By the beginning of the 2008 world financial and economic crisis, the economy and the social sphere of the Kaliningrad region had been rapidly developing, and in many aspects, surpassing the national average rate. At the same time, there were sore spots and tensions, which started to grow as the crisis began.

In 2006, the region entered a new stage of its socioeconomic development with the adoption of the new law "On the Special economic zone in the Kaliningrad region and on amending certain legislative acts of the Russian Federation" (it was signed by the President of Russia on January 10, 2006).

The previous SEZ regime set up by the 1996 Federal law granted the regional enterprises compensation for the exclave position of the region in the form of a customs free zone benefits and oriented the regional economy towards the import substitution model. The new law on the SEZ in the Kaliningrad region, without ruling out the possibility of import substitution, provided the preconditions for the transition of the regional economy to export orientation and a radical restructuring of the regional economy.

The law provides two types of reliefs: the customs relief (in the updated version of the law) and the taxation one (for major investors who invested not less than 150 mln roubles during a period of 3 years). The focus was placed on major projects, implemented by large investors from other regions of Russia (first of all, from Moscow and Saint-Petersburg) and partly by foreign investors. 60 resident companies with a stated investment of more than 36 bln roubles were registered at the beginning of May 2009 [19]. Some of the projects had been completed by then.

The development of the transport and energy infrastructure of the region continued to secure the investment projects.

As to the energy sector, the first power unit of the CHPP-2 came online and the construction of the second unit commenced. The 2300 MW Baltic NPP is under construction. In order to ensure gas supply to the region, the existent facilities of the Minsk — Vilnius — Kaunas — Kaliningrad pipeline are being expanded.
As to the transportation infrastructure, Phase 1 of the "Primorskoje koltso" highway ring road was completed and Phase 2 is underway. A multifunctional passenger and cargo motor-railway ferry complex and a marine passenger terminal were built in the town of Baltiysk. A ZAO BaltNafta oil transhipment terminal was put into operation in the town of Svetliy. The Kaliningrad maritime canal was modernised. Phase 1 of the new air terminal complex at Khrabrovo airport was completed.

These large-scale projects contributed to the increase in GRP and industrial production in the Kaliningrad region, which was significantly above the national average (see the table).

### The 2005—2009 dynamics of selected indicators for the Kaliningrad region and the Russian Federation

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP/GRP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GRP of the Kaliningrad region, % from the previous year</td>
<td>103.6</td>
<td>115.3</td>
<td>119.9</td>
<td>104.7</td>
<td>87.0</td>
</tr>
<tr>
<td>Russian GDP, % from the previous year</td>
<td>106.4</td>
<td>107.7</td>
<td>108.1</td>
<td>105.6</td>
<td>92.1</td>
</tr>
<tr>
<td>Industrial production index</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kaliningrad region, % from the previous year</td>
<td>127.4</td>
<td>166.6</td>
<td>134.8</td>
<td>104.3</td>
<td>89.5</td>
</tr>
<tr>
<td>Russia, % from the previous year</td>
<td>104.0</td>
<td>103.9</td>
<td>106.3</td>
<td>102.1</td>
<td>89.2</td>
</tr>
<tr>
<td>Processing industry index</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kaliningrad region, % from the previous year</td>
<td>106.3</td>
<td>131.0</td>
<td>190.7</td>
<td>111.1</td>
<td>80.9</td>
</tr>
<tr>
<td>Russia, % from the previous year</td>
<td>105.7</td>
<td>104.4</td>
<td>109.3</td>
<td>103.2</td>
<td>84.0</td>
</tr>
</tbody>
</table>

Source: [18; 22; 23].

Owing to the new law on the SEZ and the import substitution enterprises established under the 1996 SEZ law, the processing industry was rapidly developing in the Kaliningrad region — particularly a cluster of enterprises, specializing in TV, motor car and home appliances assembling.

Before the financial crisis of 2008, the Kaliningrad region accounted for 75% of Russian television set production [4]. About 150 mln dollars were invested in the television cluster; 12,000 people were employed in the industry [4]. These enterprises also produced such house appliances as vacuum cleaners (84% of the total national production in 2006 [16]), microwave ovens, DVD-players, etc.

