RUSSIA'S ECONOMIC RELATIONS WITH THE EU 2000-2008

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DECLARATION

I declare that the dissertation entitled "**RUSSIA'S ECONOMIC RELATIONS WITH THE EU, 2000-2008**" submitted by me for the award of the degree of **Master of Philosophy** of Jawaharlal Nehru University is my own work. The dissertation has not been submitted for any other degree of this University or any other university.

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CONTENTS

List of tables and Charts

Abbreviations

CES	Common Economic Space
CFSP	Common Foreign and Security Policy
CIS	Commonwealth of Independent States
COMECON	Council for Mutual Economic Assistance
ESDP	European Security and Defence Policy
FDI	Foreign Direct Investment
FTA	Free Trade Area
ICSID	International Centre for the Settlement of Investment Disputes
IPR	Intellectual property rights
OSCE	Organization for Security and Co-operation in Europe
PCA	Partnership and Cooperation Agreement
PPP	Purchasing Power Parity
TACIS	Technical Aid to the Commonwealth of Independent States
UNCITRAL	United Nations Commission on International Trade Law
WTO	World Trade Organisation

Chapter 1

Introduction

Relations between the European Union (EU) and the Russian Federation are those of two neighbouring entities that have been following different development paths. The EU has been progressing from an economic cooperation into a political union, while Russia has been on the road of transformation from an authoritarian to a democratic system. At the same time, both entities are major players both in the world and, especially, on the European continent and as such it is important that relations between them are of good working quality. Russia is the European Union's largest neighbour and, after the last enlargement in May 2004, it is now bordering five member countries (Finland, Estonia, Latvia, Lithuania, and Poland) with a border stretching over 2200 kms. This extension also meant that a part of Russia, Kaliningrad, became an enclave in the body of the European Union. Russia is the EU's main energy supplier, while the latter provides a market for around 50 percent of Russia's Exports. These developments enhanced the need for cooperation. Russia is not just one of the neighbours and it does not tolerate treatment like that of other countries. It still considers itself a major power – confirmed by its UN Security Council membership and its belonging to the G8 – and insists on being treated like that. Even though the EU tried its usual policy of conditionality, Russia let it to be known that this method does not work in its case. Russia is aiming to be an equal partner.

Consultations cover a wide range of issues starting from trade and the economy and going through nuclear safety, environmental protection, and security questions to cross-border cooperation and energy issues. The instruments of collaboration are just as numerous and wide-reaching, causing a degree of confusion. Relations between the EU and Russia are burdened with numerous problematic questions. These result from the position and ambitions of the two entities as significant powers, the interdependence between the two and the number and complexity of issues involved.

Historical Overview

Relations between the EU and earlier the European Communities (EC) on the one hand, and Russia and its forerunner, the Soviet Union on the other, do not look back on a long history. No official relations were set up between the two until Mikhail Gorbachev's reform-minded leadership. The establishment of mutual relations came only in 1988 when they signed a declaration of future cooperation. The following year came a ten-year trade and cooperation agreement between the EC and the USSR (Hansen 2004). This agreement was not long-lasting, as at the end of 1991 the Soviet Union fell apart. The EC recognized the successor states quite early and was looking for a new way to standardize its relationship with them. The solution came in the form of the Partnership and Co-operation Agreements (PCA) which were meant to conform to the specific characteristics of the country involved. (Piening 1997)

They aim for economic cooperation with the prospect of eventual free trade. The first one of the PCAs was signed with Russia and Ukraine in June 1994. The year 1997 saw the adoption of the Amsterdam Treaty, which introduced a new mechanism among the foreign policy tools of the Union, common strategies. Common strategies are "to be implemented by the Union in areas where the member states have important interests in common." The first ever common strategy to be implemented was the Common Strategy of the European Union on Russia, adopted in 1999(Gower 2001). It was accepted for an initial period of four years, which was extended in 2003 by one additional year. (Forsberg 2004) As the instrument of common strategies did not turn out to be a success, this particular one was not extended beyond June 2004.

The next policy instrument coming from the EU is the European Neighbourhood Policy (ENP), which targets those neighbouring states that do not have a prospect of membership. (Romanova and Zaslavskaya 2005) The main objective is to create a "ring of friends." Russia refused to be taken into consideration under this arrangement, as it did not consider itself to be just one neighbour and did not agree with the general approach of the ENP

The development of EU-Russian relations since the dissolution of the Soviet Union

In the wake of the dissolution of the Soviet Union, relations between the EU and Russia were initially modelled on a Trade and Cooperation Agreement (TCA) signed at the end of 1989. In 1990, the European Council in Rome resolved that closer ties with the Soviet Union were desirable so that the EU could open its doors to provide food aid and technical assistance49 as a tragic fall in living standards began to spread across the region. A year later, the Council asked the Commission to start negotiating an extension of the programme so that political and cultural activities could be financed as well as economic and financial cooperation. These negotiations led to the signing of a PCA in 1994. The PCA entered into force on 1 December 1997 for a period of ten years; it was extended for a period of one year in 2007. The PCA with Russia is more comprehensive than the former TCA but not as comprehensive as the agreements signed with the Central European candidate countries at the time. Russia's accession to the EU was not considered because neither the EU nor Russia wanted it to be. Its membership is still not on the agenda. The EU highlighted respect for human rights in the PCA and it was agreed that in 1998 the parties would together consider whether and when negotiation of a free trade area could begin. The PCA also includes a framework for regular political dialogue, with an EU-Russia conference at the highest political level twice a year to discuss both the political and economic transition. From the beginning, therefore, the relationship with Russia was cast in a different institutional framework and had a different political character than the EU's relationship with its other neighbours, which was shaped by the concept of the ENP. Russia did not want to be thrown into the same pot as the EU's other neighbours but it did want to participate in the programmes the EU offers them. This means that the financial instruments available to ENP countries would also apply to the PCA with Russia.

Russia was initially wary of the EU's enlargement in Central Europe because it feared export competition from the former COMECON countries, which would operate within the common market after acceding to the Union. It also feared that its own exports would be restricted by EU tariff walls. The EU showed its sensitivity to these issues. As a result, economic cooperation was the first to be agreed, with the goals of removing trade barriers, diversifying trade and working step by step towards a free trade area and membership of the World Trade Organisation (WTO). The framework of the PCA therefore focused on the economic transition towards a market economy as well as on human rights.

The common economic space was not supplemented with three other spaces for long-term cooperation until the St Petersburg summit in May 2003. The three other common spaces are:
freedom, security and justice;
_ external security;
_ research, education and culture.
Agreement on giving more substance to these four common spaces was reached in 2005.

The layout of the four common spaces

There are major differences between the four common spaces, not only in the themes themselves but also in the instruments. With regard to the importance of the four spaces, the Russians could not be clearer: economic cooperation is by far the most important.

Cooperation in the common trade and economic space

As already noted, the EU is Russia's main trading partner by far. More than half of all Russia's exports go to the EU; two-thirds of them consist of gas and oil. Russia is the EU's third largest trading partner, after the US and China. The EU's exports to Russia are more diverse and include machinery, chemicals, transport equipment, food and live animals. Trade in services is relatively small but growing gradually. Foreign direct investment (FDI) is growing rapidly. According to The Economist, EU FDI in Russia in 2006 was estimated at about EUR 18 billion. This only partly reflects the improvement in the business climate, because much of the investment is made in the form of loans to state companies, particularly in the energy sector. The recent dispute between the BP energy group and its Russian partner TNK illustrates once more the problems foreign investors face in Russia. Although FDI in Russia amounted to EUR 24 billion, this is no more than 3% of gross national product (GNP). Foreign direct investment is lower than in, for example, Ukraine, and FDI in non-energy sectors has actually fallen sharply since 1999. The Russian investment climate has to be improved further; in particular, property rights must be protected more effectively. This is essential for the balanced development of economic relations between the EU and Russia. To date, economic relations have been sorely frustrated by lack of legal certainty. Lack of legal certainty also places more general restraints on trade and investment. The foreign debt of Russian companies is estimated at USD 400 million, not much less that the country's foreign reserves. Four-fifths of Russia's exports consist of oil and gas, raw materials and semi-finished products. With prices on the world market for a third of Russia's GNP being vulnerable to wide fluctuations, Russia needs to diversify its economy to ensure sustainable economic growth. This will require a gradual integration into the world economy. A more open and integrated market with the EU would make a substantial contribution to this. The common economic space should be seen in this context. So far, little of real substance has been achieved. Nevertheless, dialogue between the Russian government and the Commission services has started in many areas.61 Talks are being held on, for example, investments, the protection of intellectual property, procurement and technical regulation (standards and the like). There has also been an energy dialogue since 2000. Dozens of official working parties have in any event gradually increased understanding of each other's regulations and the improved contacts may be important in future negotiations.

The mandate to negotiate a new PCA contains a long list of subjects in the field of trade and economic cooperation with a view to removing obstacles to trade and investment and achieving the maximum possible convergence of legislation. In this respect it is particularly important that Russia pick up the pace of WTO accession. WTO membership will obviously not resolve all the country's economic woes, but it is a precondition for a level playing field with clear and enforceable non-discrimination obligations and rules to settle trade disputes. Membership will also put an end to the use of trade restrictions for political purposes. WTO membership should precede the further deepening and widening of economic relations with the EU. However, it is still uncertain when Russia will have finalised the necessary preparations for membership. WTO membership negotiations therefore cannot be completed yet. The ball is clearly in Russia's court. Russia has raised a number of peripheral problems to delay matters, presumably under pressure from domestic interests that fear liberalisation. Fear of not being able to stand up to competition or of being swept away by dumping probably plays a part in this. However, the WTO negotiations will lead to detailed agreements on mutual obligations and associated timetables. Dumping will then no longer be possible, and timetables will be agreed for each sector or industry so that Russian companies can adapt to the new situation. The fears are therefore groundless.

Nevertheless, Russia is exploiting a number of bilateral sticking points with certain member states in order to stall the negotiations. The recent rise in nationalist tendencies might be a political factor that further delays membership. The future talks between the EU and Russia should give priority to Russia's WTO accession, since without it there is no prospect of widening and deepening economic ties with the EU.

Only when WTO membership has been achieved can a start be made on negotiating a Free Trade Agreement (FTA) covering all trade in goods and services, including energy products. As well as further liberalisation obligations, an FTA could also include WTO-plus provisions on investments, procurement and cooperation on legislation. By definition, the negotiations will be conducted on the basis of equality with Russia. The Commission will act on behalf of the EU, thus minimising, if not eliminating, the risk of member states being played off against each other. As noted above, the negotiations must culminate in a detailed timetable of mutual obligations and agreements on the removal of trade barriers, dumping practices, transitional provisions and the like.

Cooperation in the common space of freedom, security and justice

Cooperation in this space is also known as cooperation in Internal Security, Justice and Home Affairs. It includes the promotion of the rule of law, democracy and human rights and also provides for cooperation between police forces and judicial authorities. Both parties recognise the benefits of cooperating on such dossiers as human trafficking, child pornography, cybercrime and the exchange of counterterrorism information. On more than one occasion the EU has not confined itself to Russia but has also involved other members of the CIS in joint operations. This cooperation is based on the many common interests in the field of cross-border security, such as terrorism, the arms trade, financial crime, illegal migration and environmental crime. The fact that the EU member states are themselves open to criticism of their methods is an additional incentive for Russia to take this part of the current PCA seriously. Cooperation in the common space of external security

The Common Foreign and Security Policy (CFSP) and the European Security and Defence Policy (ESDP) are chiefly intergovernmental in nature. In mid-1999, the EU prepared a strategy paper on Russia (as provided for in article 13 of the EU Treaty) as part of the CFSP and with a view to Russia's involvement in the Kosovo conflict.

