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TABLE OF CONTENTS

SLOVAKIA'S 2004 YEAR REFORMS FRUCTIFY

Slovakia gained the hallmark of a reform country in the previous years. A great number of different international institutions and foreign media have described Slovakia as an "economic tiger" (*The New York Times*), "one of the most attractive business climates in the region" (*Fitch Ratings*), "Europe's fastest reformer" (*Newsweek*). This is a big change in comparison with years of transition as the country lagging behind in reforms. Experts usually commend Slovakia for its tax reform, pension reform, and labor market reform among others (for example health care reform and public finance management reform). It is obviously too early to evaluate the complex impact of economic reforms, but it is unquestionable that they have a significant impact on the way the economy functions and emerges.

SLOVAKIA'S 2004 REFORMS

The so called "19%" ***tax reform***, introduced on 1st of January 2004, greatly simplifies the tax system of Slovakia and in the opinion of the Finance Minister, Ivan Miklos, it strongly supports the economic growth. The new personal income tax consists of a single rate of 19% and a high tax free threshold. It replaces the previously existing 21 different tax rates, which were including a five band rate structure on wage income that ranged from 10 to 38% and withholding tax rates on capital income ranging from 5 to 25%. Among others, the corporate income tax rate has been reduced to 19% as well. The single value-added tax (VAT) rate of 19% replaces dual VAT rates of 14 and 20%. The dividend taxes have been completely abolished. Only excise taxes were increased to be aligned with EU requirements.

The ***pension reform*** was approved in 2003. It reshaped the existing public pension system and introduced a mandatory, privately funded pillar in the previous structure. The reform of the public pay-as-you-go system provides for a gradual increase in retirement ages to 62 years for both men and women, from 60 (men) and 57 or less (women). Moreover it establishes a closer link between future benefits and contributions. The new privately funded (additional) pillar started operations in January 2005. Citizens will be able to start depositing a part of their present contributions to old-age pension insurance schemes (nine percent of their gross salary) to their personal account in a pension fund. According to the Labor Ministry's expectations the majority of Slovakian citizens will have until June 2006 to decide whether they will voluntarily join the pension savings system or not.

The main element of the 2004 welfare reform was the introduction of the "***activation program***". It restructured the benefit formula so that it became dependent on work effort. Although basic benefit was significantly reduced (cut to half of the original amount), on the other hand, the reform introduced an "activation allowance for which recipients are required to demonstrate effort to improve their situation, for example participation in community volunteer work or retraining programs.

The eligibility periods have been cut and the unemployment benefit more closely linked to past contributions. An unemployed person is eligible for benefits for up to 6 months, compared to 9 months before 2004. The replacement rate is 50% of past gross income; which does not mean a significant change compared to the previous rate.

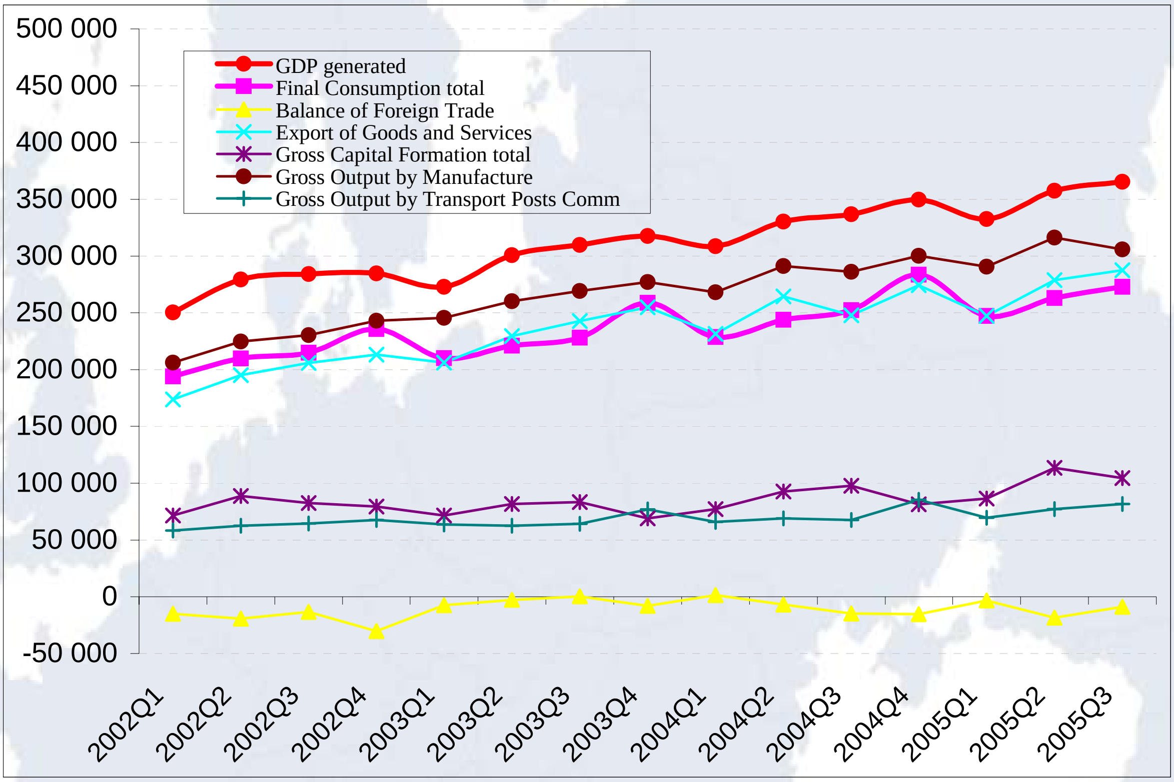
According to a decision by parliament the country's next scheduled general elections will take place on 17th of June 2006 instead of September. Apart from that, President Ivan Gasparovic is convinced that the next government to take power will be forced to continue with the economic reforms. The latest opinion-poll results also confirmed most Slovak citizens agree that reforms should be continued.

