—with the exception of a temporary setback after the 'Orange Revolution' in Ukraine in 2005—investor sentiments have vastly improved, including those for FDI. Still, even when compared to Bulgaria and Romania (let alone the more advanced new EU members), both countries are still lagging behind in terms of FDI penetration and, as a result, have had rather limited success in upgrading and diversifying their economic structure away from energy and metals.

Turkey's steady economic performance has largely resulted from a comprehensive reform package launched in 2002 aimed at improving the fiscal situation and mending the rampant inefficiencies in the country's state-dominated industrial sector. Although Turkey has never had a truly planned economy of the Soviet type, its private sector had been basically confined to retail trade and services, whereas large industrial assets had been state-owned and protected from international competition. The weak competitiveness of domestic industry had typically led to import booms, culminating in the balance-of-payments crises. However, over the last few years, the bulk of state-owned banks and industrial enterprises have been privatized, and the climate for FDI has drastically improved. The country's exports grew

strongly and trade deficits declined. Budget deficits declined as well, forcing banks to look for alternative investment options rather than the budget deficit financing. Since 2002, the economy has been growing on average roughly 7 percent per year, and the country's vulnerability to future crises has arguably decreased.

Industry Performance

Predictably, the devastating impact of the transformational recessions has been most visible in industry, where output fell victim to the abrupt opening to international markets. Apart from purely systemic transition factors such as price liberalization, abolition of subsidies, privatization and the scaling down of military spending, industry suffered over-proportionally also due to the dismantling of regional trading blocs such as COMECON (Bulgaria and Romania) and the USSR (Russia, Ukraine and particularly the Caucasus countries). As a result, Georgia lost 80 percent of its industrial output by 1995, Azerbaijan 70 percent by 1997, and Armenia 50 percent by 1993. By the time the recovery started in 1998-1999, Russia, Ukraine, Bulgaria and Romania had lost about half their industrial output. Turkey is again a special case, as the relatively smooth industrial growth in this country was only briefly interrupted in 1994 and 1999.

Despite the rapid industrial recovery since the mid- and the late 1990s—accompanied and partly fueled by restructuring, re-orientation to new markets and inflows of foreign investments—only Ukraine has so far managed to fully restore its previous level of industrial output; the remaining countries are still 15-20 percent below their 1990-1991 peak (Georgia is even 60 percent below—see Table 1).⁵ Since 2000, the fastest industrial growth has been recorded in Azerbaijan (largely thanks to the development of oil fields), Ukraine (steel and chemicals), Bulgaria, Georgia and Armenia (foodstuffs, textiles and metal products). This pattern largely squares with the industrial structures currently observed in individual countries. Thus, Azerbaijan is now specializing in hydrocarbon extraction (70 percent of industrial output), Armenia and Georgia in food and beverages (32 percent and 38 percent, respectively), Ukraine in metals (25 percent), while Bulgaria and Romania are specializing in a combination of food, beverages and

⁵ Turkey is an exception, as its industrial output more than doubled between 1990 and 2006.

basic metals. The respective industrial structures are largely reflected in the commodity composition of exports, as we discuss later.

Structural Changes and Labor Market Developments

The relative decline of industry and the extraordinary fast development of services, which had been neglected or virtually non-existent (e.g. banking, insurance and real estate activities) under the previous system, was one of the outstanding features of transition in the Black Sea countries, bringing their economic structure closer to that of Western Europe. By now, almost all countries of the Black Sea region are service-oriented—except for Azerbaijan where the extraction industry accounts for 51 percent of gross value added. In Russia, Ukraine and Georgia, about 60 percent of gross value added originates in the services sector; the respective shares are somewhat smaller in Bulgaria, Romania, Turkey and especially Armenia (36 percent). In Bulgaria and Turkey, but also in Armenia, Georgia and Azerbaijan, tourism is of growing importance—though still below its potential. At the same time, Romania, Turkey, and particularly Armenia and Georgia (20 percent of gross value added in both countries) are still highly dependent on agriculture, especially as far as employment is concerned—a clear sign of underdevelopment.