Russia clearly wants to be involved in the implementation of the EU's CFSP. In principle, it is willing to contribute to peacekeeping operations under the Union flag, at least in so far as they do not take place on the territory of the former Soviet Union. This is illustrated by the logistical support, modest though it may have been, it provided for the EU military mission in Chad. The Russian government seems to attach great value to a role in EU decision-making. It does not want to be presented with faits accomplis that offer it no alternative other than saying 'yes' or 'no' to EU requests for participation. That is why Russia advocates the establishment of an EU-Russia Council, more or less analogous to the NATO-Russia Council, where it sits at the table with all member states. Such an arrangement is out of the question for the EU, however, chiefly because it is contrary to the Union's treaty system.

Cooperation in the common space of research, education and culture A limited number of initiatives have been taken in this space. The EU and Russia cooperated, for example, on the EU's Sixth Framework Programme for Research and Technological Development. This common space is in principle politically non-controversial and therefore lends itself to closer cooperation. Contacts between people in general and between professionals in particular (peer to peer) can make a positive contribution to better understanding between the European Union and Russia and also establish the trust necessary to undertake more demanding projects. Cooperation can be sought in areas where each party can learn from the other.

Summing up the experience of the EU-Russia cooperation within the Common Spaces the following might be the main three conclusions as noted by Alexander Duleba: First, the Common Spaces structure is a well established institutional framework to maintain a wide ranging political and sectoral dialogue between the EU and Russia, and should be preserved; Second, except for some positive samples of progress achieved on sectoral issues Common Space has brought rather modest outcomes in relation to the initial expectations of both sides; and Third, the reason for the limited results of the dialogue and cooperation within all four Common Space is of a political nature: a lack of political will or mutual trust, inability of both sides to agree on terms and values, Russia's reluctance to accept EU standards, etc.

RUSSIA IN INTERNATIONAL ECONOMIC RELATIONS

Although Russia has lately gone through many economical difficulties, it has still been named as a second greatest power besides the US. It is important to note that Russia is a vast country by the surface area (world's largest) and by its population (ninth in the world), but by economical indicators it does not have the same greatness. For instance, in 1988, the importance of the Soviet Union in overall world export was only 3,8% and in import 3,6%. Today, as it is estimated that the members of the World Trade Organization make up some 95% of the international trade and Russia is not a member of this organisation, its import and export proportions in the world trade are more or less the same.

The recent tendencies, however, show that Russia, who is one of the BRIC49 countries, is forming into considerable global economic power. Russia's economy has been in a constant rise since 1999, and if the influence of the latest global economical crisis is not considered, it shows no signs of weakness.It reveals that Russia is developing into a more powerful economy. At the same time, when elaborating on the international dimension and particularly on the relations with the EU, then it can be seen that, due to the lack of integrated trade relations based on legal grounds, those interrelations are developing more slowly than they could or should. To put it simply, there is no consensus on how international economic relations should be like. These are not only economical issues that impede the mutual understanding in international cooperation. One must also take into consideration, for instance, law, history and politics as areas that form the relations. The latter is probably the main instrument in today's international community. Kosovo crisis, the US missile defence project in Czech Republic and in Poland, the removal of a Red Army victory monument from the centre of Estonia's capital Tallinn to its outskirts are only some examples which have led Kremlin to show its displeasure. These examples of irritating Russia are rather of a political nature, but as the country has shown in many cases, it tends to use economical means as political instruments to express its anger.

The structure of Russia's economy

To understand a country's behaviour, one must study various aspects of its actions. It is important to be aware of history as well as culture in order to see patterns of practice and the soul of the nation. Moreover, this knowledge is also essential as to form an opinion on state's trade. The development of Russia's economy has gone through several distinct stages in history, the most substantial one being the collapse of the Soviet Union in 1991. Until that time, centrally planned economy was practised, but since then, Russia has turned to market economy. It can be argued whether contemporary Russia really has a market economy or not, but if we look at the time period during which Russia has had the new economical system – only 20 years or so –, then it is understandable that some elements of the old system have still remained. Changes take time and one system cannot be substituted with another in just a day's time.

From Soviet Union's centrally-planned economy to market economy

The Union of Soviet Socialist Republics was formed on 30 December 1922. From that time on, the main elements of the union's economy were industrialisation, collectivisation and central-planning. The development of the economy was aimed at the production growth. For instance, in the industry sector, the plan was to increase manufacturing figures by 70% in 5

years (1950-1955). Another field where Russia invested enormous amounts of material, labour and financial resources was military industry. These investments on military development were made on the account of other economical sectors. Disproportionate development of military industry caused backwardness in other sectors and ultimately brought along disadvantages in international competition.53 Faulty economical planning led from one problem to another and instead of further development, the administration of economy turned out to be a constant fixing of numerous issues. It was clear that a centrally-planned system with too general approaches to diverse aspects cannot be sustainable.
In 1990, the whole political and economical system of the Soviet Union collapsed. Although, the reforms for solving the aforementioned problems started already in 1989 – hints were seen even earlier –, they only resulted in high inflation and unemployment rate. As described briefly, the Soviet Union collapsed mainly because of its ineffectively planned economy that could not withstand armament races with the US. Besides the economical reasons of the collapse, there were political reasons as well. Namely, it was impossible to prevent the evident processes of disintegration of the Soviet Union, because one after another, republics declared their independence.

Unlike the majority of the other republics, Russia launched rather radical economical reforms after the declaration of independence. The two most important keywords in economical renewal starting from 1992 were the liberalisation of prices and a unique privatisation program in the whole world by its scale and capacity. Due to the lack of competence in market economy system and changes that were implemented too suddenly, the economy of Russia still did not develop in the way that was wished.As the transition of Russia's economy from one system to another is not the primary point of research in this thesis, then details have been left out. What one should comprehend is that while trying to understand Russia, a strict condemnation is not a solution. As could be seen from the previous, Russia has had many fundamental changes in the past few decades, therefore the setting up takes time. From another perspective, one could ask how willing Russia is on developing a true market economy with adherence to the concept of free trade.

Russia's position in international trade relations

It is somewhat interesting to follow the developments in Russia's trade relations because although the nature of its international trade has changed as Russia wanted, it still has a certain recurrent line. For instance, Russia has always protected its domestic market from foreign investments and foreign goods, services etc. This has to do with the functioning and the structure of the economy, because protectionism economics policy as a shortcoming has been revealed in Russia's WTO accession process, which is currently one of the most important subjects in international trade for the country. Even though Russia practises protectionism policy, it still has to have international trade relations. Russia mainly imports from China (12.9%), Germany (12.6%) and Japan (6.9%).

The commodities that Russia imports include vehicles, machinery and equipment, plastics, medicines, iron and steel, consumer goods, meat, fruits and nuts as well as semi-finished metal products. Russia's main export partners are the Netherlands (12.2%), Italy (9%) and Germany (6.9%). Export articles include petroleum and its products, natural gas, wood and its products, metals, chemicals and a wide variety of civilian and military manufactures. This shows that Russia exports industrial products and imports more high-technology products. If we compare the figures of export and import, the statistics are $295.6 billion to $196.8 billion (2009 estimated) respectively. With these numbers, Russia is the world's 14th exporter and the 18th importer, whereas the EU is first in both. It demonstrates that Russia's trade is not of a substantial importance in the world and that it is not in balance – it exports more than imports. The latter is an indirect expression of protectionism in certain sectors.

All in all, Russia has had rough times when practising a certain economical model. It is quite evident that structural changes are not easy to follow through and not very quick by means of time. What is more, according to statistical figures, Russia is not the most powerful trading country in the world. This lets us presume that Russia is behaving modestly on the international stage and develops its economy to be internationally competitive. Nonetheless, in practice it is not so, which can also be seen in Russia's WTO accession process and in relation to its neighbours concerning trade.

The development of trade relations between Russia and the EU

In the changing world, relationships between neighbours also have a dynamic nature; therefore, it can be argued how future relations will be formed. As said before, in order to understand the status of interconnections between states at least to some extent, one can look into the past. When trying to simplify the situation and see things from Russia's point of view, a model of the world can be created – there is Russia and there is the West. As the EU is also a part of the West, it can be considered pertinent to this topic as a representative of the West.

Throughout the history, states have declared various positions towards other countries, whereas these standpoints seem to change. The latter is evidently obvious as the world order itself changes. At the same time, certain expectation of states' behaviour could be formulated in these changing conditions. When referring to Russia, it is difficult to see this straightforward or expected acting policy on the international level. When the Russian tsar Peter I stated in 1702 that Russia will, from now on, concentrate on Europe and shaped the purpose of taking over the values of the Evening Lands, it was the first great leap towards Russia's integration to the West. The mentioned decision was a pure expression of an absolute ruler and gave a firm base for reforms. It is also worth noting that law was meant to be the guide to Russia's way of implementing western values. In case of success, this kind of approach would have had a vast effect on making international relations more coherent. Let everybody be the judge of how this integrating process has turned out, but probably it has not been as smooth as one could hope.

Key aspects of EU-Russia Relations (since 2000).

What Russia wants from the EU

President Putin and his government will continue to resist any outside attempts to shape Russia's domestic development. What he wants from the EU is not policy advice, or even financial assistance. He sees relations with the EU as a way of strengthening the domestic economy through trade and, to a lesser extent, investment. A stronger and more stable economy is the precondition for restoring Russia to its former great power status in the world. In short, Putin does not seek good relations with the West for their own sake. He sees the West, and the EU in particular, as a "modernisation resource" (Trenin 2004). Foreign policy during the Yeltsin years was characterised by bluff and bluster. When Putin took over the presidency at the start of 2000, he started from a much more realistic reassessment of

Russia's position. The outcome of this reassessment was sobering. Russia's economy was weak and unstable, and its total output dwarfed by that of the Netherlands. Over 40 per cent of all Russians were living in poverty. Life expectancy had fallen to rates usually found in third world countries. The population was shrinking at an alarming pace. The once proud Soviet army was in disarray, and the entire Russian GDP could not match the US defence budget. Putin soon realised that Russia had to regain its internal strength before it could once more become a big player on the global stage. He therefore launched an ambitious programme of economic and judicial reforms. He re-consolidated power in the Kremlin and cut regional governors and business oligarchs down to size. But in his quest for control, he also systematically eliminated all potential sources of political opposition. By the time of his re-election in March 2004, Putin had gained almost complete control over the government, both houses of parliament, the largest political parties and the mass media. Press freedom is severely curtailed, and a new draft law may prohibit public demonstrations. Civil society organisations complain about frequent visits from the FSB (formerly known as the KGB).

The Russian army continues to trample on human rights in Chechnya, and the Kremlin appears unwilling to hold the perpetrators to account. (Jack 2004)

After the tumultuous Yeltsin years, they associate democracy and capitalism with chaos and corruption. They value stability above all else. Opinion polls show that less than one-quarter of Russians regard Putin's regime as democratic, yet more than 70 per cent voted for the architect of 'managed democracy' in the last presidential election in March 2004.