ASSESSMENT OF THE EFFICIENCY OF THE REFORMS

Slovakia's successful entry into ERM II on 25th of November 2005 was facilitated by smart macroeconomic management and a wide range of fundamental structural reforms over the past few years. Slovakia will be expected to adopt the euro for January 2009.

Robust economic growth has continued in 2005: GDP stood at SKK 365.5 billion (=EUR 9.5 billion) in the third quarter of 2005, rising by 6.2% year-on-year. Private consumption and fixed investment demand have increased appreciably, but have been accompanied by inventory rationalization. The Slovak Investment and Trade Development Agency managed 28 foreign investment projects in Slovakia from January to September in 2005. The value of the investments is over EUR 139 million and the new projects will create thousands new jobs. A large positive swing in net exports has occurred in the second half of the year (*Source: Statistical Office of the Slovak Republic*).

Chart 1. Different macroeconomic indices in SKK million on current prices 2002-2005



Source: Statistical Office of the Slovak Republic

Although the economy is well poised in many respects (in particular, Slovakia already meets the Maastricht criteria for long-term interest rates and the public debt ratio), risks and challenges remain. The immediate challenges are to reduce inflation and the fiscal deficit to levels that meet the Maastricht criteria and there is problem with the high unemployment rate too (in the third quarter of 2005 was 15.6%).

Still, mainly reflecting developments in the first half, the external current account deficit is projected to widen to 5.6% of GDP by year-end, but much of it is covered by FDI inflows. The carmakers, for example PSA Peugeot Citroen plans to increase its investment in Slovakia further, which investments will create another job not only in the industry but in the supplier network too, or the Getrag Ford Transmissions invested in Slovakia to build a transmissions production plant.

Fiscal performance in 2005 has been better than expected, because tax revenues have been enhanced by stronger growth in their underlying bases (wages, employment, consumption, and enterprise profitability) and should exceed the budgeted levels. In addition, there have been savings in interest payments. Assuming that these additional resources are saved and are not matched by increased spending in the last few weeks of the year and taking into account forgiveness of certain foreign debt claims, the mission projects a general government deficit of 3.1% of GDP compared with 3.4% of GDP envisaged in the budget (excluding the cost of the second pension pillar). The projected outturn implies a slight withdrawal of fiscal stimulus in 2005, which is appropriate. Excluding the costs of pension reform, the analysts forecast that the deficit will be 2.9% in 2006 and lower than 2% by 2007. (*Source: IMF*)

The downward trend in headline consumer price inflation since early 2005 was partially reversed in the fourth quarter thanks to the increases in regulated prices in October. But anyway the inflation rate in December 2005 was at 3.7%, compared with 5.9% at end-2004. Koruna appreciation, falling food prices due to a good harvest and increased competition at the retail level subsequent to EU membership have eased inflation pressures (*Source: Statistical Office of the Slovak Republic*).

Economic success of Slovakia shows the fact too, that the international ratings agency Fitch increased the country's rating from A-minus to A (Hungary stands at A-minus). The A rating takes into account the 19% flat tax reform and the improvements to the business environment that has encouraged investment and last but no least the strong growth expectations. Fitch has also affirmed Slovakia's long-term local currency rating at A-plus and raised the short-term foreign currency rating from F2 to F1. The Country Ceiling has been upgraded from A-plus to AA-minus, while the outlook on Slovakia's ratings is stable.

Slovaks think that the pension reform is the most successful of all the wide-ranging reforms introduced so far in Slovakia, according to a survey published by the Labor Ministry 7th of December 2005. According to another survey made by the TASR news agency, almost 60% of respondents endorse the reform. A total of 53% of those polled said they planned to join the second pension pillar introduced by the reform (*Source: Slovak Spectator*).

According to the Finance Minister Ivan Miklos, the reforms enable the achievement of high and sustainable economic growth, but the entry into the Euro zone – after the fulfillment of the Maastricht Treaty criteria – is also important for creation of more stable conditions for the economy and business. The central bank of Slovakia (NBS) has predicted that economic growth could increase by one percent thanks to the country’s membership of the Euro zone (*Source: Slovak Spectator*).