The labor market situation and, more generally, social conditions are still very difficult in the whole region, notwithstanding recent rapid economic growth. This is reflected in the above-mentioned low GDP per capita levels and even more so in average wages, which range between 4 percent (Georgia) and 23 percent (Turkey) of the EU level (measured at exchange rates—see Table 1). The fact that the highest wages can be earned in Turkey (about €650 per month) is illustrative of the relatively low well-being in the countries concerned and explains why many workers from Azerbaijan, Georgia and Ukraine seek temporary employment in Turkey. Yet there is also significant outward labor migration from these countries and Armenia to Russia, variously estimated at several hundred thousands of persons in the case of Ukraine. In turn, a large number of Turks, and recently also Bulgarians and Romanians, have moved to seek employment opportunities in western Europe. The Black Sea region has thus been a huge source of (frequently illegal) labor migration, especially of young people. Moreover, there is also a large number of internally dis-

placed persons, particularly in Azerbaijan (from Nagorno-Karabakh), Georgia (from Abkhazia) and Russia (from Chechnya).

Outward migration may be one explanation why unemployment in the Black Sea countries is not excessively high: with the exception of Georgia, official unemployment rates are mostly in single digits, yet the share of employed persons in the population (in the absence of comparable employment rates) is in most countries rather low (Table 1). At the same time, several countries—Russia, Ukraine, Bulgaria and Romania—are currently reporting labor shortages, especially of skilled labor.

Foreign Trade Patterns and Integration

Overall Foreign Trade Developments

External economic relations are playing an increasingly important role in the Black Sea countries, as demonstrated by the recent high dynamics of their foreign trade (see Table 3). Fast export growth has been reported not only in energy-rich Azerbaijan and Russia, but also in Armenia, Georgia, Bulgaria and Romania—albeit in the former two countries from very low levels. However, in all countries except Armenia and Turkey, imports have been surging even faster, reflecting these countries' strong economic performance and the strengthening of domestic demand, but also the massive inflows of FDI and the related imports of investment goods. As a result of these developments, the majority of the countries suffer from fairly high, and rising, trade deficits. In Armenia and Georgia, exports cover less than half of imports, indicating a potentially unsustainable development and a high dependence on transfers through both private remittances and official assistance. In other cases (Bulgaria, Turkey and Ukraine), the trade deficits are at least partly compensated by exports of services such as transport and tourism. In contrast, Azerbaijan and Russia enjoy large trade surpluses thanks to their high energy exports.

Regional and Commodity Composition of Trade

The European Union, Russia and Turkey are the main trading partners of the Black Sea countries. Predictably, for Bulgaria and

Table 2 Overview of Developments in 2005-2007 and Outlook for 2008

	GDP				Consumer prices				Unemployment, based on LFS ^a				Current account			
	real change in percent (%) against previous year				change in percent (%) against previous year				rate in percent (%), annual average				percent (%) of GDP			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Armenia	13.9	13.3	13.7	9.0	6.0	2.9	4.4	4.0	7.6	7.2	6.6	—	-4.2	-4.5	-3.0	—
Azerbaijan	26.4	34.5	25.0	25.0	9.7	8.3	16.7	16.0	1.4	1.3	1.2	—	1.3	15.6	19.8	—
Georgia	9.6	9.4	12.7 ^b	9.0	8.3	9.1	9.2	8.0	13.8	13.6	14.0	—	-10.8	-14.9	-15.9	—
Turkey	7.4	6.1	4.2	4.0	8.2	9.6	8.8	9.0	10.3	9.9	9.9	11.0	-6.3	-8.2	-7.9	-6.9
Russia	6.4	7.4	8.1	6.4	12.5	9.7	9.1	12.0	7.2	6.8	6.2	5.8	11.0	9.8	5.9	2.4
Ukraine	2.6	7.1	7.3	6.5	13.5	9.1	12.8	19.0	7.2	6.8	6.4	6.4	3.1	-1.5	-4.2	-6.0
Bulgaria	6.2	6.1	6.0	5.5	5.0	7.3	8.4	10.0	10.1	9.0	6.9	6	-12.0	-15.7	-21.6	-18.8
Romania	4.1	7.8	6.0	5.5	9.0	6.6	4.8	8.0	7.1	7.3	6.5	6.5	-8.7	-10.4	-14.3	-14.9
NMS-10^c	4.8	6.5	6.1	5.4	3.6	3.2	4.2	4.8	9.7	10.0	8.2	7.4	-4.6	-6.1	-7.1	-7.2
EU-15^c	1.6	2.8	2.7	1.8	2.1	2.2	2.0	2.6	7.9	7.7	7.0	7.0	0.0	-0.2	-0.4	—
EU-25^c	1.9	3.1	3.0	2.1	2.1	2.2	2.2	2.8	8.8	8.2	7.3	7.1	-0.2	-0.5	-0.6	—
EU-27^c	1.9	3.2	3.1	2.2	2.3	2.3	2.2	2.9	8.7	8.2	7.2	7.1	-0.3	-0.6	-0.8	—