As to the motor car industry, in 2007, the Avtotor motor company produced 106,700 cars becoming the largest manufacturer of international makes of cars in Russia [11].

Other important import substitute sectors of the Kaliningrad economy are the meat processing (22.6% of the tinned meat produced in Russia in 2006) [20] and future manufacturing industries (ca. 6% of the national furniture sales).
However, import substitution enterprises using imported raw materials and components were heavily dependent on the sustainability of import and the demand in the national market, their products were meant for.

Giving a boost to big business, the new law on the SEZ virtually excluded medium and small-size business from the participation in investment projects subject to the tax and duty reliefs, since it is virtually impossible for SMEs to use substantial funds (not less than 150 mln roubles) over a limited period (three years). Moreover, the investment made prior to the registration as a SEZ resident was not taken into account.

The new Law on SEZ severely affected the international cargo road haulage in the region, which employed almost 15,000 people. Out of almost 10,000 road trains, more than a half were customs cleared for the region only [8]. The road trains, customs cleared for the region and enjoying the SEZ duty reliefs, predominantly handled transportation between the mainland Russia and European countries bypassing the Kaliningrad region. According to the new Law, from April 1, 2006, they could no longer transport cargoes to mainland Russia without entering the region. The only way to avoid it is to register the vehicle according to the rules applicable on the whole territory of Russia and paying the customs duty. But it turned out to be rather complicated due to financial reasons. As a result, the international cargo transportation sector significantly shrunk, losing its market share to other, mostly international, transportation companies.

The new Law also affected the local car trade, which employs, according to the estimation of the local dealers, almost 20,000 people (out of which 3,000 deliver cars from abroad on a regular basis) [3]. The abolishment of the regional customs clearance relief, the subsequent increase in duties for second-hand international make cars in 2009, and the fact that imported cars were registered at the only one customs point in Kaliningrad led to a dramatic reduction of the local car trade. The logic of the Russian government is easy to understand — the import of second-hand cars hampered the assembly of international makes at the industrial scale and affected domestic producers. This sphere was developing spontaneously and was highly criminalised. At the same time, the delivery of cars from abroad and related car services were the main income source for many Kaliningrad families, who were forced to look for alternatives on their own, without any support from either the region or the state. As a result, many of those people formed the core of the opposition that took to the streets in December 2009 and January 2010.

The transition from the 1996 SEZ to the 2006 SEZ almost coincided with another dramatic change in the geopolitical and geo-economic position of the Kaliningrad region — the enlargement of the European Union on May 1, 2004. After Poland and Lithuania acceded to the EU, the region became a Russian island encircled by the enlarged EU. The introduction of the visa regime with Poland and Lithuania in 2003, the subsequent abolishment of free multi-entry visas for the residents of Kaliningrad from June 1, 2007 and the tightening of the customs regulations led to the reduction in the cross-border "shuttle" trade. In its heyday, 10,000 people were permanently em-
ployed within the "shuttle" trade [26]. In view of the "infrastructure" that developed around it, the calculated employment within the cross-border trade sector amounted to 100,000 people [10], which, in our opinion, is an overestimation. Anyway, tens of thousands of people were employed within the sector. As in the case of car delivery, this sphere belonged to the shadow economy, was highly criminalised and closely connected with contraband and tax evasion. However, those who were forced out of the "shuttle" business had to look for new jobs and sources of income, which increased social unrest in the Kaliningrad region, specifically, in the districts bordering on Poland and Lithuania.

The EU enlargement also deteriorated the situation around the export of Kaliningrad goods into other regions of Russia and thus, undermined the functioning of the import substitution economy of the exclave. After Lithuania acceded to the EU on May 1, 2004, the cost of cargo transit increased 1.3—1.5 times due to the phytosanitary and veterinary inspections and other paid services introduced by Lithuania [7]. The special agreement with the European Commission and Lithuania, proposed by Russia, which would ensure stable transit and prevent further deterioration of the situation, has not been concluded yet.