RECENT UPDATE OF THE CZECH CONVERGENCE PROGRAM

The Czech Republic submitted the updated version of its Convergence Program on 24th of November 2005. The program covers the period 2006-2008 and was assessed by the European Commission on 11th of January 2006. According to the Commission, the program of the Czech government follows the specified model structure for convergence programs and contains all compulsory and most of the optional data. Although highlighting some weaknesses the Commission praised the program. As a final step on 24th of January 2006, ECOFIN (European Union's Economic and Financial Affairs Council) approved the program, which means that euro will replace koruna in 2010.

THE ECONOMIC DEVELOPMENT OF THE CZECH REPUBLIC – MAIN INDICATORS

The Czech Republic has faced more back-sets since its formation in 1993. The first throw-back appeared in 1997 when the 4.2% real GDP growth of the previous year was followed by a 0.7 percentage point drop. In 1998 the recession went on and real GDP continued to decrease by 1.1 percentage points. At the same time inflation accelerated from 8.5% in 1997 to 10.7% and the unemployment rate worsened by 1.7 percentage points to 6.5%. The recovery phase started in 1999 and lasted for 2 years. In 2001 the economy started to slow down but the throw-back was less deep and the growth gained dynamics in the following year (*Table 1*). Besides the positive development of the GDP and the inflation rate the government deficit and the unemployment rate assign a reason for concern. The budget deficit was very high in two consecutive years. Although this indicator dropped sharply in 2004 it is not stabilized at this relatively low level according to the estimation for the following year. The unemployment rate has increased since 2002 despite the accelerating growth of the real GDP.

Table 1. Key indicators of the Czech Republic and projections by Ministry of Finance in the Convergence Program

	2001	2002	2003	2004	2005*	2006'	2007'	2008'
Real GDP (previous year = 100%)	102.6	101.5	103.2	104.4	104.8	4.4	4.2	4.3
Inflation rate (%)	4.7	1.8	0.1	2.8	1.9	2.2	2	2.1
Unemployment rate (%)	8.1	7.3	7.8	8.3	7.9	7.4	7.1	6.9
Government deficit (% of GDP)	-5.9	-6.8	-12.5	-3	-4.8	-3.8	-3.3	-2.7
Government debt (% of GDP)	26.3	29.8	36.5	36.8	37.4	37.1	37.9	37.8

**estimation 'projection*

Source: Czech Statistical Office and Czech Convergence Program

The estimated data for the year 2005 forecasts the continuation of the recent positive economic trends concerning real GDP growth and inflation rate. The update of the Czech Convergence Program is based on the assumption of the ongoing economic growth.

THE UPDATED CONVERGENCE PROGRAM

The main objective of the Czech economic policy is to promote growth, reduce unemployment and increase competitiveness. In order to achieve these objectives the government adopted two strategic documents containing economic policy priorities: the Economic Growth Strategy for 2006 to 2013 and the National Reform Program. The priorities were formulated in four policy areas: fiscal, monetary, structural and labor market policy.

The fiscal policy concentrates on reducing public deficit reaching a sustainable level of under 3% of GDP by 2008. In order to consolidate public finances the pension system and the system of healthcare financing is going to be stabilized. The monetary policy would like to achieve low and stable inflation with help of the inflation targeting regime. For the period of 2006-2008 the inflation target is defined as 3% year-on-year CPI growth with a maximum deviation of one percentage point in each direction. The Czech Republic would like to join the Euro zone in 2010. In the preparation period the country intends to stay in ERM II (Exchange Rate Mechanism II) only for the required two years.

The structural policy focuses on strengthening and increasing the competitiveness of the Czech economy. The reform measures are defined in the National Reform Program. The measures include the creation of a stimulating environment for science, research and innovation; the commercial application of R&D; modernization and development of transportation, information and communication networks; a good corporate environment facilitating market entry and promoting new business creation and the reduction of corporate bureaucracy.

The labor market policy faces a low level of flexibility and low labor force mobility resulting in a high structural rate of unemployment. To overcome these problems the labor market policy plans to expand contractual freedom, to reduce statutory non-wage costs and increase the territorial mobility of the labor force. Furthermore market flexibility should be strengthened by the new Labor Code currently being discussed in the Czech Parliament.

The Convergence Program plans with a real GDP growth rate higher than 4% in each year of the period 2006-2008. The main reason for the dynamic growth will be the higher total factor productivity generated by improved institutional parameters of the economy, the quality of business environment and the new technology associated with inward FDI. Other pro-growth factors are: the recovery of domestic demand, the positive foreign trade balance and the country's membership in the EU. On the contrary high oil prices and the slow growth of the most important export markets effect negatively the economic growth.

The inflation targeting regime helped to maintain the low inflation rate having characterized the country since 1999. Thus the Czech government does not expect any acceleration in inflation. However the inflation rate can increase due to higher prices of oil and natural gas and higher taxes on tobacco.