What the EU wants from Russia

The EU wants a Russia that is stable, wealthy and reliable as a neighbour, energy supplier and political partner on the world stage. Russians have similar aspirations. But although the two sides' ultimate interests and visions may coincide, their short- to medium-term objectives are very different. The EU's main goal is to nudge Russia along the path of economic reform and democratisation. The EU is not being altruistic; it fears that trouble within Russia could quickly turn into a security threat for the whole continent, not only because the 'wrong' people might take over in the Kremlin, but also because a poor, chaotic Russia could be a major source of organised crime, terrorism, weapons smuggling, illegal migration and environmental hazards. To achieve this objective, the EU has resorted to its tried and tested methods of integration and association. It offers a closer relationship but attaches heavy conditionality. In the case of the Central and East European countries, this method resulted in one of the most successful instances of 'regime change' ever undertaken. Countries such as Latvia, Hungary and Poland went from post-communist upheaval to orderly EU membership within a decade and a half. Russia's case is different, however. The overriding wish to join the EU as quickly as possible served as a powerful 'anchor' for reforms in the East European candidate countries. The EU has not offered Russia membership, nor will Russia be interested in this prospect in the foreseeable future. Russia sees itself as an independent player, a regional great power with global aspirations. Unlike the Central and East European countries, Russia has political clout that is out of proportion with its economic might. Russia's economy is small by global standards, equivalent to only 4 per cent of EU GDP (about the same as the ten new EU members taken together). As a former superpower with one of the world's largest armies and a formidable (if rusty) nuclear arsenal, it likes to throw its weight around. Countries such as Hungary and Slovenia hope to gain international clout by being part of a big and powerful club. Russia likes clubs where it can mingle with other great powers, such as the UN Security Council or the G8. But it does not want to be constrained by rules. As Ivan Ivanov, a former deputy economics minister, put it at a Geneva conference in January 2002 that Russia is a world calibre power, belongs to both Europe and Asia and thus prefers to have free hands in its foreign and economic policy along all azimuths. There are other reasons why Russia's transition from Soviet central planning turned out to be more difficult than that of the Central and East European countries. Russia has never experienced a sustained period of democracy and market economics. Setbacks, muddle and delay have stymied its post-communist reform process. Huge oil and gas reserves have helped economic recovery, but also fostered cronyism and corruption on a scale unseen in other transition economies. The sheer size of the country makes it harder for the government to implement reforms, introduce competition and move people from remote villages and declining industrial regions to booming cities. While reforms in Russia proceeded at a snail's pace, westerners oscillated between dizzy optimism and utter despair about Russia. But now the West is moving to a more sober assessment of Russia's prospects. Russia will need decades to build a competitive market economy, and its political development will not be smooth.

The reform challenges are much larger than they were in Central and Eastern Europe, not least because the process lacks an external anchor. The EU has been hugely successful in influencing countries that are queuing for membership. It has been much less adept in and

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Second, Russians have very different ideas about the role of law. The EU is the epitome of a rules-based community. Its single market, competition policy or fiscal rules, to name but a few, cannot function without assiduous adherence to, and enforcement of, the law. Russia's confusing and contradictory laws remain a breeding ground for petty bribes, recent improvements notwithstanding. Overworked and often corrupt judges cannot be relied upon to protect rights and enforce obligations. The recent arrest of several high-profile businessmen, including Yukos boss Mikhail Khodorkovsky, shows that in Russia the law of power is still stronger than the power of law.

Third, the EU likes to uphold the idea that all countries are equal. Most Russians believe that their country is unique. They argue that Russia needs to do things the Russian way, not the European or the western way. Such perceptions serve as a powerful impediment to Russia accepting EU conditionality. In addition, Russia's new-found self-confidence and a resurgence of nationalism are making the country ever more sensitive to outside interference.

Fourth, Large parts of Russia's policy establishment remain wedded to old-fashioned concepts such as spheres of influence, zero-sum games and strict reciprocity. Many EU policy-makers and most Brussels bureaucrats believe in 'post-modern' ideas of statecraft, such as mutual interests, shared sovereignty and win-win solutions.

TRADE BETWEEN THE EU AND RUSSIA: THE IMPACT OF EU ENLARGEMENT

Clearly, the EU accession of most European formerly centrally managed countries on 1 May 2004 – to be followed by Bulgaria and Romania, hopefully in 2007 – has changed the economic and political map of Europe. This change is bound to have a deep impact on Russia as well. Some of the probable consequences have been touched upon above. Thus, the enlarged Union will need time and effort to absorb its new members by making appropriate changes in rules and regulations. On the one hand, the accession will further complicate decision-making. On the other, though accession countries are evidently poorer than the old members, the asymmetry in size between the EU and Russia will grow even larger. Due to their relative poverty, new members receive transfers from the Union on a scale that is much larger than the pre-accession transfers they have enjoyed so far. There is a possibility that the attention and resources received by Russia will diminish, as the enlargement will tend to shift the Union's attention southwards. Much naturally depends on whether some of the new EU members – Poland and Lithuania might be the prime candidates – will follow the earlier Finnish lead of the Northern Dimension by either trying to re-emphasise the importance of Russia or trying to shift more attention to Belarus, Moldova and Ukraine, in the framework of what was earlier known as the New Neighbours Initiative, now as the European Neighbourhood Policy.

EU enlargement will have an impact on Russia's trade through several channels. There will be some trade diversion away from Russia, as new members will face no tariffs in their trade with EU countries, which have now become part of their internal markets.

With the possible exception of agriculture, this impact will be small, as the accession countries already face low tariffs due to the pre-accession Europe Agreements. There will also be some change in relative European prices. Established Russian patterns will consequently need to be changed. Finally, trade will be created, as European welfare hopefully improves due to increased competition and economies of scale. This will benefit Russia as a supplier. At the same time, Russian exports in many cases are facing lower tariffs in new member countries. On average, Russian exports have faced lower tariffs in the EU than in the accession countries.

Changes in tariffs are indeed one concrete economic consequence of EU enlargement. Russia has received Most Favoured Nation treatment from the EU. In 1999,Russia's industrial exports therefore faced an average value-added weighted tariff of 4.7 per cent and all sectors an average tariff of 6.6 per cent (Hamilton 2002). These are low figures. However, some high peaks of tariffs for specific commodities may well hide behind such low averages. Adding the impact of non-tariff barriers and anti-dumping measures, the EU rate of overall protection for industrial goods was 6.8 per cent and for all sectors 12.3 per cent. The latter figure is increased by the EU's protectionist agricultural policies, which imply an overall protection rate for agriculture of 31.7 per cent. As Russia (and Ukraine) now emerges as a major grain exporter, this is bound, as already mentioned, to become a major irritant.

Among the accession countries, Russia enjoys MFN status in Hungary but not elsewhere. Thus, there will be tariff changes mainly as regards non-energy trade, because trade barriers on imports of energy and raw materials are everywhere zero or extremely low. The share of energy and raw materials in Russian exports to the major accession countries in 2000 varied between 80 and 90 per cent (Hamilton 2002). Thus, though Russian imports comprise a major share in few accession countries, the impact of the tariff changes is bound to be small. In general, as just mentioned, the EU has lower tariffs than accession countries, though this varies across countries and commodities.

Carl B. Hamilton (2002) has estimated an upper limit for the enlargement-induced change in tariff barriers for Russian exports to Hungary, Poland and the Czech Republic. He finds that relative to tariffs in place in 1999, Russia would benefit vis-à-vis Poland from tariff reductions between 1.4 and 11.4 per cent. As regards Hungary and the Czech Republic, Russia would lose modestly as a result of tariff increases of some two per cent. The situation may be somewhat different concerning anti-dumping measures, which the accession countries have so far used only to a limited extent. That changes with enlargement, and the impact might in fact be larger than that for tariffs. Hamilton's estimate is tariff equivalents of 16–21 per cent for Hungary, 5–7 per cent for Poland, 2–9 per cent for Estonia, 9–17 per cent for the Czech Republic and 23 per cent for Slovenia. That looks – and is – high, but one should keep in mind two things. First, the absolute export values are modest; in the case of Hungary, the impact would be less than 2 million USD, in the other countries even less. Second, as seen before, the use of anti-dumping in EU trade policy may be decreasing generally, and recent measures against Russia have been very rare. Hamilton's concern might well prove excessive.

Given such considerations, Sulamaa and Widgren (2002, 2004) are probably correct in concluding that the impact of EU enlargement on Russia's foreign trade will be negligible. That did not prevent Russia from demanding compensation for trade losses at least from Poland. Legally, Russia as a non-WTO member is not entitled to any compensation. Economically, it stands to benefit, not lose from enlargement.Diplomatically, such demands– they were also made when Finland was joining the EU– have an old-fashioned appearance.
In early 2004 various frictions emerged in EU–Russia relations. Seen from the Russian side (Karagedov, 2004), there were disagreements concerning Chechnya, Georgia, Transdniestr, as well increasing problems with the visa regime. A hardening of the EU tone was in general noted. And many of the problems seen by the Russians concerned EU Eastern Enlargement.

Thus, the EU demanded that the PCA should be automatically extended to the new members as well, and Russia should unconditionally recognise all existing borders, including those with Estonia and Latvia. As seen from the EU side, Russia once more made unconnected and often unfounded demands, as if it could exert a veto on EU enlargement.

In January 2004 Russia presented to the EU a list of fourteen 'Russian concerns in the context of EU enlargement'. The list, which was duly leaked, was a mixed bag (Schuette, 2004). It included justified and negotiable issues on, e.g., the enlargement of Russian steel export quotas to accommodate traditional exports to the new members. But it also included topics that remained unclear, like that of a Russia – EU veterinary regime based on the principle of equality Russia also raised an old canard, demanding written guarantees that there were no internal EU requirements setting ceilings on energy imports from Russia. The issue of Kaliningrad was also raised, as was the position of the Russian-speaking community in the Baltic countries–as if EU accession might worsen it. To clear the way for enlargement, the EU and Russia finally issued a joint statement (Joint, 2004). As seen above, that did not prevent Russia from raising many of the same issues later during the year. The EU Commission, on the other hand, had been doing its own re-appraisal of EU– Russia relations. It concluded (European Commission, 2004) that the relations should continue to be based both on shared values and common interests.

Therefore, Russia respect for values to which it had committed itself as a member of the Council of Europe and OSCE would to a large extent determine the nature and quality of the relation. As importantly, the Commission noted that the relation should move beyond political declarations to concrete results. For that to take place, the Union should have explicit key objectives, speak with one voice, and stick to agreed positions. Previously, progress had often been blocked by the Russian tactic of taking advantage of differences among the member states and of linking often unrelated issues. (Sutela 2005)

Chapter 2

Russia-EU Trade and Investments: structure and trends.

The European Union is commonly referred to as an 'economic giant.' Following the same logic, Russia can be addressed as a 'political giant.' According to the common wisdom, relations between two 'giants' in a small world cannot be simple and unproblematic. Thus, there is nothing extraordinary about the fact that at the beginning of the 21st century, relations between Russia and the European Union remain largely controversial. On the one hand, both sides are strongly tied by a multitude of common interests and objectives in economic, political and cultural spheres, which makes it impossible for them not to be involved in a multifaceted and complex dialogue. On the other hand, however, there are still disagreements as well as an asymmetry in EU-Russian relations.(Baranovsky 2001) Trade is clearly a growth area in EU-Russia relations. The value of bilateral trade has more than doubled since 1995, to S85 billion in 2003. However, the headline figures reveal little about the true content of the EU-Russia trade relationship. As one economist puts it: "The two key words characterising Russia's trade with Western Europe are energy and asymmetry."(Hamilton 2003)

The asymmetry is twofold. The EU is clearly Russia's single most important trading partner, accounting for more than half of total trade after enlargement. But the same does not hold true the other way round. Only 3 per cent of the EU-15's exports went to Russia in 2003, and 5 per cent of its imports came from there. For most big EU companies Russia is a market of only secondary importance. The composition of trade flows is similarly skewed. Russia mainly sells oil, gas and other raw materials to the EU but very few manufactured goods. The EU, on the other hand, exports mainly machinery to Russia, as well as cars, consumer goods and food products. Russia wants better access to the EU's S10 trillion internal market, especially for its non-energy exporters. The government worries about the economy's growing dependence on energy exports. According to the World Bank, the oil and gas sector now accounts for one-quarter of Russia's GDP, more than half of its export earnings, some 30 per cent of federal budget revenue and the bulk of investment spending. This dependence leaves the Russian economy at the mercy of volatile international commodities markets. High oil prices since 2000 have fuelled Russia's economic recovery, leading to GDP growth rates of 5-10 per cent a year and sustained surpluses in the state budget and the external accounts.