Notes: **NMS-10**: The New EU member states (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia).

^aLFS—Labor Force Survey (except for Azerbaijan); ^bJanuary-September; ^cwiiw estimate.

Source: wiiw, Eurostat, CISSTAT, EBRD, Georgian Economic Trends, authors' forecasts.

Table 3 Foreign Trade of Black Sea Countries, 2000-2006

	2006 Exports in euro terms (index, 2000=100)	2006 Imports in euro terms (index, 2000=100)	2006 Exports (€ million)	2006 Imports (€ million)	2006 Trade balance (€ million)
Armenia	240	182	785	1,747	-962
Azerbaijan	268	329	5,037	4,195	842
Georgia	226	380	791	2,933	-2,142
Turkey	219	184	73,066	105,882	-32,816
Russia	214	298	240,154	105,547	134,607
Ukraine	193	237	30,556	35,870	-5,314
Bulgaria	229	261	12,012	18,479	-6,467
Romania	229	286	25,881	40,746	-14,865

Source: wiiw and CISSTAT databases.

Romania, which are EU members themselves, the EU accounts for 50 to 60 percent of their exports and imports. However, the (enlarged) EU has become also the leading trading partner for Russia, accounting for 57 percent of Russian exports and more than 40 percent of its imports in 2006, and, interestingly, also for Armenia, Azerbaijan and Georgia—despite the lack of a common border, and largely due to a marked decline in the trade of these countries with Russia. The latter partly reflects the general trend of trade re-orientation away from Russia, which has been the case for many post-Soviet republics, mainly reflecting changing patterns of comparative advantage, but—particularly in Georgia’s case—also trade restrictions, such as Russia’s embargo on imports of Georgian mineral water and wine.⁶ For Ukraine, the importance of the EU is somewhat lower: the EU accounted for 34 percent of Ukrainian imports and less than 30 percent of exports in 2006. Accordingly, the importance of Russia for Ukraine’s foreign trade is rather high, particularly on the import side, reflecting massive energy imports. However, the country’s exports to Russia (particularly transport vehicles and other machinery) have been

⁶ Officially, the embargo was justified by the allegedly poor quality of Georgian products, but there are good reasons to believe that the decision was largely politically motivated, given the strained relations between the two countries over the issues of Abkhazia, South Ossetia, and especially Georgia’s NATO membership aspirations.

booming recently as well, so that Russia's share as an export destination has risen markedly.⁷

Table 4 provides an overview of the top trading partners for the Black Sea countries. It also highlights several interesting features of regional trade specialization, with important implications for regional integration. First, foreign trade of the Black Sea countries is relatively well diversified: the top five trading partners combined account for 38 percent (Turkey) to 66 percent (Azerbaijan) of exports, and between 40 percent (Russia) and 58 percent (Ukraine) of imports. In general, Russia's and Turkey's geographical trade concentration is the lowest among the Black Sea countries, which is not surprising given their size.

Second, trade *within* the Black Sea region is most important for Georgia and least important for Russia and Turkey. This can be seen in Table 4, where each country's top trading partners that are also Black Sea countries are marked in bold. Russia, Turkey and Ukraine as larger markets typically dominate regional trade, whereas Bulgaria and Romania are invariably missing on the list, since they trade mostly with the EU. Generally, the geographic trade patterns of the countries involved do not give an impression of the Black Sea region being a distinct trading block per se, and in those cases where important regional trade links do exist (Russia, Ukraine, and Turkey), this seems to be explained first of all by these countries' size rather than by the fact that they are part of the Black Sea region.