The Czech public finance reform implemented in 2004 included measures aimed at strengthening the income side and achieving expenditure savings. The Conception of Public Finance Reform focusing on binding medium-term expenditure frameworks is going to be continued. The expenditure-oriented fiscal consolidation could ensure a gradual reduction in the government deficit and result in a public finance deficit lower than 3% of GDP in 2008 (*see Table 1*.). The Czech Republic could reach a medium-term public budget deficit target of around 1% of GDP by 2012 according to the revised Stability and Growth Pact but long term budgetary development will depend on the success of structural reforms needed because of an ageing population. As government debt dynamics are going to be determined almost entirely by the general government deficit and nominal GDP growth, by the end of 2008, an increase of 1 percentage point is expected against 2004 reaching 37.8% of GDP.

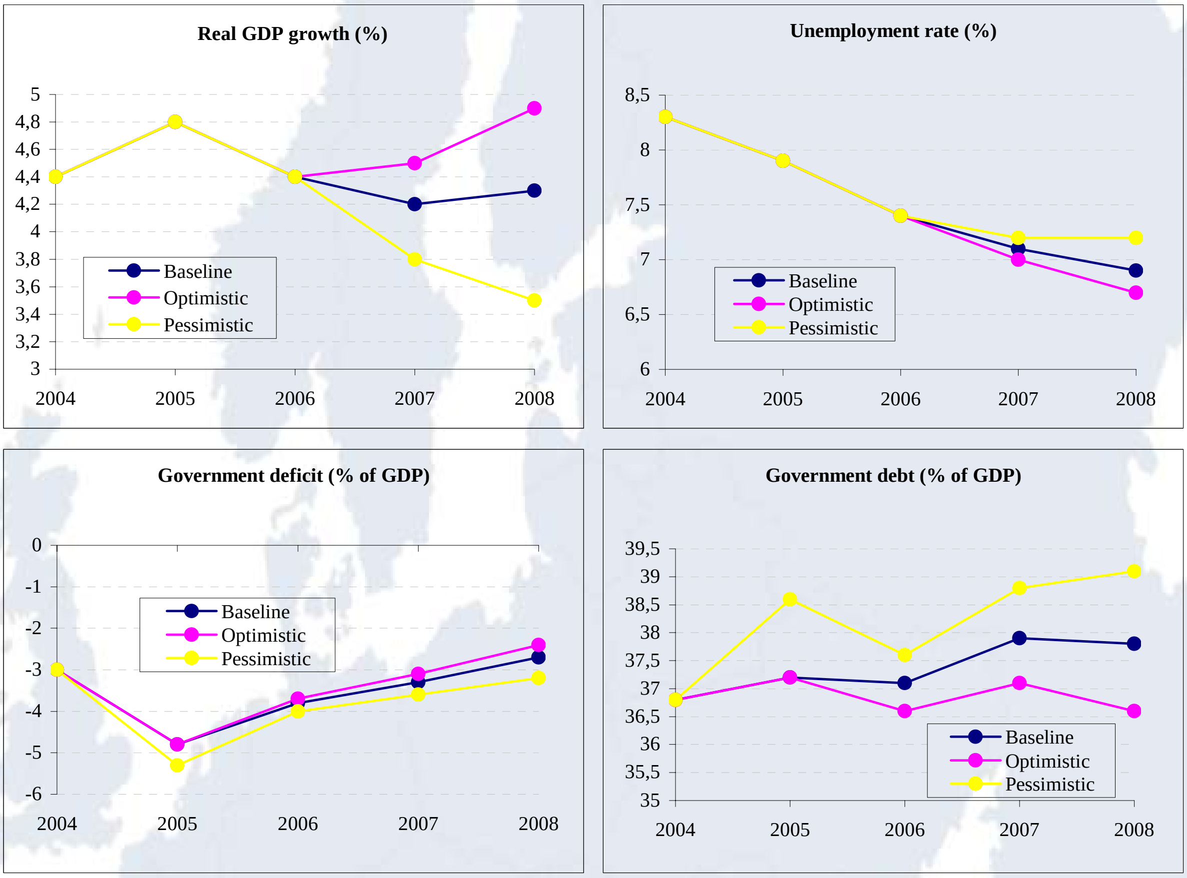
The unemployment rate should decrease thanks to the implemented structural policy measures, but also to the high economic growth affecting the demand side of the labor market.

As a result the unemployment rate would be 6.9% in 2008. Missing implementation of the reforms could negatively affect economic growth.

EXPECTATIONS, SCENARIOS

The Convergence Program contains an optimistic and a pessimistic scenario besides the baseline projections. Two exogenous variables, oil price and GDP growth of the EU-15 are changed in the different scenarios: the optimistic projection counts with lower oil prices and more dynamic growth of the European Union.

Chart 2. Scenarios of the Convergence Program on main indicators 2006-2008



Source: Ministry of Finance, Convergence Program

According to the different scenarios it can be concluded that even in case of disadvantageous exogenous variables the main economic indicators will develop positively but slower. However the pessimistic scenario includes some risks concerning the introduction of euro as the government deficit would exceed the GDP reference value of 3% by 0.2 percentage points.