But a prolonged oil price slump could quickly send the Russian economy back into recession and instability.

AN OVERVIEW OF EU-RUSSIA ECONOMIC RELATIONS

Although the geographical distribution of Russian foreign trade changed dramatically in the first half of the 1990's, one fact has remained unchanged is that Russia's main trade partners are European countries. In 1985 approximately 55 percent of Soviet trade was conducted within the Council for Mutual Economic Assistance (Comecon or CMEA). By contrast, 26 percent of Soviet exports went to and 28 percent of Soviet imports came from developed countries of Western Europe, Japan, the United States and Canada. In 1991, after the dissolution of the former USSR, only 23 percent of Russian exports and 24 percent of Russian imports were with the former Comecon member states. Based on the Eurostat data it is interpreted that within a decade, between 1994 and 2004, Europe's share in Russian trade increased from some 35 percent of Russia's imports and 36 percent of its exports in 1994 to 53.8 and 52.1 percent respectively in 2004. Thus, the EU25 has become the major Russian trading partner. Moreover, it is worth noting that the share of Euro in the foreign currency basket of the Central Bank of Russia has increased from 10 percent since the time the Euro was introduced to 40 percent currently, which can be to a large extent attributed to EU Russian economic interdependence.

At the same time, economic relationships between Russia and the EU are often described as asymmetrical.(Barysch 2005) The proponents of this point of view argue that the first evidence of the imbalanced character of the EU-Russian relations is the asymmetry in economic size i.e. an inconsistency between the important geopolitical role of Russia and its low economic performance(Sutela 2004) This implies that economically (in terms of GDP) Russia is comparable in size to the group of accession countries of the current [2004] EU Eastern enlargement."(Sutela 2004)

Another proof of asymmetry is that the European Union is Russia's single most important trading partner, whereas the same does not hold true the other way round. In 2004 the EU25 accounted for more than half of Russian foreign trade turnover, whereas in the same period Russia's share in the total EU25's trade was 6.3 percent. Yet another sign of asymmetry is the composition of trade flows. Most Russian exports to the EU consist of oil, gas and other raw materials. Table 1.1 illustrates this situation

Table 1.1Structure of Russian Exports, 2000-2004

	2000		2001		2002		2003		2004	
Total Exports Billion USD	105.0		101.9		107.3		135.9		183.2	
	Bln. USD	% of Total	BLn. USD	% of Total	Bln. USD	% of Total	Bln. USD	% of Total	Bln. USD	% of Total
Raw materials,ores,other minerals	4.671	4.5	4.10	4.1	4.69	4.5	5.92	4.4	8.6	4.8
Fuels	52.84	51.2	53.4	53.1	55.73	52.2	70.85	53.0	90.74	49.9
Chemicals	5.006	4.9	4.838	4.8	4.658	4.4	5.83	4.4	7.99	4.4
Only metals and steel	16.087	15.6	13.6	13.3	13.64	12.8	16.59	12.4	26.46	14.6
Machinery, transport equipment	6.039	5.9	6.24	6.2	6.21	5.8	9.25	6.9	8.84	4.9

Source: GosKomStat

When the shares of industrial production in Russia are compared with the production of resources it is evident that the Russian reliance on the resource industries makes up more than two thirds of Russian exports. According to Eurostat data in 2004 the share of mineral fuels, lubricants and related materials together with manufactured goods classified mainly by material, accounted for more than 70 percent of total Russian exports to the EU. In contrast, the EU exports to Russia comprise mainly machinery and transport equipment, chemicals and miscellaneous manufactured goods. The share of these goods accounted for more than 80 percent of Russian imports from the EU in 2004. At the same time, there are several other facts that should not be disregarded. The first point to be emphasized is the dynamism of the

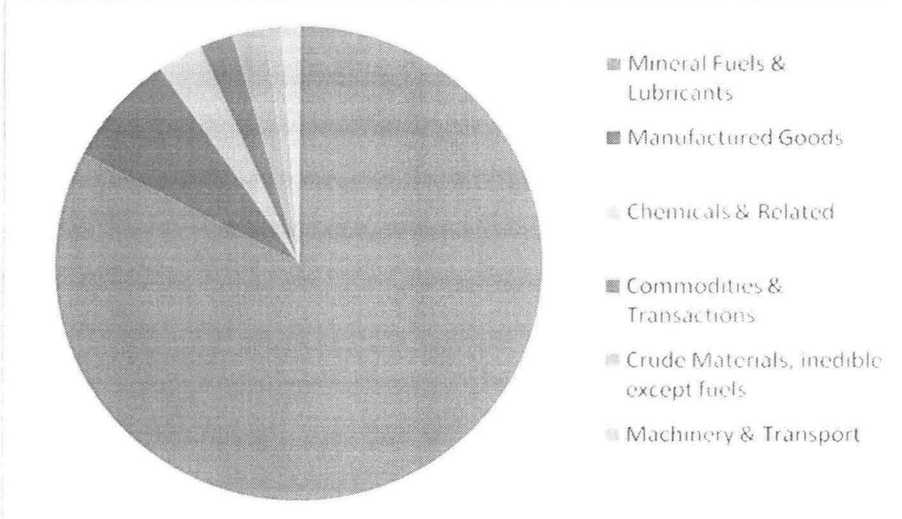
EU-Russian economic partnership: EU-Russian trade is growing both in absolute and relative terms. Table 1.2 showing the volume of Russian foreign trade can be interpreted with regard to the EU taking into account that the destination of about 60 percent of Russian exports is the EU. If in 2000 the value of Russian trade with countries which now form part of the EU25 was approximately 72 billion US dollars, by 2004 it more than doubled in absolute numbers to roughly 147 billion US dollars.

Table 1.2 Foreign Trade of the Russian Federation, 2000-2005, bln. US dollars

	2000	2001	2002	2003	2004	2005 (Jan-Oct)
Foreign Trade Turnover	149.9	155.6	168.3	212.0	278.0	296.7
Exports	105.0	101.9	107.3	135.9	183.2	199.7
Imports	44.9	53.8	61.0	76.1	94.8	96.9
Balance	60.1	48.1	46.3	59.9	88.4	102.8
	In percent to the previous year					In percent to Jan-Oct 2004
Foreign Trade Turnover	130.2	103.8	108.1	126.0	131.1	133.6
Exports	139.0	97.0	105.3	126.7	134.8	136.6
Imports	113.5	119.8	113.4	124.8	124.7	127.8

Source- Goskomstat 1

European Union inports from Russia



Source: EUROSTAT 1

Another issue worth mentioning in EU-Russian trade is that Russia traditionally has a positive trade balance: in 2004, for example, Russia's surplus in trade with EU25 was around 35 billion Euros. Moreover, in the past five years it has almost doubled. In addition, Russian foreign trade is more and more oriented toward the EU. The shares of total Russian exports to and imports from the EU are increasing. If in 2000 the relative share of countries which now form part of the EU25 in Russian foreign trade was approximately 48 percent, in 2004 their share was already 57.1 percent Besides, the share of exports to Russia in total, EU exports is increasing at an average annual rate of 19.4 percent, and the share of imports from Russia is growing at an average annual rate of 7.2 percent. Despite the fact that the rise in value of EU-Russian trade, and Russian exports in particular, reflects to a large degree the increase in oil and gas prices in the world market, the strategic character of energy supplies as well as the increase in non-resource trade between the parties give us grounds to consider that EU-Russian trade relations are improving and have a mutually beneficial character. (*Korobchenko 2006)* Another broad economic sphere in which the cooperation between Russia and the EU is visible is the creation of the Common European Economic Space (or Common Economic Space, CES) between Russia and the EU. The creation of CES is potentially beneficial for both partners. As it is pointed out in the Road Map for the Common Economic Space,the overall objective of the CES is the creation of an open and integrated market between the EU and Russia. The aim is to put in place conditions that will increase the opportunities for economic operators, promote trade and investment, facilitate the establishment and operation of companies on a reciprocal basis, strengthen the cooperation in the fields of energy, transport, agriculture and environment, reinforce economic cooperation and reforms, and enhance the competitiveness of the EU and Russian economies.

The situation with which CES can be viewed from a different perspective. Given the geographical proximity, the complementary character of economic resources coupled with significant mutual interests in cooperation, the idea of CES seems to be plausible and feasible from political, legal and economic perspectives. For Russia, this is an opportunity to obtain access to the single European market, gain valuable experience on the eve of WTO accession, and acquire better access to capital markets and improved corporate governance practices required for successful competition in the global economy and attraction of FDI into Russian economy.(Sutela 2005)

For the EU this is a chance to secure its strategic energy and material supplies, ensure its stake in the growing Russian market, and guarantee stable relations with its largest direct Eastern neighbor.(*Korobchenko 2006)* Realizing their benefits from CES, in 2005 the parties agreed on the aforementioned Road Map for the Common Economic Space, which aimed at speeding up the process of cooperation *inter alia* on regulatory policy, investment issues, competition, financial services, telecommunications, transport, energy, intellectual, industrial and commercial property rights, environment, space activities and space launching Moreover, in December 2005, two dialogues, namely a regulatory dialogue and a dialogue on industrial and enterprise policy, aimed at speeding up the process of creation of CES were launched.
It should be pointed out that there are several other important steps the parties have taken towards one another in the recent past. In 2002 the EU finally granted Russia the market-economy status. In 2004 the parties finally managed to extend the PCA to ten new EU members and concluded the bilateral negotiations on Russia's accession to the WTO. In 2005, the Kyoto Protocol eventually came into force after Russian ratification. Besides, the parties signed a new Steel Agreement for 2005-2006, reducing quantitative restrictions to Russian Steel exporters by 25 percent.(Korobchenko 2006) Despite certain visible complications in bilateral relations the general atmosphere of cooperation between Russia and EU is improving.