Therefore, one can state that after the new Law on the SEZ came into force in 2006 and the external conditions of the functioning of the exclave altered with the 2004 EU enlargement, the Kaliningrad region has experienced a change in the economic model, which formed in the framework of the previous Law. The main features of the new model are as follows:

- transition from customs to tax relief without comprehensive economic calculations and the analysis of what share of the Kaliningrad import substitution economy will "survive" the abolition of customs preferences in 2016;
- orientation towards large investment projects (mainly those with the participation of Moscow and Saint-Petersburg business without paying enough attention to the development of local SMEs and their integration into major business projects);
- transition from the import substitution to the export oriented economy without a comprehensive analysis of either export prospects of Kaliningrad goods and services, or external markets.

The reduction in the shadow economy, which thrrove thanks to the border position of the exclave, a positive phenomenon per se, left tens of thousands of people unemployed without offering them any alternative job opportunities or life prospects in general.

Furthermore, the Kaliningrad region became one of the pilot regions for a number of reforms, including the problem-plagued healthcare reform. Although the experts of the State University — Higher School of Economics believe that the Kaliningrad region made a significant breakthrough in the system of healthcare financing and was becoming the leader region in terms of the scale of changes [25], many aspects of the reforms caused unrest and concerns among a large amount of Kaliningraders. The matters of concern are the per capita healthcare expenditure which is below the national aver-
age, the closure of the hospital for fishermen (Medical Station No.1) and maternity departments in the towns and districts of the region, the problems related to pharmaceutical benefits, etc.

In the framework of the utilities reform, which aims at citizens paying their utilities in full, utility tariffs were constantly rising. In 2009 in the Kaliningrad region, the gas tariffs increased by 26%, electricity tariffs by 10%, and cold water tariffs by 30%. Heating and hot water price in Kaliningrad turned out to be above the average in the North-West by one third despite the favourable climate conditions [6]. This increase was mainly caused by the growing cost of fuel transportation into the exclaves region, when neither the regional, nor municipal budgets could allocate financial support.

The education reform led to the closure of a number of small rural schools throughout the region, which resulted from the need to improve the quality of education. However, according to the opponents of this reform, it contributed to the decay of rural areas, which are losing their cultural centres.

The problems of the regional economy and the social sphere came to the fore during the crisis that befell both the Russian and world economy in 2008. First of all, the crisis led to a dramatic decrease in the number of new import substitution enterprises, which used to be the driving force of the regional economic growth. As to the TV assembling cluster, the causes of recession were the following ones:

- the world economic crisis, in which large manufacturers made their production units run at full capacity taking orders away from their licenced branches. In 2009, such international brands as Sony and Panasonic went out of the Kaliningrad region;
- the falling demand in the internal market under the crisis conditions;
- the abolition of duty relief for the import of plasma modules and LCD screens according to the Government decree of September 11, 2008 No. 659, which deprived Kaliningrad assemblers of the SEZ benefits¹;
- an extremely low duty on the import of home appliances, which made import more lucrative than the assembling in Russia².

Due to all the factors mentioned, for the first time in the 9 months of 2009, the TV assembling decreased by 80%, microwave oven production — by 85%, digital laser player production — by 80%, and vacuum cleaner production by 87% from the previous year [12]. The employment rate within the TV assembling cluster in the Kaliningrad region had reduced from 12 to 2.5 thousand people by the end of the first quarter of 2009 [4].

The regional motor car industry had faced problems before the crisis. In 2006, there was an attempt to deprive the “Avtotor” company of duty relief for the import of vehicle component parts, which the company enjoyed ac-

1 There are rumours that this decision was lobbied by large international companies — Flextronics and Jabil — which assemble Sony, Panasonic, Philips, NEC, etc. electric appliances in mainland Russia [24].
2 The duty on the import of assembled LCD and plasma TVs amounted to only 10%.
According to the Law on the SEZ. This decision was explained by the aspiration of the government to avoid the situation when the Kaliningrad car assemblers might threaten the interests of other carmakers (including the international ones, operating in the framework of the Decree No. 166 on industrial assembly). The company's competitors, naturally, supported (if not lobbied) this approach. As a result, in spring 2008, “Avtotor” stopped assembling Chinese cars “Chery” (more than 40,000 cars of this make were assembled in 2007), which competed not only with other assemblers of international makes of car, but also with “AvtoVAZ”.