The Commission assessed the baseline scenario. According to its assessment the growth assumptions are plausible, the risks to the budgetary projections balanced and the government debt is expected to be well below the 60% of GDP reference value. The only critical point of the Convergence Program appears to be the sustainability of public finances according to the Commission. The ageing population requires structural reforms and will increase budgetary costs which could result in higher deficit and rising debt ratio in the long term projections until 2050. The recommendations of the Commission include the necessity of structural budgetary adjustment and enhancement of the quality of budgetary planning as the margin between the targeted and the reference value is only 0.3 percentage points. The Commission also suggests improving the long term sustainability of the public finances by accelerating the pension reform and starting the reform of the healthcare system.

The program was approved by ECOFIN on 24th of January 2006, thus euro could replace koruna in 2010 if the Czech government implements its Convergence Program consequently and the economic environment does not worsen to the extant of the pessimistic scenario.

RUSSIA HOPES TO JOIN WTO BY THE END OF 2006

After a long and hard lobby-work, Russia may join the World Trade Organization (WTO) by the end of 2006, even before the end of the Doha Round, which seems to have been newly revived after the meeting in Hong Kong in December, 2005.

The Russian Minister of Economic Development and Trade German Gref announced at his arrival at the World Economic Forum that Russia hopes to join the WTO in 2006. According to him Russia has a good chance to finish negotiations.

SUM UP OF EVENTS

To sum-up the process of Russian's accession to the WTO „The slower you go, the further you'll get" could be a proper description for it. It can be considered neither hurried nor ill-considered. Russia introduced its application for WTO membership in 1993, the negotiations on Russia's accession started in 1995.

Any country that would like to join the 149-member-WTO has to go through a complex process of negotiation - the acquisition of the WTO membership doesn't go as automatically as in some other cases of other organizations, like the IMF.

The negotiations between Russia and the WTO are led by the so-called "Working Party," which consists of the WTO Member Countries. The Working Party is open to all Members of the WTO. The first meeting of the Working Party took place in Genova in 1995.

The applicant government has to present a memorandum covering all aspects of its trade and legal regime to the Working Party. After this, multilateral negotiations start determining the terms and conditions of accession for the applicant government. During its transitional period the applicant country has to make the necessary legislative and structural changes for the implementation. Simultaneously, the applicant government pledges itself in bilateral negotiations with interested Working Party members about concessions and commitments on market access for goods and services. The final "accession package" consists of the results of both the multilateral and bilateral phases, the Report of the Working Party containing a summary of proceedings and conditions of entry and a Protocol of Accession, Schedules of market access commitments in goods and services verified between the acceding government and WTO Members. The „accession package" is adopted at a final formal meeting of the Working Party. Next the General Council or the Ministerial Conference approve of the documents, and redistribute it as a non-restricted document, and finally the applicant is free to sign the Protocol of Accession stating that it accepts the approved „accessions package" subject to ratification in its national Parliament.

In Russia's case the Working Party was established in 1993, the Memorandum was presented in March 1994, the first Working Party meeting was in July 1995, negotiations about goods started in 1998 and about services in 1999. The Draft Working Party Report was completed in October 2004. The last, the 29th meeting of the Working Party took place in October 2005.

The negotiations are held at both multilateral and bilateral levels. Negotiations have been full-scale covering all the aspects of Russia's accession to the WTO, since 2000.

One of the turning points of the process of Russia's accession happened in May 2004 when Russia and the EU signed an agreement removing a hard obstacle. The EU specified the increase of domestic energy price especially the price of gas as the condition of Russia's accession, hoping the European gas sector firms can compete under better conditions at the Russian market. The EU pressed the opening of the Russian financial, service and telecommunication market, and the reduction of the customs of airplanes and that of motor cars. In return for the EU not obstructing Russia's accession any longer Moscow promised to accelerate the process of the ratification of the Kyoto Protocol.

The bilateral accession talks have become more intensive recently. Russia signed a final bilateral protocol on Russia's accession to the WTO with Brazil and Switzerland in Davos and with India on 7th of February. By now Russia has already completed negotiations with 55 countries among the 58 member countries, over 50 of them are involved in the negotiations on goods market access and more than 30 of them on service market access. The negotiations are still continuing with the United States, Australia and Colombia.

Russia has to draft the final, fifth, version of the report that satisfies all partners of Russia.

DIFFICULTIES IN THE PROCESS OF ACCESSION

Although Russia has already finished negotiations with many counties, there are still factors that could make the accession more difficult.

A bilateral accord with the United States remains the most difficult task. US President George W. Bush supports Russia's accession bid - Putin said at his annual press conference in the Kremlin. One of the biggest problems in Russia's negotiations with the U.S. is the violation of intellectual property rights. The U.S. and other countries want Russia to crack down on legislation and penalties for intellectual property theft. The Russian authorities have increased the seizures of pirated CDs, DVDs and other intellectual property. Progress has been achieved about Russia's aircraft construction but negotiations about financial services are still stalling. Agriculture, bank and energetic sector also seem to be critical areas.

Joseph Stiglitz, the once leading economist of the World Bank, called the American approach about Russia's membership as „blackmail at the entrance". Russia doesn't want American banks and security companies to have subsidiary companies in Russia. But the United States is aiming to maximize its advantages, and threatens by opposing Russia's integration.