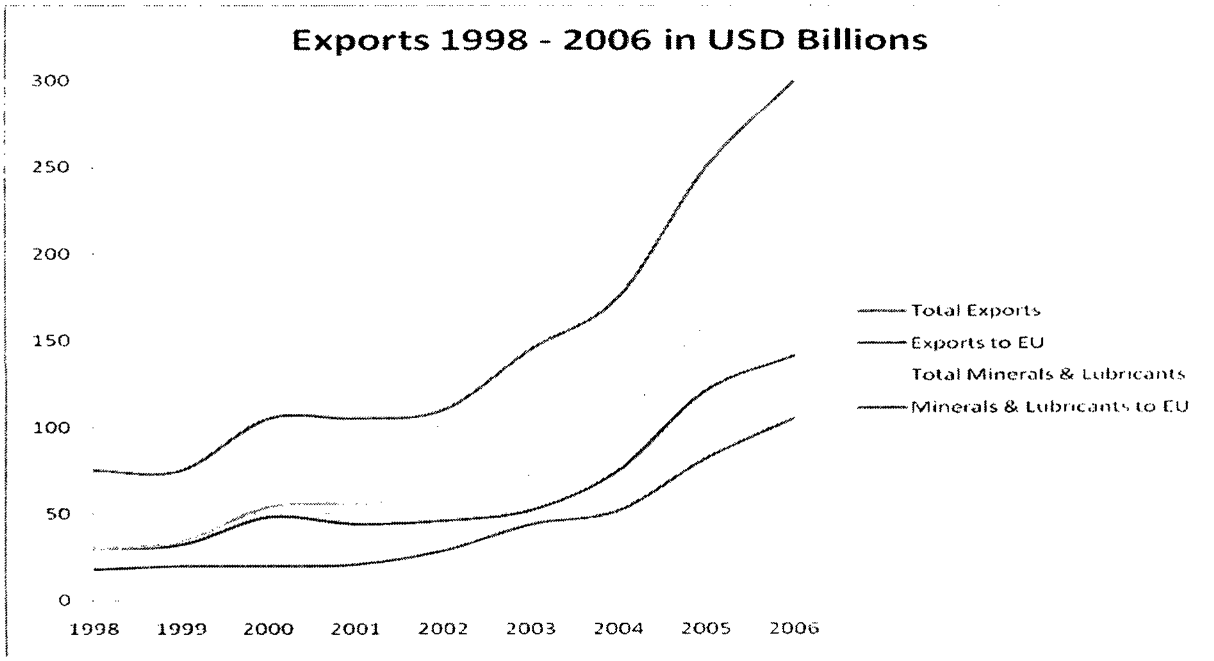
A Relation of Asymmetries

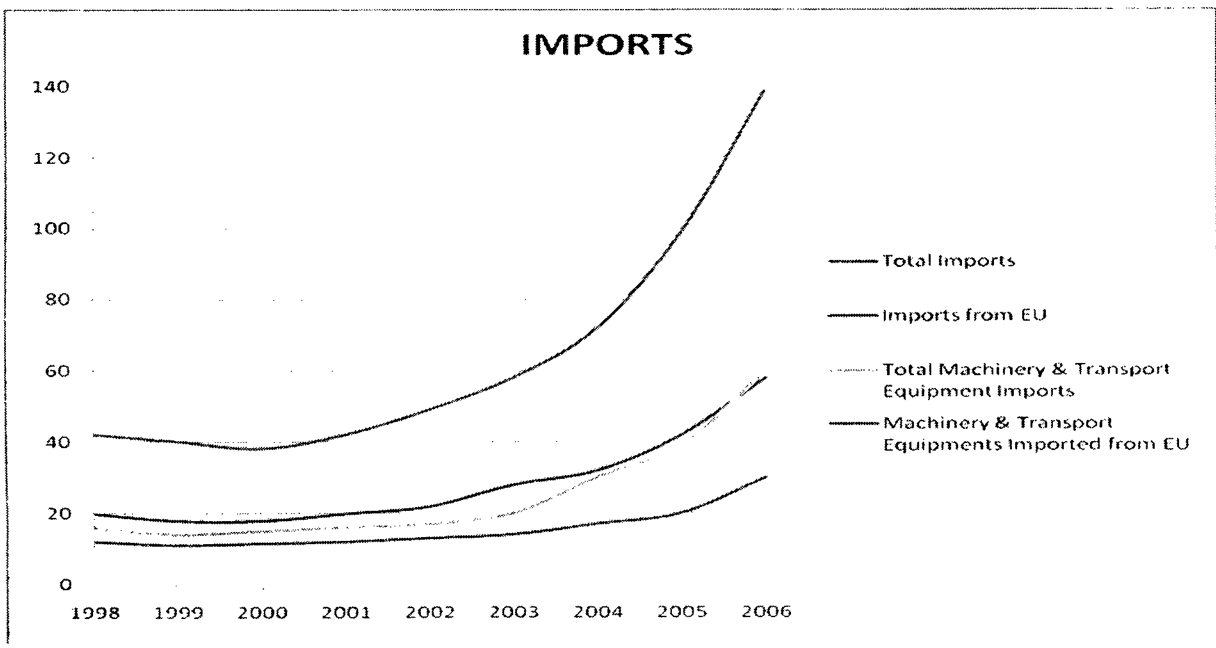
The Russian EU Strategy furthermore emphasises that partnership should be 'on the basis of equality without dividing lines'. This strengthens the general idea that true partnership should always be between equals: partners of similar size, importance and prestige. And naturally, as just said, partners will share values. This is simply not the case in the EU–Russia relationship. The brief characterisation usually given is that Russia is a political heavyweight while remaining an economic midget. This will change, as Russia will probably remain one of the fastest-growing economies in the world for a number of years, and the international economic size of the country will also be boosted by the rouble appreciating in real terms. The EU, by contrast, is dubbed a political midget but an economic giant. This will also change, as at least the core countries of the Union will only grow slowly, leading to a relative decline in the EU's global economic weight. At the same time, the EU is growing politically, as much work on a stronger political and security union is underway. But, for the moment at least, the short characterisations remain basically correct. Therefore, it is not surprising that Russia tends to be interested in high politics, including grand declarations of will, while the EU would rather concentrate on the legal and other nitty-gritty of trade policy, but increasingly also of competition policy, regulation, as well as justice and home affairs. This comparison is a useful starting point, but does not come close to a full picture of the asymmetries between the Union and Russia. One has to start with the issue of economic size. After enlargement, the EU's population is now about three times that of Russia's, which is declining.

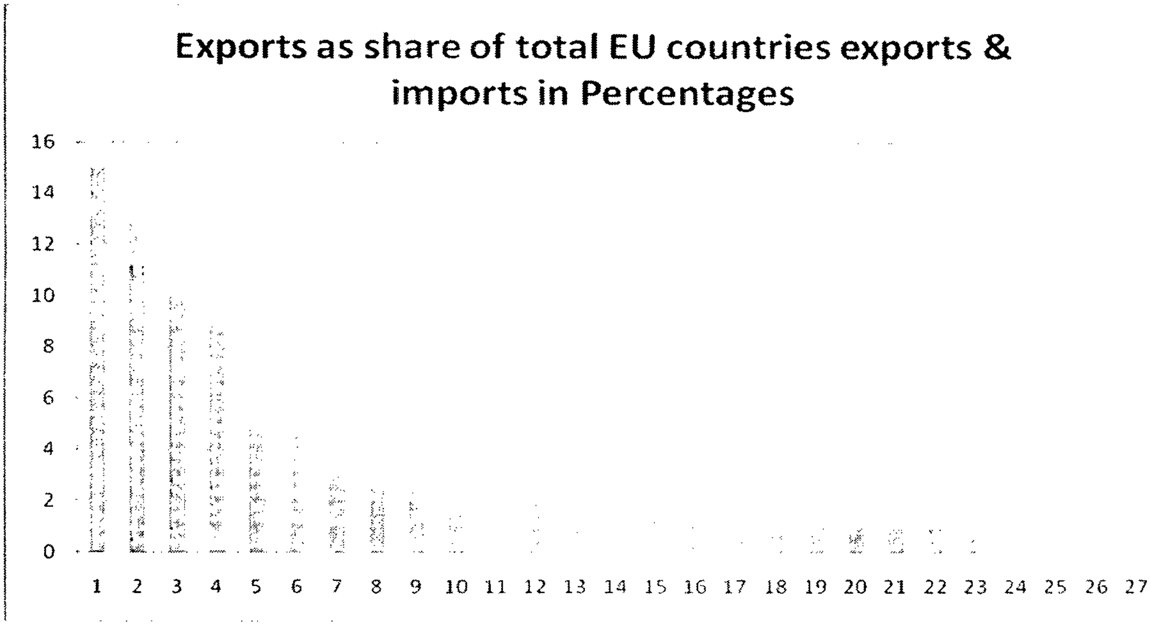
Though the exact relation shifts with exchange rates, Russia is at current exchange rates, with an estimated GDP of 384 billion euro (433 billion dollars) in 2003, economically roughly similar in size to Finland and Sweden put together. Given that Russia has a population of 145.5 million, this size translates into a per capita GDP of 2665 euros. That is close to a tenth of the income level in a medium-income level EU country like Finland, with a per capita income of 26800 euros in 2003. Such comparisons are probably marred by the deficiencies of Russia's GNP calculations and certainly by the undervaluation of the rouble. At World Bank purchasing power parities (PPP) – thought by some to be generous to Russia – Russian GDP and income level are roughly three times higher than at market exchange rates Russia has 2.4 per cent of the world population and, at purchasing power parity, 2.7 per cent of global GDP. But it only accounts for 1.7 per cent ŏf global exports6 and 0.3 per cent of total gross foreign direct investment inflows. The existence of political asymmetries are also evident. Though Russia is naturally politically immensely more 'European' than was the USSR, issues of democracy, human rights, media freedom, the development of civil society and the normative gaps revealed by Kosovo and Chechnya still separate it from the EU. One difference in geopolitics may make the idea of Russian membership in the Union impossible, if the Union were in fact to develop common foreign and security policies. The EU's foreign security interests are in the Balkans and potentially in Northern Africa. Russia, on the other hand, now faces challenges in the Caucasus and Central Asia, in the future possibly also farther east. Europe has little interest or capability to get involved – at least in terms of hard security, which is Russia's main concern – in those regions either now or in the foreseeable future. Only the US shares Russia's vital hard security interests in these regions. As important as mutual energy dependence might be for Russia and Europe, only the USA is a natural security policy partner for Russia. The asymmetry in economic size translates into asymmetry in trade relations. The EU is for Russia undoubtedly and irreversibly the main trading partner. According to Russian customs statistics, the share of EU countries in overall Russian imports was in 2003 38 per cent, slightly down from 40 per cent in 2002. In exports, the EU share remained stable at 35 per cent. The share of the new members in imports grew to almost 8 per cent but declined to 12 per cent of exports.13 CIS (former Soviet) countries have a 15 per cent share in Russian exports and a 24 per cent share (up from 19.9 per cent in 2002) in imports. Basically, after enlargement the EU thus takes half of all Russian foreign trade. This is a very high trade share. The EU is the market that Russia has.

Russia's exports to the EU are more concentrated than total exports. In 2006 fuels and related items made up 78% of Russian exports to the EU, up from 55% in 1998. By contrast, at around 43%, the share of machinery and transport equipment in Russian imports from the EU is almost identical to the share of machinery and transport equipment in total Russian imports. In 2007 Russia was the EU's third largest trading partner, with a share of more than 7% in exports and a 10% share in imports (Table1).

Compared with the late 1990s, the importance of Russia in EU trade has more than doubled, reaching 7.9% in 2007. In terms of the major commodities traded, Russia accounts for 7% of total EU exports of machinery and transport equipment, up from less than 2% in 1999, but more than 28% of total EU imports of fuel and related items. Since 1999 the latter share has risen by more than 6 percentage points. The largest EU countries – Germany, Italy, France, the United Kingdom and Spain – are, together with the Netherlands and neighbouring Finland and Poland, Russia's major trading partners in the EU. Conversely, Russia's share in the trade of individual EU countries is by far the highest in Lithuania and the other Baltic states. Finland and other new Member States follow, while Russia's share in the total trade of the larger EU Member States, such as Germany, France, the United Kingdom and Italy, is less than 3% for exports and less than 5% for imports.