Further problems arose from the economic crisis, which limited the solvent demand for the company's production in the Russian market and from the absence of state support during the crisis (evidently, due to the negative attitude to the company, which had formed in the Ministry of Industry and Trade) [2; 14]. Although, in 2009, “Avtotor” was still the largest national producer of international makes of car, in 2007—2009, its output fell from 107 to 60 thousand cars per year [1; 11].

As a result of the falling demand for furniture both in the Kaliningrad region and other regions of Russia, its production had decreased, by summer 2009, by 50% from the previous year; 8% of jobs were shed within the industry [13].

In the conditions of the crisis, the region's connections with both foreign states and other regions of the Russian Federation were weakened; the volumes of cargoes processed in the ports of the region dramatically decreased.

At the end of October 2008, financial problems befell the leading Kaliningrad airline — “KDAvia”, which, that year, was ranked eighth among Russian airlines by the passenger traffic volume (1.37 mln passengers) [17]. Until then, the airline was successfully implementing the project of the transformation of “Khrabrovo” airport into an international air hub connecting other regions of Russia with Europe. As a result of the company's escalating financial problems, on September 14, 2009, the Federal Air Transport Agency revoked the “KDAvia”’s air carrier certificate on September 14, 2009 and the company ceased to operate flights. In October 2009, the company was placed on credit watch.

The cessation of “KDAvia” operation resulted in Kaliningrad being deprived of direct flights to many Russian cities. Now, one can reach them only by a connecting flight from Moscow or Saint-Petersburg. Furthermore, since April 2009, the company's employees have not received their salary; as a result by the end of January 2010, the back pay had amounted to 540 mln roubles (93% of the regional total) [5]. Therefore, on January 1, 2010, the Kaliningrad region ranked first in terms of back pay among all regions of Russia [21].

The direct flight to Warsaw operated by the Polish airline LOT was discontinued on September 1, 2008. Nevertheless, LOT resumed the flight at the end of June 2010.

The rail communication between Kaliningrad and Berlin was suspended in December 2009.
In mid-2008, due to the non-competitive railroad rates for cargo transportation in Kaliningrad direction via the territory of Lithuania, the cargo traffic was diverted to other ports of Russia and the Baltics, which led to a dramatic decrease in cargo transported by Kaliningrad railways (from 18.5 mln tonnes in 2008 to 12.2 mln tonnes 2009) and the reduction in the freight turnover in the ports of Kaliningrad (from 15.4 to 12 mln tonnes) [18].

As a result of all the problems mentioned, in 2009, the economic and industrial recession in the Kaliningrad region was sharper than the national average (see the table). The regional 2009 unemployment rate (calculated by the ILO methodology) was above the national average by 18.3 %. The share of the population with substandard income, which reduced from 20% in 2005 to 12.4 % in 2007, started increasing again and amounted to 14.4 % in 2009 (2.9 % above the national average) [18; 22; 23].

One can arrive at the conclusion that the current socioeconomic problems of the Kaliningrad region are determined by several factors. First of all, as mentioned above, the economic model that formed in the framework of the 1996 Law on the SEZ has been changing since 2006. A number of current economic problems relate to the transition period when certain mechanisms of the previous model turn out to be dysfunctional and new mechanisms do not work at full capacity yet. One should also mention that the new export-oriented model focused on large investment projects lacks thorough calculation and is mostly of declarative nature. It is unclear what new production units should specialise in and, what is more important, what external markets they should aim at.

Secondly, the reform of the social sphere that was absolutely necessary was implemented in the Kaliningrad region much more rapidly than in most other regions of Russia. Thus, the region had to learn from its own mistakes, which, unfortunately, could not be avoided.

Thirdly, the federal policy towards the region, regrettably, despite the adoption of the new Law on the SEZ and the extension of the “Federal target programme of the development of the Kaliningrad region until 2014”, did not become systematic. It predominantly follows the "challenge-response" pattern, i.e. the federal centre reacts to the arising problems instead of foreseeing and preventing them.

Fourthly, the 2004 enlargement of the EU and the subsequent enlargement of the Schengen area toughened the border and customs regime around the Kaliningrad region and made both cargo and passenger transport connection of the exclave with the rest of the Russian Federation and other European states more difficult. Russia failed to persuade the EU to transform the Kaliningrad region into a "pilot region" of the EU-Russian cooperation in the 21st century, as it was declared in the "Medium-term strategy for the development of relations between the Russian Federation and the European Union (2000—2010)" (2000). As a result, not only a special agreement between Russia and the EU regarding the Kaliningrad region has not been concluded, as it was proposed by an number of experts including the author of the article, but it is also highly probable that the new agreement on the EU-Russian
cooperation, which is currently under negotiation, will not incorporate a section on the Kaliningrad region [15].