At the same time Russia doesn't want to rush the accession, and would not like to join any of the Committees where not every member state of the organization is represented. President Vladimir Putin stated that Russia would join the WTO only on acceptable standards.

Furthermore the latest events about the Russian-Ukrainian gas-debates have raised again questions about whether Russia is eligible for WTO-membership, because Russia violated the spirit of WTO and the spirit of agreement.

CONDITIONS OF THE ACCESSION

The membership states some requirements that Russia has to meet: the country must improve the existing conditions of the access of Russian products to foreign markets and should prepare for nondiscriminatory treatment of Russian exporters, bettering existing conditions for the access of Russian products to foreign markets and provide non-discriminatory treatment for Russian exporters and facilitate the access to the international dispute settlement mechanism.

It is a must to create a more favorable climate for foreign investments, extend the opportunities of Russian investors in the WTO member-countries, especially in the banking sector, ensure the conditions for the growth of domestic production quality and competitiveness, which come from the bigger flows of foreign goods, services and investments to the Russian market, participate in negotiations of the international trade agreements considering national interests.

The objective of Russia's accession negotiations is to achieve the best conditions for the integration, to reach the best balance between benefits and concessions that the membership requires in forms of tariffs reduction and domestic market opening. German Gref underlines that balance of rights and obligations of Russia during its accession should contribute to its economic growth and not vice versa. He asked members on 24 June 2005 to understand Russia's difficulty in trying to become a market economy and complete its membership agreement by the end of the year.

PROS AND CONS OF ACCESSION

WTO opens market to new members. Consequently a country's product can be more easily exported without trade barriers. Those who support Russia's accession hope growth in trade turnover, growth of Russia's budget, economic growth, the strengthening of Russia's position on the world market, increasing exports, improvement of the quality of goods on the Russian market, strengthening of its financial system, improvement of the living standards.

On the other hand, WTO members commit themselves to open their domestic markets to foreign competition. There is a fear that the Russian producers will lose the competition with foreign ones. There is risk of the increase in the internal natural gas prices that can result in higher inflation. Furthermore, the obligation to follow the WTO requirements may negatively influence Russia's political and economic independence.

Table 1 shows the expected effects of the Russia's accession to WTO on different sectors.

Besides mentioned difficulties other conflicts in the integration process have recently also appeared.

The European trade commission will probably discuss the possibility to cancel trans-Siberian over-flight fees for foreign air carriers. The EU threatened to withdraw from the Russian-EU agreement if Russia did not cancel the over-flight fees, which bring it USD 300 million annually. Russia has promised to discard the fees in a decade. Russian Economic Minister however, does not believe Europe would resort to withdrawing its support.

Table 2. Tariff Rates, Export Tax Rates, Estimated Ad Valorem Equivalence of Barriers to FDI in Services Sectors and Estimated Improved Market Access from WTO Accession* (Ad valorem in %) - by sector

Sector	Tariff rates	Export tax rates	Estimated change in export prices from WTO accession	Equivalent % barriers to FDI	
				Base year	Post-WTO Accession
Electric industry	4.5	0	0		
Oil extraction	0	7.9	0		
Oil processing	3.8	4.6	0		
Gas	0.5	18.8	0		
Coalmining	0	0	0		
Other fuel industries	2.6	2.6	0		
Ferrous metallurgy	2.9	0.4	1.5		
Non-ferrous metallurgy	7.4	5.3	1.5		
Chemical & oil-chemical industry	7.1	1.6	1.5		
Mechanical engineering & metal-working	7.2	0	0		
Timber & woodworking & pulp & paper industry	9.9	6.9	0		
Construction materials industry	10.6	1.6	0		
Light industry	11.8	4.1	0.5		
Food industry	11.3	3.1	0.5		
Other industries	6.4	0	0.5		
Agriculture & forestry	8.2	0.6	0		
Other goods-producing sectors	0	0	0.5		
Telecommunications				33	0
Science & science servicing				33	0
Financial services				36	0
Railway transportation				33	0
Truck transportation				33	0
Pipelines transportation				33	0
Maritime transportation				95	80
Air transportation				90	75
Other transportation				33	0

Source: World Bank

However, WTO members were pressuring Russia and trying to reduce the figures stipulated in previous agreements, namely USD 9.2 billion in annual state support for agriculture, Russia's Agriculture Ministry will protect the parameters of state support for the agro-industrial sector. Russia hopes to end the negotiations successfully while standing its ground on the parameters.

The fact that Philippe DE BUCK, head of the Union of Industrial and Employer's Confederations of Europe (UNICE), on 9th of February urged not to delay Russia’s accession to the WTO is also a good sign that Russia could finally join WTO by the end of 2006. Let us hope for the best.