Outside the Black Sea region, important trading partners are Germany, Italy and the Netherlands. The United States plays the biggest role for Turkey (6 percent of exports and 4.5 percent of imports), but also to some extent for Armenia (4.8 percent of imports), Russia (4.6 percent of imports), Azerbaijan and Georgia (3.5 percent of imports), and also serves as an export market for Ukraine and Russia (about 3 percent of exports).

The geographic patterns of trade flows are related to their commodity composition. We will just highlight key features, without going into detail. The exports of Azerbaijan and Russia are dominated

⁷ It is important to mention in this context that from the EU viewpoint, the Black Sea region is not too important either as an export market or as a source of imports. The single exception is Russia, which is the main supplier of energy to the EU; yet in 2006, it accounted for just 3.7 percent of overall EU imports, and Turkey accounted for another 1 percent.

Table 4 Top Five Trading Partners of Black Sea Countries in 2006

	Exports	Imports
Armenia	Germany, Netherlands, Russia , Belgium, Switzerland (59 percent of total exports)	Russia, Ukraine , Kazakhstan, Germany, Belgium (41 percent of total imports)
Azerbaijan	Italy, Turkey , France, Russia , Iran (66 percent of total exports)	Russia , United Kingdom, Germany, Turkey , Turkmenistan (53 percent of total imports)
Georgia	Turkey, Azerbaijan, Russia, Armenia , Turkmenistan (44 percent of total exports)	Russia, Turkey , Germany, Ukraine , USA (51 percent of total imports)
Turkey	Germany, United Kingdom, Italy, USA, France (38 percent of total exports)	Russia , Germany, China, Italy, France (42 percent of total imports)
Russia	Netherlands, Italy, Germany, China, Ukraine (39 percent of total exports)	Germany, China, Ukraine , Japan, Belarus (40 percent of total imports)
Ukraine	Russia , Italy, Turkey , Poland, Germany (42 percent of total exports)	Russia , Germany, Turkmenistan, China, Poland (58 percent of total imports)
Bulgaria	Italy, Turkey , Germany, Greece, Belgium (47 percent of total exports)	Russia , Germany, Italy, Turkey , Greece (50 percent of total imports)
Romania	Italy, Germany, Turkey , France, Hungary (54 percent of total exports)	Germany, Italy, Russia , France, Turkey (49 percent of total imports)

Source: wiiw, CISSTAT, Turkish statistical office.

by mineral products (supplemented in the latter country by metals), and those of Ukraine, Armenia and Georgia by metals and other low-processed goods. In contrast, Bulgaria and (even more so) Romania export mostly manufactured products, including machinery and transport equipment. Also, all former Soviet republics still exhibit a distinct commodity structure when it comes to exports to the CIS (mostly to Russia) where some of the traditional processed manufacturing trade still remains: food and beverages from Armenia and Georgia, chemicals from Azerbaijan, transport equipment from Georgia, and transport vehicles and military equipment from Ukraine. The majority of these exports are not competitive in other markets and represent

legacy structures from the Soviet past. Therefore, as these countries advance economic reforms and make further progress in their transition to market economies, their foreign trade patterns and particularly the commodity composition of their trade with Russia and other CIS will most probably undergo serious change.

Regional Integration

The presently rather low level of regional integration of Black Sea countries can be attributed to their economic heterogeneity as well as to political issues. Formally, economic cooperation between the countries of the region is carried out within the framework of the Black Sea Economic Cooperation (BSEC). The BSEC was established in 1992, has its headquarters in Istanbul, and since 1999 enjoys the legal status of an international organization. It encompasses twelve member states: the eight countries covered in this chapter as well as Moldova, Greece, Albania and Serbia. However, in spite of the existence of BSEC, in reality multilateral cooperation in the Black Sea region is overshadowed by the relations between these countries and the European Union. In other words, regional cooperation generally proceeds only to the extent to which it is compatible with the format of these countries' relations with the EU. As already mentioned in the introduction, this format differs widely between individual countries of the region. EU relations with these countries can be grouped into three broad types:

1. EU membership (Bulgaria and Romania) and EU accession (Turkey being an official candidate);
2. European Neighborhood Policy (all other Black Sea countries, except Russia); and
3. 'Four Common Spaces' and Strategic Partnership (Russia).