Fifthly, due to its dependence on external connections both with other regions of the RF and foreign countries, the region turned out to be more vulnerable under the conditions of the world financial and economic crisis than most Russian regions. What are the measures that could alleviate the consequences of the socioeconomic crisis in the Kaliningrad region, expedite its termination, resume the economic growth, and contribute to the solution to social problems?

At the regional level

1. To draw up a new strategy and a mid-term programme of the development of the region having taken into account the experience of the implementation of all previous documents and the changed external and internal conditions of the development of the region.

2. To carry out a marketing research on the export potential of the Kaliningrad region and potential international markets for the regional goods and services and to draw up and implement the regional programme of export stimulation.

3. To develop and implement the regional marketing strategy, which would include marketing the region and promoting its brand, as well as the region’s places of interest and infrastructure, ensuring support of the region residents, politicians, and organisations (the formation of a friendly attitude towards the residents of other regions and countries, the development of the feeling of unity, an increase in the level of education in order to meet the demands of the target markets), advertising, and communications.

4. To transfer the cross-border cooperation of the Kaliningrad region with the regions of other countries into the sphere of specific investment projects.

5. To establish a regional venture capital investment fund in order to support innovative business.

6. To inquire into the adequacy of utility rates and reset them to the optimal level (including their possible reduction and freezing during the crisis).

7. To increase the per capita healthcare expenditure.

At the federal level

1. To specify the long-term national priorities regarding the socioeconomic development of the Kaliningrad region.

2. To amend Article 8 of the federal law of the Russian Federation of January 10, 2006, No. 16-FZ "On the special economic zone in the Kaliningrad region and amending certain legislative acts of the Russian Federation", which would extend, due to the financial and economic crisis, the period of the customs regime of a customs free zone for five years (until 2021) [1].

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[1] For the legal entities that operate under the Law No. 13-FZ "On the Special Economic Zone in the Kaliningrad Region".
3. To increase the financial support to the region in the form of subsidies to the regional budget. Such additional support will not be necessary after all the projects under implementation are finished, first of, the construction of the Baltic NPP, whose cheap energy will encourage the development of new large production facilities in the region.

4. In view of higher prices and low incomes of the residents of the Kaliningrad region, it is necessary to examine the possibility of the introduction of the exclave coefficient for salaries, pensions and student allowances (analogous to the North and the Far East salary uplifts).

5. To include a section on the Kaliningrad region into the new agreement between Russian and the EU.

6. Given the enclave position of the Kaliningrad region within the European Union, to guarantee a simplified procedure of obtaining multiple entry Polish and Lithuanian visas for the residents of the region as well as a compensation for the visa fee and the cost of insurance policy to be paid from the federal budget.

7. In the short term, to transform the Kaliningrad region into a pilot region of mutual visa-free regime for the citizens of RF and EU.

8. To expedite the beginning of the implementation of the "Lithuania-Poland-Russia" cross-border cooperation programme for 2007—2013.

9. To continue negotiations with Lithuania and Belarus on equal conditions for the transit of cargoes to the ports of the Baltic Sea, while basing the calculation of fees on the principle of equality of the tonne-kilometre cost.

10. To simplify the border and customs procedures in the Kaliningrad region by introducing modern equipment, advanced information technologies, administrative techniques, and effective coordination with the border and customs authorities of Poland and Lithuania (the establishment of common border-crossing points).

11. To investigate the possibility of the construction of a branch of the "Nord Stream" in the Kaliningrad region.

12. To allocate funding from the federal budget in order to equalize the aggregate rates for the cargo transportation between other regions of Russia and the Kaliningrad region and those within mainland Russia.

13. To restore the status of the air hub in Kaliningrad as a federal investment project strengthening connections between the exclave region and mainland Russia and cementing the ties between Russia and other European countries via Kaliningrad.

14. To expedite the establishment of the Baltic Federal University in Kaliningrad.

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