Ukrainian-Russian Gas Dispute is Temporarily Finished

From 1st of January, the Swiss-registered joint venture RosUkrEnergo, owned by Gazprom and Naftogaz in 50-50%, buys Russian gas on price USD 230 per 1000 m^3. But the company also integrates Central Asian gas suppliers like Turkmenistan and Kazakhstan on much lower price. Thus the gas sold to Naftogaz (Ukrainian oil- and gas company) is of price USD 95 per 1000 cubic meter instead of USD 50 price that applied in April 2001 and instead of "European market price" USD 230. In the same time the transit price of the Russian gas directed to Europe and passing Ukrainian pipelines is agreed to grow by USD 0.51 to USD 1.6 for every thousand m^3. European politicians, business leaders and the whole European public opinion acknowledged with resignation this agreement, even if in medium-long term the energy security of the EU can be resulted serious concerns.

The seemingly favorable agreement led to political crisis in Ukraine as the government of Jury Jekhanurov was dismissed by the Parliament. On 25th of January, the agreed contract is still unsigned by sides. The Ukrainians justified it with still missing information on ownership of RosUkrEnergo.

The Past of Ukrainian-Russian Gas Cooperation

After collapse of the Soviet Union in 1991, Russia did not shift to market oriented price system with the former republics. There were several reasons behind this decision: first of all political (stability, CIS, bargaining factor), but also because of transit position of Byelorussia and Ukraine. Also the corrupt systems and other illegal structures had the interest to keep prices low.

Nevertheless, on the millenary, parallel with the boom in oil and gas price and with the change in nomenclature headed by president Putin, the former system of bilateral agreements seemed to be unsustainable. This led to more active and strong discussion between the partners, like Byelorussia-Russia and Ukraine-Russia. In February 2004, the Byelorussian president Lukasenko after fast fencing managed to reach USD 47 price on gas without delivering its pipeline system to Russia.

The Ukrainian-Russian gas dispute resulted in much more loud conflict. Russia claimed the USD 230 price, while Ukraine announced the USD 95 gas price so far bearable. Apparently, the reason behind the wish putting on market base price configuration is not the only reason from Russia's initiative. As the gas and other energy resources represents political bargaining power, after Orange Revolution led by President Viktor Yushchenko backed by Western Countries, Putin found the time for soft invasion to set back Russia's sphere of interest.

Energy Positions of Russia in The Light of Europe

The state of gas war between Russia and Ukraine is crucially important for Europe, as Russia is the main supplier and Ukraine is the transit gate to Europe by its pipeline net.

Gas is the second fastest-growing energy source after non-hydro renewables in the global energy mix. Gas demand rises at 2.7% per annum. Its share in world primary energy demand increased to 23.7% in 2004 (oil 36.8% and coal 27.2%). Most of this increase will come at the expense of nuclear energy and coal. Gas demand is expected to surpass coal demand after 2010 by the expectations of *International Energy Agency (IEA).*

In 2004 Europe and Eurasia own 35.7% of all world proved reserves – 64.5 trillion cubic meters. Nevertheless, almost 75% of it belongs to the Russian Federation (26.7% of world reserves). The second and the third place occupied by two Central Asian countries: Kazakhstan (4.69%) and Turkmenistan (4.53%). From the EU only The Netherlands and Norway has above 2% share. The production division shows much more favorable picture from the point of view of the EU, as Russia produces a bit more than 56% of all European and Eurasian production and the following three countries are EU members: UK (9.12%), Norway (7.47%), The Netherlands (6.54%). So while the EU-25 has only 1.5% of all gas reserves of the world, it produces 8% of all produced worldwide. Thus the R/P ratio is 12.8, which shows the length of time that those remaining reserves would last if production were to continue at that level. (*Data Source: Statistical Review of BP 2005 and ICEG calculations*)

From the consumption side, Russia has also leading position, as it consumes 36.2% of all natural gas consumed in Europe and Eurasia. It is reasonable and also reflected in the primary energy consumption structure of the country. 54% of all consumed fuels by Russia are natural gas, oil's and coal's share are 19.2% and 15.8% respectively. The second consumer is UK (8.84%); third Germany (7.75%), fourth Italy (6.61%) and the fifth is Ukraine (6.38%). As regarding Ukraine's primary energy consumption structure: natural gas 44.5%, coal 27.6%, the third place surprisingly is of nuclear energy (13.8%) and not the oil (12.2%). It is in line with the fact that the economies of former Soviet Union are dependent mainly on gas supplies, while the EU-25 and the OECD group on around 25% addicted to natural gas. For contrast, China is mainly coal-dominated economy (69%), while the USA is oil (40%). Thus the consumption structure depends on natural factor endowment and of course on the cost of exploitation. (*Data Source: Statistical Review of BP 2005 and ICEG calculations*).

As of trade, almost 40% of all - by EU-25 members imported - gas is originated from Russia reflecting high dependence ratio and primary supplier role of the Federation. (*ICEG calculations*) However, the EU-15 and Switzerland managed to diversify its gas supply portfolio over last decade, while the Central European new EU member states are gradually and slowly moving away from a former 100% dependence on former Soviet Union gas and oil. For instance the transit country Hungary consumes more than 7% of all traded Russian gas. Directly 90% of all imported gas, indirectly almost 100% is originated from former Soviet Union/Russia. The share of gas in Hungary's primary energy structure is around 50%. Though the energy structure of new member states (NMS) can differ, the gas endowment is of mainly Russia's, less of other's deal. (*For trade statistics see Table 1.)*

UKRAINE

Over 90% of Russian gas exports to Europe transits via Ukraine with the exception of Finland and Poland - including gas being delivered through the Yamal system. This means that Ukraine is the gateway for some 25% of total European gas supplies.