In addition, relations with the EU within the first two types take place almost exclusively on a bilateral basis—despite regular 'synergy meetings' between BSEC and the EU.⁸ This is in stark contrast to EU initiatives in other geographic regions, which were conceived from the

⁸ This is part of the EU's so-called 'Black Sea Synergy' strategy, which has been pursued since the EU was granted an observer status at BSEC in June 2007. The first such meeting (at foreign minister level) took place in February 2008 in Kyiv.

Table 5 Commodity Composition of EU Imports from Black Sea Region Countries, 2006 (in percent)

	Total	Rus	Ukr	Tur	Arm	Aze	Geo	Bul	Rom
Agriculture, hunting and related service activities	2.16	0.23	4.07	3.47	0.00	0.55	9.11	3.90	1.89
Forestry, logging and related service activities	0.13	0.64	0.61	0.02	0.38	0.00	0.02	0.09	0.08
Fishing, fish farming and related service activities	0.19	0.00	0.00	0.19	0.83	0.00	0.00	0.00	0.00
Mining of coal and lignite; extraction of peat	0.44	2.27	0.74	0.00	0.00	0.00	0.00	0.00	0.00
Extraction of crude petroleum and natural gas	8.33	55.21	1.01	0.06	0.00	86.24	33.43	0.09	0.00
Mining of metal ores	0.61	0.68	6.83	0.30	1.66	0.00	7.90	1.09	0.04
Other mining and quarrying	0.57	1.03	2.28	0.77	1.05	0.00	0.09	0.30	0.07
Manufacture of food products and beverages	5.29	0.63	7.15	4.42	0.61	0.07	8.90	4.66	1.11
Manufacture of tobacco products	0.22	0.01	0.01	0.02	0.02	0.00	0.01	0.01	0.01
Manufacture of textiles	1.79	0.08	0.83	11.46	0.17	0.02	0.01	6.00	5.04
Manufacture of wearing apparel	2.40	0.06	4.70	17.90	3.73	0.00	0.51	16.22	17.85
Tanning and dressing of leather	1.14	0.14	2.10	0.39	0.02	0.00	0.01	3.86	8.88
Manufacture of wood and wood products	0.89	1.15	3.22	0.10	0.04	0.02	0.90	1.38	3.18
Manufacture of pulp, paper and paper products	1.77	0.44	0.33	0.33	0.04	0.00	0.00	0.60	0.31
Publishing, printing	0.48	0.03	0.02	0.08	0.79	0.00	0.02	0.14	0.11
Manufacture of coke, refined petroleum	3.46	16.85	6.03	2.18	0.00	6.82	28.07	3.47	2.01
Manufacture of chemicals and chemical products	11.98	2.71	8.76	2.55	2.72	0.28	3.62	4.49	2.99
Manufacture of rubber and plastic products	2.57	0.11	0.89	3.25	0.02	0.01	0.03	1.48	3.22
Manufacture of other non-metallic mineral products	1.13	0.11	0.57	2.49	0.07	0.00	0.03	2.24	0.99
Manufacture of basic metals	6.88	11.08	34.18	6.92	62.29	0.10	5.77	26.16	8.86
Manufacture of machinery and equipment	7.01	0.26	1.92	6.64	0.08	0.42	0.81	7.12	8.45
Manufacture of office machinery and computers	4.59	0.02	0.38	0.10	0.02	0.00	0.05	0.33	1.41
Manufacture of electrical machinery	3.27	0.15	2.51	2.56	0.03	0.03	0.11	3.96	12.63

Table 5 Commodity Composition of EU Imports from Black Sea Region Countries, 2006 in percent (%) (continued)

	Total	Rus	Ukr	Tur	Arm	Aze	Geo	Bul	Rom
Manufacture of radio, TV and communication equipment	5.84	0.09	1.46	6.08	0.50	0.01	0.13	1.47	1.88
Manufacture of medical, precision and optical instruments	2.73	0.06	0.16	0.29	0.07	0.37	0.23	1.66	0.71
Manufacture of motor vehicles, trailers	10.19	0.10	0.40	20.64	0.03	0.00	0.10	0.40	6.22
Manufacture of other transport equipment	2.49	0.18	1.22	1.13	0.04	0.02	0.05	0.98	1.83
Manufacture of furniture	2.35	0.48	1.29	1.94	24.70	4.95	0.02	2.83	5.98
Electricity, gas, steam and hot water supply	0.44	0.36	1.69	0.00	0.00	0.00	0.00	1.93	0.34
n/a	6.10	4.65	2.82	0.71	0.00	0.00	0.00	1.00	0.88
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
of which: manufacturing	80.74	34.89	79.78	94.45	96.00	13.20	49.43	91.56	96.67