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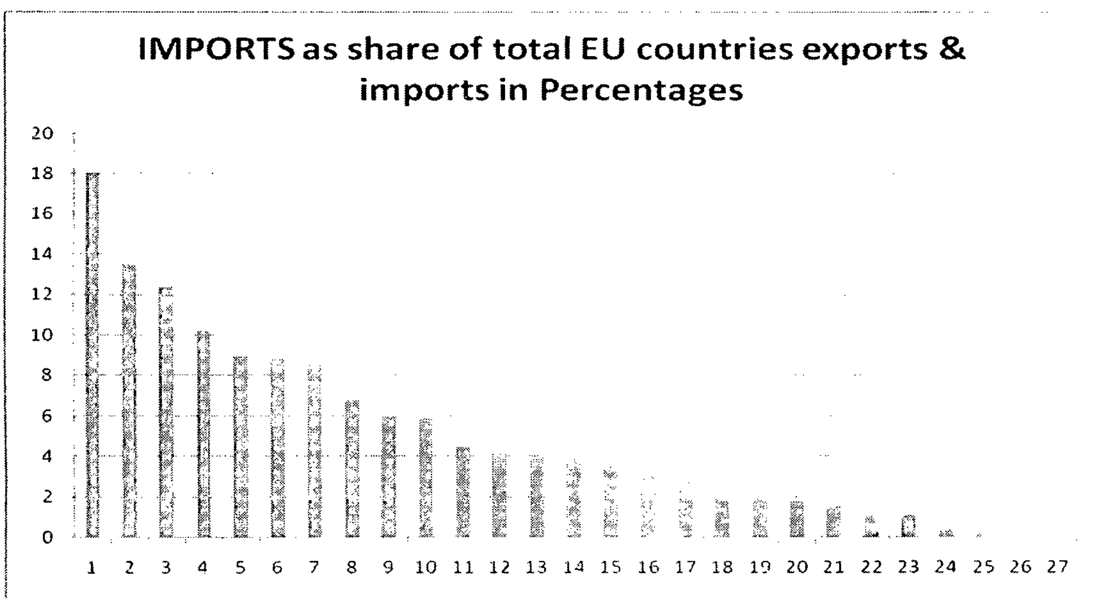

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THE IMPACT OF EU ENLARGEMENT ON TRADE BETWEEN THE EU AND RUSSIA

Traditional trade theory (Viner, 1950) suggests that the direct effect of EU enlargement on trade between a Member State and Non- Member State, such as Russia, is a dual one.
Among the Member States of the enlarged EU, trade will be supported by the abolition of all trade barriers and the enlargement of the single market (trade creation). At the same time, according to the theory, trade between the enlarged EU and Russia should decline, as tariffs and non-tariff barriers remain in place putting Russia – like any other country outside the EU – at a disadvantage in its trade both with the EU15 and with the Member States in central, eastern and south-eastern Europe (trade diversion). Trade diversion effects may be outweighed by market size and income effects, suggesting that non-member countries may also benefi t from regional integration arrangements. In the case at hand, the enlarged EU internal market should raise effi ciency and income levels, which may increase the demand for goods and services both inside and outside the EU. Non-EU countries may also face lower transaction costs for exports to the EU, as harmonised rules and regulations apply for a larger market, thereby raising efficiency. Implicitly, the work by Rose (2000) on the endogeneity of optimum currency areas suggests that a currency union would have trade creation and trade diversion effects similar to those of a free trade area, a customs union and a single market. Micco, Stein and Ordonez (2003), as well as Baldwin, Skudelny and Taglioni (2005), suggest that the introduction of the euro has led to increased trade not just among euro area members, but also between the euro area and the rest of the world. A great deal of literature aims to measure the trade creation and trade diversion effects of existing regional trade arrangements.

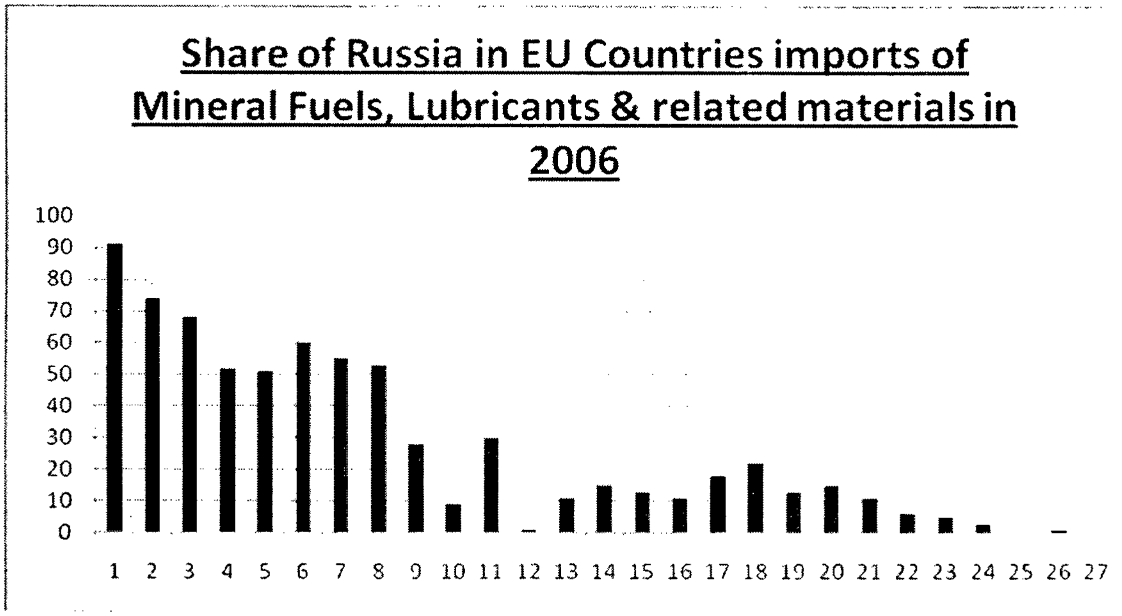
Results range from almost no effect to significant creation and diversion effects in line with standard theory.

Empirical studies and simulations looking at the impact of the process of EU enlargement on trade between the EU and Russia suggest that effects have been minimal at best. For example, for the period 1993-2002, when trade liberalisation between the EU and central and eastern European countries advanced significantly on the basis of the European and Interim Agreements, the gravity model estimated by Mordonu (2006) shows no evidence of trade diversion for Russian exports to the EU15 and the former accession countries. Also on the basis of a gravity model, Alho (2003) even reports a positive impact on Russian exports to the central and eastern European Member States, while Wilhelmsson (2006) finds limited trade diversion effects owing to EU enlargement. Sulamaa and Widgrén (2004) simulate the impact of the recent EU enlargement on Russia on the basis of the Global Trade Analysis Model (GTAP). Their results suggest that the impact of enlargement on Russia is negligible in terms of growth, slightly negative for imports, but again positive for exports. Similarly, research by Vinhas de Souza (2004) suggests that the main benefi ciaries of the 2004 enlargement were the EU10 countries, while the impact on Russia and other EU neighbouring countries was marginal.

CHALLENGES IN IDENTIFYING THE IMPACT OF EU ENLARGEMENT ON TRADE BETWEEN THE EU AND RUSSIA

It is difficult to trace possible trade diversion effects in post-2004 trade between the EU and Russia, as – in parallel – substantial changes have been taking place in the structure of global trade. These include the increasing integration of emerging market economies – particularly those of emerging Asia – into the global economy, as well as the rising price of oil and gas, Russia's major export items.

Moreover, strong growth in Russia and the expansion of the euro area have provided an extra boost to trade between the EU and Russia in recent years. Finally, the liberalisation of trade between the EU and the former accession countries had started well before 2004. Thus, trade diversion effects may have already occurred, while any additional impact of the 2004 enlargement would have to be traced back to the expansion of the single market.



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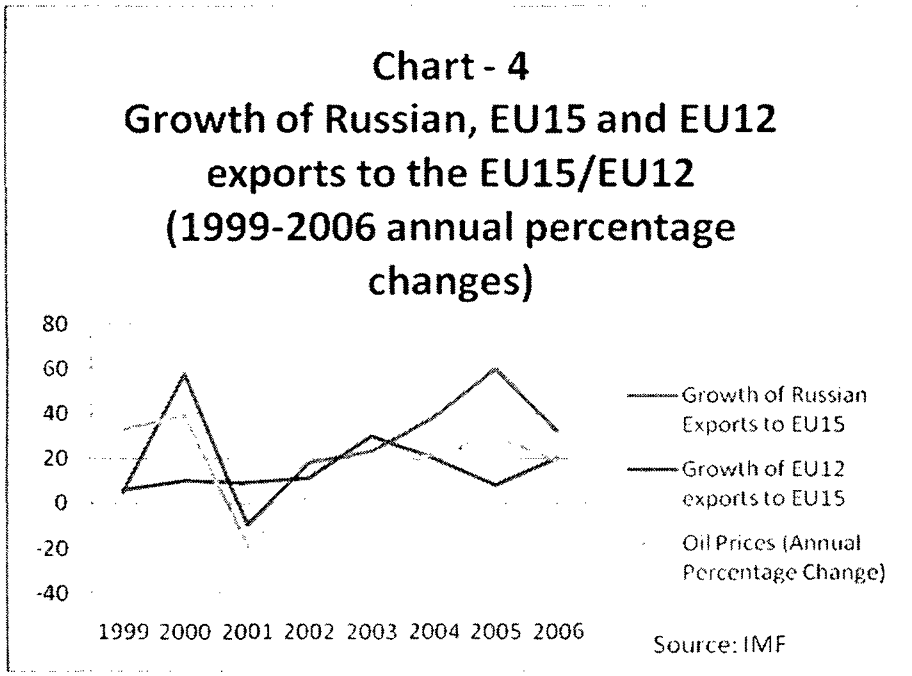
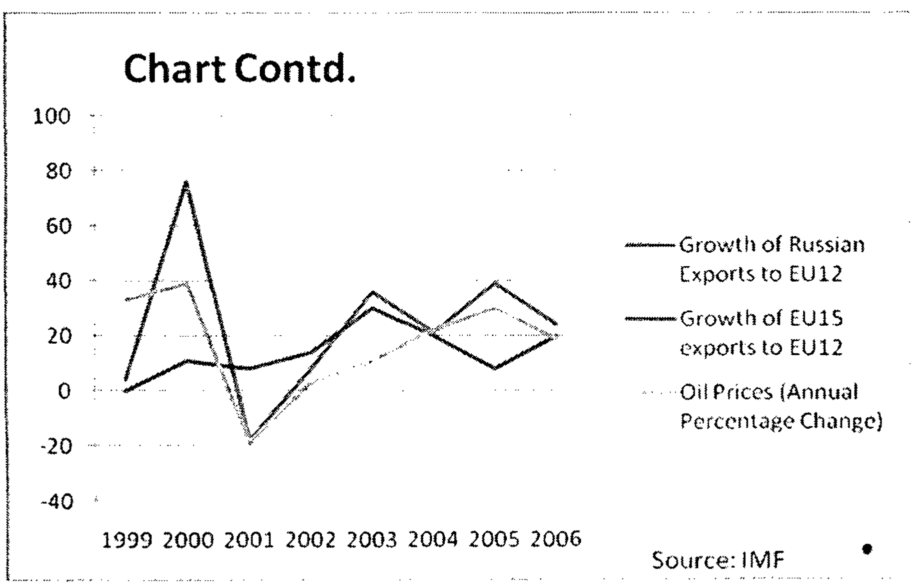
27: Luxembourg