The only alternative export route bypassing Ukraine to Europe is the so-called Yamal pipeline through Belarus and Poland to Germany, whose first string with a capacity of 23 Bcm/year was completed late in 1999. Once fully completed, the Yamal pipeline system through Poland will have a capacity of 64 Bcm.

Gas is the number-one fuel in Ukraine, accounting for 45% of total. More than 43% of total gas supplied is consumed by the residential-commercial sector, 28% is used to generate electricity and heat, and 25% is used by industry.

Table 3. Natural Gas main trade movements to EU countries by pipelines 2004

To	From Denmark	Germany	NL	Norway	UK	Russia	Algeria	Total imports
Austria	-	1.00	-	0.80	-	6.00	-	**7.80**
Belgium	-	1.20	7.60	7.20	0.20	0.20	-	**16.40**
Czech Republic	-	-	-	2.62	-	7.18	-	**9.80**
Finland	-	-	-	-	-	4.61	-	**4.61**
France	-	-	9.20	14.65	1.00	11.50	-	**36.35**
Germany	2.64	-	21.90	26.40	3.08	37.74	-	**91.76**
Greece	-	-	-	-	-	2.20	-	**2.20**
Hungary	-	0.83	-	-	-	9.32	-	**10.15**
Ireland	-	-	-	-	3.70	-	-	**3.70**
Italy	-	-	9.00	7.00	-	21.00	23.60	**60.60**
Latvia	-	-	-	-	-	1.40	-	**1.40**
Lithuania	-	-	-	-	-	2.60	-	**2.60**
Luxembourg	-	0.70	-	-	-	-	-	**0.70**
Netherlands	0.26	4.50	-	4.31	1.82	2.67	-	**13.56**
Poland	-	0.50	-	0.50	-	7.90	-	**8.90**
Portugal	-	-	-	-	-	-	2.25	**2.25**
Slovakia	-	-	-	-	-	7.30	-	**7.30**
Slovenia	-	-	-	-	-	0.56	0.44	**1.00**
Spain	-	-	-	2.21	-	-	7.53	**9.74**
Sweden	0.90	0.15	-	-	-	-	-	**1.05**
Switzerland	-	1.20	1.00	-	-	0.30	-	**2.50**
United Kingdom	-	0.60	0.50	9.10	-	-	-	**10.20**
TOTAL	**3.80**	**10.68**	**49.20**	**74.79**	**9.80**	**122.48**	**33.82**	**304.57**

Source: BP Statistical Review 2005

EXPECTATIONS FOR UKRAINE

The change in gas price will raise costs in pull sectors of Ukrainian industry, like metallurgy and basic chemistry, where a strong competition is observable with Russian competitors. Thus it can cause further slowdown in Ukrainian real GDP growth that was under 3% in 2005 after the two-digit rate in 2004. However the gas price rise can push up the already high two-digit 10.5% inflation rate. And through slow economic growth and higher costs of energy consumption by public sector the general government deficit will rise.

Nevertheless there are possible positive effects as well. The matter will stimulate more effective energy consumption and seeking for new alternative supplies. And also through rising Russian exports to Europe the transition fee can cover remarkable part of losses.

CONSEQUENCES FOR THE EU MEMBERS

The matter lighted the problem of high EU dependence on Russian gas supplies. Several possible solutions are known but all of them need long-term measures.

Gas supply diversification. In better case, the planned 3300 kilometers long Nabucco pipeline from Turkey to Austria will be implemented not earlier than in 2011 with a EUR 4.6-5 billion. The pipeline would transfer primarily Central Asian gas. The consortium includes the Turkish Botas, Bulgarian Bulgargaz, Hungarian MOL, Austrian OMV Gas and the Romanian Transgaz.

Gas type diversification. From the South side of the Equator the main type of gas exploitation is the Liquefied Gas (LG), that needs also new pipelines and special technologies for use. The most important final user of traded LG is Japan and South Korea accounting for around of 60% of total. In Europe, Spain and France are the biggest consumers of LG. These EU countries are getting LG from Oman, Qatar, UAE, Algeria, Libya and Nigeria.

New energy resources. The EU approach has to be rethought, especially in direction of renewable energy resources connected with intensified R&D activity. But this can be a solution only of long term. By already known alternative energy resources, like wind, biomass, sun it is not possible to considerably diminish the importance of fossil fuels.

New age for nuclear energy. The possible re-launch of nuclear energy, even in the case of problem related to recycling nuclear dust, has to be rethought.

Gas demand cut. The consumption of gas by all types of consumers has to be radically cut but use of effective technologies. The investment into economic heating systems, modern isolation for instance can radically decrease household and institutional consumption.

Price conditions. Especially in the case of consumer countries the introduction of market based gas pricing can prove negative shock to make steps in order to decrease the share of not only gas, but oil consumption. This can have the form of inter country and intra country price liberalization.