Abbreviations: Russia (Rus), Ukraine (Ukr), Turkey (Tur), Armenia (Arm), Azerbaijan (Aze), Georgia (Geo), Bulgaria (Bul), Romania (Rom).

Source: authors' calculations based on Eurostat COMEXT Database.

very beginning in regional—rather than bilateral—format and have been partly institutionalized.⁹ The bilateral approach preferred by the EU with respect to the Black Sea countries results not least from the fact that BSEC is often perceived in the EU as an organization confining itself to mere declarations. This is due in part to bilateral tensions between some of the Black Sea countries, most notably between Armenia and Azerbaijan, Armenia and Turkey, and Turkey and Greece. In fact, the multilateral cooperation of the Black Sea countries with the EU is largely confined to *sectoral* initiatives such as the Interstate Oil and Gas Transport to Europe (INOGATE), the Transport Corridor Europe-Caucasus-Asia (TRACECA), the Black Sea Pan-European Transport Area (PETrA), and the Danube-Black Sea Environmental Task Force (DANBLAS). As a result, the EU fails to act as a ‘center of gravity’ promoting deeper regional integration for the Black Sea region as a whole.

⁹ The examples are the Northern Dimension (Baltic Sea region), the Stability and Association Process (Western Balkans), and the Euro-Mediterranean Partnership.

At the same time, multilateral integration in the Black Sea region under the auspices of Russia, which, given its economic size, could potentially serve as an alternative ‘gravity center’, appears to be equally problematic.¹⁰ This holds true even for Ukraine, Georgia, Armenia and Azerbaijan, all of which belong to the CIS. Although there is a formal CIS-wide free trade agreement, a number of important commodities are exempted, and there are frequent frictions and even occasional bans on imports into Russia of selected (primarily food) products from these countries, such as wines from Georgia (or neighboring Moldova, for that matter) or dairy and meat products from Ukraine. Another example is quotas and anti-dumping measures against the imports of Ukrainian steel products into Russia. Furthermore, Georgia and Armenia have been WTO members for several years (since 2000 and 2003, respectively), Ukraine is currently at the final stage of WTO accession (and is negotiating a ‘deep’ free trade agreement with the EU),¹¹ while Russia and Azerbaijan—both aspiring to WTO membership—are still negotiating. The unequal speed of WTO accession complicates regional trade integration and investment issues even further, as it provides countries which joined earlier with a possibility to put forward extra demands to the applicant countries, which enables them to negotiate better market access terms for themselves or block the applicant country’s accession altogether (Georgia’s veto on Russia’s WTO accession is a relevant example).

The prospects of closer economic integration between the CIS and the non-CIS Black Sea countries potentially involve problems of an even greater dimension. Bulgaria and Romania are EU members. Therefore, any integration steps with these countries would necessarily require deeper integration with the EU as a whole. Besides, Turkey is also a long-standing member of a customs union with the EU, which means that the Turkish trade regime for imports from the third countries is unified with that of the European Union. An additional problem concerns bilateral trade relations between Turkey and Armenia (both countries remain deeply split over the ‘genocide issue’),

¹⁰ The important exception is energy trade, as Russia is the leading supplier of oil and gas for the Black Sea countries (except Azerbaijan and, with some reservations, Georgia). However, co-operation in the area of energy does not require formal integration, as energy is traded on a customs-free basis.

¹¹ The agreement on Ukraine’s WTO accession was signed in February 2008, but still has to be ratified by the country’s parliament to ensure formal accession. Negotiations of a free trade agreement with the EU started in February 2008 as well.