The impact of the rise in oil and gas prices may be the most diffi cult to account for when analysingthe impact of EU enlargement on trade between the EU and Russia. This is also because data on bilateral trade are only available in terms of values, not volumes(Barisitz and Ollus 2007). Thus, it is not possible to track possible trade diversion effects in real terms. It should also be mentioned that gas prices rose, in particular for some of the new EU Member States, because Russia increased the gas prices charged to former Soviet republics from the low levels charged previously. As a result, the Baltic countries, while still paying lower gas prices than other EU customers in 2005-06, faced the highest prices of all the former Soviet republics (Czarny and Toporowski, 2008). Comtrade data suggest that the Baltic countries, Slovakia, Romania and Finland import more than 80% – some of them even close to 95% – of their gas from Russia. While imports from Russia account for approximately 28% of total EU imports of mine ral fuels, the dominance of Russia as a supplier of mineral fuels is much more pronounced in the EU member States of central, eastern and south-eastern Europe, with the share of Russian imports reaching more than 50% in seven countries

Growth of Russian, EU15 and EU12 exports to the EU15/EU12

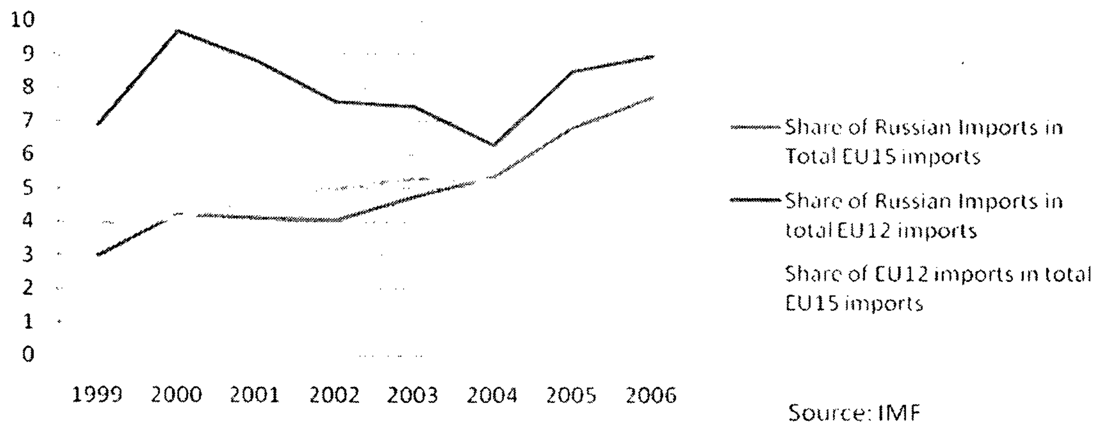




Slower growth in Russian exports to the EU15 and the new Member States in central, eastern and south-eastern Europe (EU12) following enlargement might have been indicative of corresponding trade diversion effects, in particular if it were accompanied by a rise in export growth among the EU sub-groups. However, since 2001 the growth rate of Russian exports to the EU15 has been higher than that of EU12 exports to such countries, and the growth rate of Russian exports to the EU12 has been higher than that of the EU15 exports to those countries (Chart 4). Prima facie, this suggests that enlargement has not been diverting Russian exports to the old or new Member States as a consequence of the creation of trade between new and old Member States. At the same time, however, oil price developments seem to have played an important role in explaining the growth rates of Russian exports to the EU15 and the EU12. As indicated in Chart 4, the growth rates of Russian exports to the EU15 and EU12 have been closely following changes in global oil prices. Thus, the strong performance of Russian exports to the EU after enlargement might largely refl ect the rise in oil and gas prices, making it diffi cult to draw strong conclusions as to possible trade diversion effects.

Oil price developments may also distort the analysis when focusing on the shares of Russian and EU12/EU15 imports in total EU15/EU12 imports. The share of imports from Russia in total EU15 imports has been rising since 2002, i.e. with the rise in oil prices (Chart 5, left panel). For total EU12 imports (right panel), the raw data provide a less clear-cut message, as the share of Russian imports in total EU12 imports fell quite markedly between 2000 and 2004. However, it is again difficult to draw strong conclusions from this, as the share of the EU15 in total EU12 imports was relatively stable over the same period. When oil price increases accelerated in 2004-05, the share of Russian imports in total EU12 imports rose again. This underlines the dominant infl uence of oil price developments on movements in the share of Russian imports in the total imports of the new Member States in central, eastern and south-eastern Europe.

Chart 5 - Share of Russian & EU15/EU12 imports in total EU15/EU12 imports (1999-2006 in percentages)



Summary

The enlarged EU is Russia's most important trading partner, with energy dominating Russia's exports to the EU and manufacturing products being the EU's major export item to Russia. While, according to traditional trade theory, the effect of enlargement on trade between the EU and Russia would be trade diversion, this may be offset by positive market size and income effects. It is diffi cult to capture the effects of EU enlargement on trade between Russia and theEU. Econometric studies based on ex ante and ex post calculations, the latter reviewing the period of increasing trade liberalisation between the EU and the former accession countries before 2004, suggest that the trade diversion effects of EU enlargement on trade between the EU and Russia should have been marginal.

Actual post-2004 trade data show a substantial increase in trade between the EU and Russia after enlargement, both in absolute and relative terms. However, this does not rule out the occurrence of diversion effects as suggested by traditional theory, as these effects could have been offset by rising trade, reflecting strong growth in Russia and the EU, as well as the rise in oil and gas prices.

Investments

Russia is not a major player in international investment flows. In 2000–2003 the share of Russia in world gross inward foreign direct investment (FDI) flows was just 0.3 per cent, a third of the share of the Czech Republic or Poland. The share of the USA was 20.0, that of the euro area 31.7 per cent. The share of Russia in EU–15 outward FDI flows has – partly at least due to reasons of geographical proximity – been somewhat higher. However, since 1997 it has never reached two per cent, while the share of acceding countries fluctuated around five per cent until it rose to 12.4 per cent in 2002, when overall European outward FDI declined sharply This means that the EU FDI stock in Russia was in 2002 just 10.8 billion euros. Russia, according to available statistics, has been a country with high savings ratios, a relatively low domestic investment ratio, and consequently a country experiencing net capital outflows. The exact amount of the outflow has been subject to much debate, but clearly it has been high, though recently on a declining trend.

There is evidence that capital that left the country in the 1990's was starting to return, at least until 2004, when the flow again seems to have turned outward. The Russian government is running a budget surplus for the fifth year, and the stock of sovereign foreign debt has been decreasing. Indeed, the sovereign debt-to-GDP ratio will soon approach 25 per cent. The Bank of Russia has accumulated very major foreign exchange reserves. At more than 115 billion dollars, they are among the largest in the world. In contrast to the public sector, Russian companies have recently engaged in strong borrowing on the international bond and loan markets. According to Russia's Statistics Committee, total foreign investment in Russia increased in 2003 by 50 per cent and reached 29.7 billion USD. Most of the investment, 76 per cent, consisted of loans and trade credit, while portfolio investment declined by 15 per cent and only amounted to one per cent of the total. Overall, Russian financial markets remain small, though they have recently grown fast. In early 2004, the domestic corporate debt market only amounted to 18.5 billion dollars, up from 2.7 billion dollars in early 2000. Of this, 12.5 billion dollars was denominated in foreign currency, mostly dollars, up from 1.6 billion dollars four years earlier.

Against this background, it is not surprising that the share of Russia in the consolidated foreign claims of euro-area banks was in 2000–2003 on average just 0.8 per cent. The share of emerging Europe in total foreign claims of euro-area banks has decreased somewhat since

1999. Most notably the share of Russia within emerging European claims has decreased steeply from about a third in 1999 to a tenth in 2003. Russia is a marginal source of FDI into the EU. In 2002, this stock was just 2.8 billion euro, slightly down from the previous year. Russian companies are mostly smallish and in the very beginning of internationalisation, which often seems to take place along energy supply routes to the CIS and Eastern and Central Europe. There is still not a truly international Russian company, though Gasprom/Rosneft might one day become such.

The enlargement of Russian energy companies into the CIS and also to Eastern and Central Europe is consistent with Russian political efforts to be increasingly influential in these areas. There might be a consistent strategy of buying up energy-related assets, in particular in the former Soviet region, as they become available. In doing this, Russian companies sometimes come up against EU interests, and not rarely prevail. This again is consistent with the Russian view that does not accept that it shares with the EU 'a common neighbourhood' here, but sees a mere Russian sphere of interest

According to the newspaper *Finasovie Izvestiya,* the largest share of stock foreign investments (around 70.7 percent) comes to Russia from five EU countries, namely Cyprus, Luxemburg, the Netherlands, Great Britain and Germany. According to the data of the Russian State Statistics Agency (GosKomStat) and the Russian Ministry of Economic Development and Trade, major direct investing companies to the Russian economy are also located in the European Union. The inflow of foreign capital into the Russian economy at the beginning of the 21st century is illustrated in Table 2.1 below.

Table 2.1 Foreign Capital in the Russian Economy, 2000-2005.

	2000		2001		2002		2003		2004		Jan-Sep 2005		**Cumulative, Bln USD 1989-2005**
Gross Inward Investments, Bln USD	10.6		14.3		19.8		29.7		40.5		26.8		**96.5**
	Bln USD	% of total	Bln USD	% of total	Bln USD	% of total	Bln USD	% total	Bln USD	% total	Bln USD	% total	**% of cumulative**
Direct	4.43	40.4	3.98	27.9	4	20.2	6.8	22.8	9.4	22.3	6.6	25	**44.9%**
Portfolio	0.15	1.3	0.45	1.3	0.47	2.4	0.4	1.4	0.33	0.8	0. 37	1.4	**2.0%**
Others (credits, trade credits, etc.)	6.4	58.3	9.8	68.9	15.3	77.4	22.5	75.8	30.8	75.9	19.86	74	**53.1%**

Source: GosKomStat

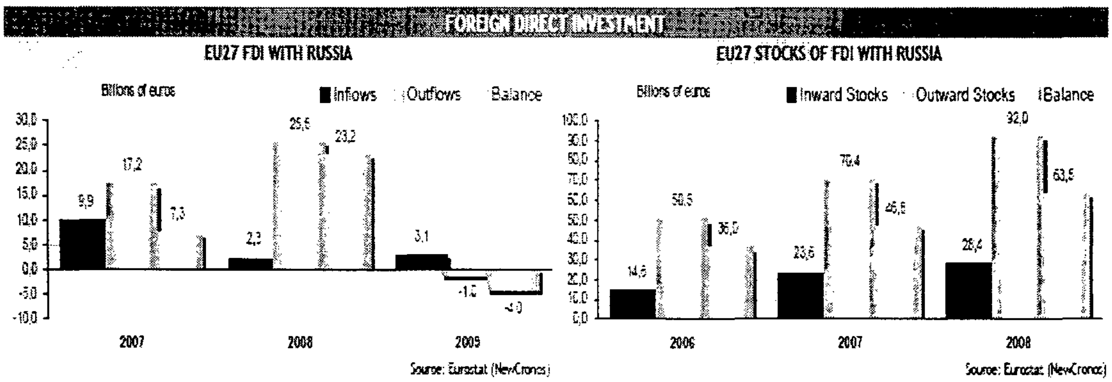
The analysis of the sectoral distribution of FDI (Table 2.2) gives us some indication about the role of FDI in overcoming Russian reliance of on natural resources and restructuring Russian economy.