Armenia and Azerbaijan (frozen conflict in Nagorno Karabakh), Georgia and Russia (the latter supporting separatists in Abkhazia and South Ossetia), which are hampered by the strained political relations. Therefore, as long as the integration prospects between the EU and Russia—energy apart—remain bleak, and bilateral relations between several Black Sea countries are low-profile, any far-reaching economic integration encompassing the Black Sea region as a whole will be highly unlikely. At the same time, with growing economic strength, Russian capital increasingly dominates important sectors in the region (such as energy, metals and telecommunications), thus possibly fostering regional integration from ‘below’.¹²

Regional Economic Challenges and Outlook

As demonstrated by the above brief analysis, the Black Sea region comprises a widely heterogeneous group of countries which face vastly different economic problems and find themselves at different levels of development—even if all of them have enjoyed recently high economic growth, accompanied by an impressive surge in bilateral trade flows. Yet many challenges remain, which differ among individual countries.

In Bulgaria and Romania, the economic outlook is stable thanks to their firm anchor in the European Union and the sizeable transfers they are receiving from Brussels. At the same time, the risks of overheating cannot be ignored. Booming domestic demand, largely financed by loans from foreign-owned banks, is increasingly facing supply constraints, which, on the one hand, contribute to inflationary pressures and, on the other hand, spill over into soaring imports. Due to sizeable inflation, both countries suffer from real currency appreciation which threatens their trade competitiveness. Widening external imbalances make these countries increasingly vulnerable to sentiments in world financial markets, raising the risk of a ‘hard landing’ (credit crunch) in the case of a sudden outflow of short-term speculative capital. Over the last two years, speculative capital has been particularly targeting Romania—in contrast to Bulgaria, where the very high external deficits have been so far largely financed by the inflows of

¹² See A. Libman, and B. Kheyfets, “Expansion of Russian Capital in the CIS Countries,” *Ekonomika* (Moscow, 2006).

FDI. However, in the longer run, should FDI inflows subside and a financial crisis break out, Bulgaria may find it more difficult to cope with external shocks. Unlike Romania, it is operating a fixed exchange rate regime to the euro within the framework of a ‘currency board’. Therefore, any currency devaluation—which might be required to improve the country’s competitiveness and thus reduce external deficits—would be very difficult to implement. This would imply leaving the ‘currency board’, with the resulting credibility loss of the country’s monetary authorities.

The issue of overheating also applies to some extent to Georgia and Armenia, although the financial vulnerability of these very small economies does not seem to be excessively exposed at the moment. In fact, Georgia and Armenia are primarily facing structural—rather than macroeconomic—problems. In both countries, poverty is still a big issue. According to the World Bank definition, it affects around 30 percent of the population on average, but is typically worse in the countryside. The reasons for this are multiple, but an important explaining factor has been the virtual dismantling of the social safety network in the wake of economic transition. The latter is manifested *inter alia* in the small size of government, particularly in Armenia, where general government expenditures hover around 20 percent of GDP.¹³ This is not only much below what is common in EU countries (generally above 40 percent), but even e.g. in Russia and Ukraine (30-35 percent). The limited ability of the Armenian government to spend is partly due to low tax morale and the widespread activities of the shadow economy, and also to the fact that some of the most dynamic economic sectors (such as construction) used to be exempted from taxation. Another problem for Armenia is the relative closeness of its economy: primarily because of the problematic relations with its neighbors Turkey and Azerbaijan. As a result, its foreign trade turnover stands below 50 percent of GDP (and exports at just 16 percent of GDP)—much lower than what the country’s small size would suggest. The costs of this are manifold: not only do missing export opportunities imply losses for the economic agents involved; the re-direction of cargo shipments via sub-optimal transport routes means eroding profit margins of exporters and higher domestic prices of imported goods. Similar problems can be observed in Georgia,

¹³ The latter is also true for Azerbaijan—see Table 1.

whose transport links to Russia are largely blocked due to the unresolved status of Abkhazia and South Ossetia.

Another issue of concern for Armenia (and, as a matter of fact, for Ukraine, whereas Georgia's export structure is, paradoxically, more diversified) is the narrow specialization in commodities whose world prices are subject to sharp and unpredictable fluctuations—which partly translates into the volatility of these countries' growth paths. In Ukraine, some 40 percent of exports is represented by metals, particularly steel; in Armenia about 60 percent of exports is represented by diamonds and non-ferrous metals such as copper and molybdenum. As exemplified by the recent successful experience of numerous east European countries (including Romania and Bulgaria), attracting FDI into industrial branches producing (and exporting) more sophisticated products (as well as potentially in tourism) helps improve the economic structure and thus represents a remedy to this problem. However, a prerequisite for that would be improvement in the investment climate, which would require *inter alia* the settlement of existing 'frozen' conflicts (in Southern Caucasus) and greater political stability in general (in Ukraine). The latter two factors explain why foreign investors have largely avoided these countries so far (see the low levels of cumulative FDI stock per capita in Table 1).

In Russia and Azerbaijan, narrow specialization in energy resources is potentially dangerous—even though in the short and the medium run oil prices are expected to stay stubbornly high, so that the risk of a crisis currently appears to be low. The necessity of diversifying the economy away from energy is generally understood by the countries' authorities.¹⁴ Therefore, the biggest policy challenge for these countries is how to take advantage of the current oil 'bonanza' in the most efficient way in order to pursue the goal of diversification. Following the experience of many other energy-exporting countries, both countries set up 'oil funds': Azerbaijan in 1999 and Russia in 2004. However, channelling energy revenues exclusively into oil funds for the benefit of future generations (as has been largely happening so far in Russia, and in line with the policy pursued e.g. by Norway)—rather than spending them on a current basis—runs the risk of depriving the

¹⁴ In Azerbaijan, this issue appears to be of particular relevance, since, according to available estimates, the country's oil production is likely to peak out already in 2009–2010—unless new oil deposits are discovered.

economy of badly needed investments, including in infrastructure and the social sphere (in so-called human capital). Indeed, it is fairly obvious that the development needs of both Azerbaijan and Russia are quite different from those of Norway. On the other hand, boosting government expenditures on a current basis (the strategy currently pursued by Azerbaijan), if driven to the extreme, may fuel inflation, leading to higher production costs and thus undermining the competitiveness of the non-energy tradable sector (the so-called ‘Dutch disease’)—thus making the goal of economic diversification even more difficult. Therefore, the policy challenge for the authorities under the current circumstances is to find a reasonable compromise by tempering the pace of fiscal expansion in order to avoid excessive ‘overheating’. Another challenge is to keep corruption in check.

Turkey faces two main economic challenges. First, despite the remarkable reform progress reached over the last few years and the much sounder banking system nowadays, the country’s persistently high current account deficits (around 8 percent of GDP in 2006–2007) and underlying trade deficits are still a concern. The domestic price level, which stands at around two-thirds of the EU average, seems to be much higher than justified by the country’s level of development, and creates problems for the country’s goods-exporting sector, particularly such less productive segments such as textiles. Second, the reform efforts of the government—however impressive thus far—largely owe their success to the country’s EU membership aspirations and may subside markedly in response to the increasingly skeptical attitude towards Turkey’s EU accession on the part of European policymakers and the broader public.¹⁵

Despite these problems, the outlook for the Black Sea countries is largely positive, with annual GDP growth in excess of 5 percent in the medium and long run being feasible—not least owing to the considerable catch-up potential of all countries concerned (for a short-term forecast, see Table 2). Apart from sound economic policies—which should go beyond the standard stabilization, liberalization and privatization tasks (all of them largely completed by now),¹⁶—it is especially

¹⁵ In fact, the public support of integration policies within Turkey has already diminished—more on that, see Pöschl, J., “Turkey’s Economy Dipping its Toe in Troubled Waters,” in Havlik, P., M. Holzner et al., *Weathering the global storm, yet rising costs and labour shortages may dampen domestic growth*, wiiw Current Analyses and Forecasts, Nr., February 1, 2008.

¹⁶ For more details, see EBRD Transition Report (2007).

the fostering of institutional reforms and related improvements of investment climate that will be indispensable for a lasting and sustainable economic development in the Black Sea region. More decisive steps towards regional and EU economic integration would undoubtedly further contribute to the favorable economic prospects of the countries involved. However, as demonstrated by our analysis, such integration would require significant changes in the stance of regional (and EU) policymakers, a higher level of mutual trust, a solution of 'frozen conflicts', and ultimately hinges on prospects for cooperation between Russia and the EU.

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