Table 2.2. Sectoral distribution of foreign investments in Russia (major recipient sectors), share (%) of total foreign investments

	2000	2001	2002	2003	2004
Total, Bln USD	**10.6**	**14.3**	**19.8**	**29.7**	**40.5**
INDUSTRY (%) out of which	43.1	39.7	37.1	41.5	48.5
Fuel	5.7	na	9.8	17.9	20.1
Metals	9.9	na	11.5	11.8	15.4
Chemicals	2.2	na	1.7	1.7	2.2
Machinery	4.3	na	2.5	2.3	3.9
Wood	2.3	na	1.6	2.0	2.4
Food	16.3	na	6.1	3.5	2.4
TRANSPORT	9.3	na	0.9	1.4	1.6
TELECOMMUNICATIONS	8.5	na	2.2	2.3	3.4
TRADE	17.8	na	44.5	35.4	32.1

Source: GosKomStat

In the year 2000, 51 percent of FDI went to industry, 17 percent to trade; 10 percent to transport and communications.52 In 2001, industry received 43- 45 percent of FDI, transport and telecommunication 20 percent and trade 20 Percent(Bradshaw 2002). In 2002 fuels and petrochemicals accounted for 19 percent of total FDI, machinery and equipment for 4 percent, food, beverages and tobacco for 15 percent, transport and telecommunications for 25 percent.54 According to the 2005 data of the Ministry for Economic Development and Trade of the Russian Federation, the share of FDI in industry was 30 percent, 29.8 percent in trade, 17.5 percent in extraction of mineral resources, and 10 percent in transport and telecommunications .The figures above suggest that although about half the FDI goes into industry and half of that into the oil and gas sector, the non-fuel part of the Russian economy is attracting more investment each year. This fact is especially sound compared to the structure of Russian exports (Table 1.1) and the sectoral distribution of overall foreign capital in the Russian economy (Table 2.2), according to which resource sectors receive the bulk of investments.



Therefore, the role of foreign direct investments as forerunners in restructuring the Russian economy needs to be emphasized. Nevertheless, despite its large endowment of natural resources, relatively cheap and highly skilled labor force, potential for the development of high-tech R&D, the large booming internal market of 143.5 million consumers with a potential to growth, and other advantages, Russia is sometimes calledan 'outsider' in terms of attracting FDI.56 The current level of foreign investments in Russia is too low compared with other countries. As the European Bank for Reconstruction and Development states, accumulated foreign direct investments in Russia (per capita) amounted to $ 71 in the year 2000, far lower than, for example, in Poland ($ 511), the Czech Republic ($ 1493) and Hungary ($ 1581)(Popov and Lemeshko 2006)

In terms of the potential for attracting EU foreign investments, Russia seems to have a unique international position and a promise of large benefits for both sides. From the prospective of business in Europe, Russia looks like an attractive FDI location. This fact is confirmed by Eurostat, according to which mutual investment flows between Russia and EU have grown significantly in recent times. If in 2001 inflows of EU's direct investments to Russia amounted to 2.6 billion Euros and in 2002 to 1.3 billion Euros, in 2003 there was a sharp increase to 8.1 billion Euros. For Russia, EU investors may become the main source of technology, know-how and thus contribute to the diversification of the distorted Russian economy. There is also evidence that Russian companies go abroad, mainly to the EU. (Popov and Lemeshko 2006) Russia's prospects are even brighter. According to data from the United Nations Conference on Trade and Development, Russian investment perspectives look very promising. For instance, Russia is ranked fourth in the list of the most attractive global business locations in 2005-2006, preceded only by China, India and the United States as listed by UNCTAD. The Russian Federation is considered the most promising investment location in the region of South-East Europe and the Commonwealth of Independent States.

According to Finansovie izvestiya, there is already evidence that Russia undertakes reforms: fights inflation; reduces Central Bank refinancing interest rate (from 55 percent in December 1999 to 12 percent after December 26, 200562); creates opportunities for the growth of foreign portfolio investments increases Central Bank reserves; uses the mechanism of Stabilization Fund to fight resource dependency; pays its foreign external debts ahead of schedule ; conducts reforms protecting foreign investors, and implements'pro-market economy' legislation._However, further positive changes in the investment climate are needed in order to attract more investments. Better protection of ownership rights, enhancing the rule of law, fighting corruption, reforming the court system, strengthening market economy institutions, adopting international accounting standards and better representation of Russia's image abroad are considered ways to improve the investment climate. Bilaterally, the EU and Russia set out some common policies promoting investments. Some principles of investment promotion and protection are defined in the PCA. They envisage the conclusion, where appropriate, of agreements between the EU member states and Russia for the promotion and protection of investment, agreements to avoid double taxation, and exchange of information on investment opportunities, laws, regulations, and administrative practices in the area of investment. Overall, both parties' perspectives for investments look promising.

Russian BITs

The right to protect European investors can in principle be created in Bilateral Investment Treaties (BITs). Russia has signed and ratified a number of these and a list of BITs and the date of their signature and entry into force appears in Annex 1. As of today, the Russian government has signed 55 BITs and ratified 36. All existing BITs were signed after February 1989, and most of them came into force before year 2000. Russian BIT partners in Europe include France, Germany, Italy, UK, the Netherlands, Belgium and Luxembourg, Austria, Finland, Greece, Sweden, Norway, and Switzerland. However, Russia has not ratified the BIT it signed with the United States in 1992. Interestingly a BIT with Cyprus, an important offshore financial centre for Russian companies, has not come into force either. Russian BITs cover about 40% of Russia's inward and roughly 15% of its outward foreign direct investment stock.

Bilateral investment treaties are designed to guarantee foreign investors treatment in accordance with the established standard in international law. They aim to protect investors and investments from discriminatory measures, uncompensated expropriations of property, denial of due process and guarantee fair and equitable treatment. Some BITs go further by providing for 'umbrella clauses' which create the obligation to respect all commitments arising under contracts between a foreign investor and the host state. A core element of BITs is to allow investors to enforce their rights under a respective BIT vis-à-vis the host state through international arbitration, so-called 'investor-state arbitration'. Venues for such proceedings are typically the International Centre for the Settlement of Investment Disputes (ICSID), the Stockholm Chamber of Commerce (SCC), or ad-hoc tribunals on the basis of the widely used arbitration procedural rules codified by the United Nations Commission on International Trade Law (UNCITRAL).

INVESTMENT AND OTHER FINANCIAL FLOWS BETWEEN THE EU AND RUSSIA: THE IMPACT OF EU ENLARGEMENT

Economic theory does not provide clear guidance on the implications of regional economic integration on FDI flows among members and between members and non-members of a regional agreement (de Sousa and Lochard, 2004). Empirical studies suggest that regional integration arrangements reinforce FDI flows between member countries, with some possible diversion effects (Levy Yeyati, Stein and Daude, 2003). For extra-regional FDI (investment flows from non-member countries to member countries), theory is less ambiguous, predicting that members will become more attractive destinations for non-member FDI inflows, as FDI is one of the main ways to enter the common market by establishing affiliates in member countries. Concerning the impact of monetary union on FDI, the main theoretical propositions refer to the positive impact that eliminating exchange rate risk and transaction costs has on FDI flows among member countries (Wei and Choi, 2002). Empirically, de Sousa and Lochard (2004) find European Economic and Monetary Union to be associated with increasing FDI flows within the euro area and between the euro area and other OECD countries.

Over the last few years Russian investment flows vis-à-vis the rest of the world have increased substantially. Total accumulated inward investment in Russia nearly quadrupled from USD 57.0 billion at end-2003 to USD 220.6 billion at end-2007. In parallel, investment outflows from Russia more than sextupled, albeit from a low level, from USD 5.2 billion to USD 32.1 billion. Meanwhile, the structure of investment flows between Russia and the rest of the world has been relatively stable. FDI and other investment (mainly loans and trade credits) have dominated, while portfolio flows account for only 3% of total inflows and less than 8% of total outflows. The service sector, in particular trade, has been the main target of FDI inflows to Russia in recent years, accounting for approximately 55% of total FDI inflows between 2003 and 2007, followed by manufacturing, receiving around 25% of FDI inflows, and mining and quarrying (Vinhas de Souza, 2008)

With enlargement, the EU has become Russia's largest single FDI partner, in terms of both Inflows and outflows. At end-2007 the EU accounted for almost 80% of Russia's inward

FDI stock, while nearly 72% of Russia's outward FDI stock had been invested in the EU (Tables 2 and 3, and Chart 6). The respective shares of other countries, such as the United States and Ukraine, either declined or stabilised at low levels.

The increasing importance of the EU as the source and destination of Russian FDI mainly reflects the fact that Cyprus and Lithuania have been major sources and/or destinations of Russian FDI. While Cyprus has been an important source and host country of Russian FDI, Lithuania has been a major destination of Russian outward FDI, particularly in 2005-06. Moreover, a significant proportion of FDI flows between the EU and Russia seem to reflect a reinvestment of Russian capital, in particular via Cyprus.13 However, the growing importance of the EU as a source of Greenfield investment in Russia (UNCTAD 2006) suggests that its increasing role in overall FDI flows does not just reflect reinvestment of Russian capital.

Table 3: Outward FDI Stock to Selected EU Countries

(as a share of total Russian outward FDI Stock; 2003-2007, in percentages)

	2003	2004	2005	2006	2007
EU15[1)]	17.7	44.1	25.5	36.7	58.4
EU25/25[2)]	19.6	45.6	35	62.6	71.9
Memo: United States	--	6.6	11.1	9.6	8.1
Memo: Ukraine	--	1.4	3.2	1.5	0.9

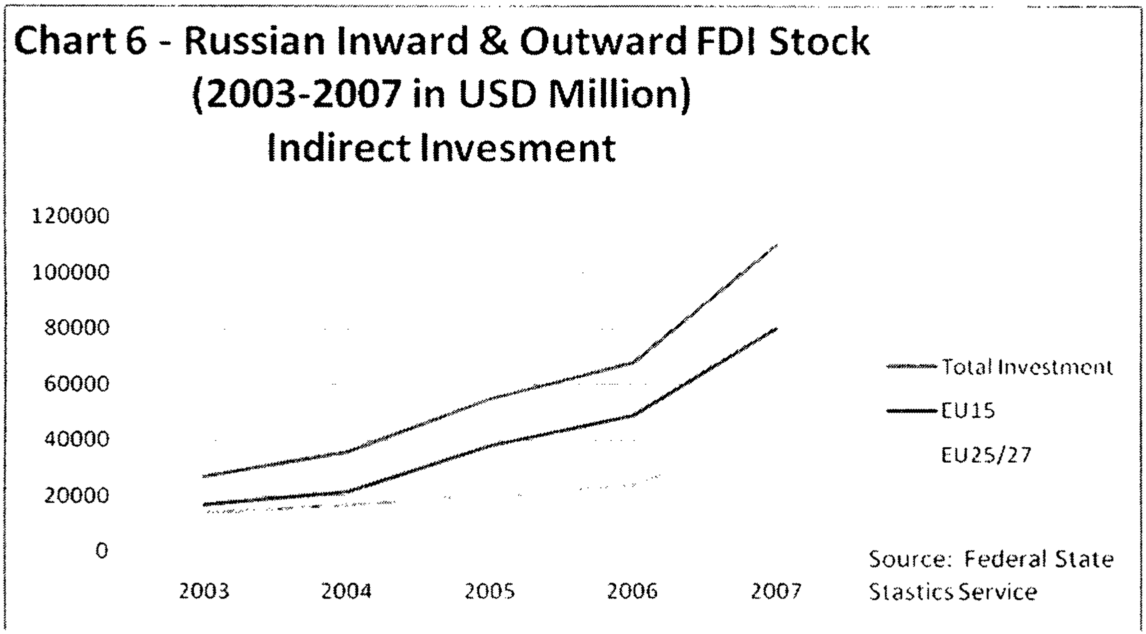
Source: Federal State Statistics Service (Rosstat)

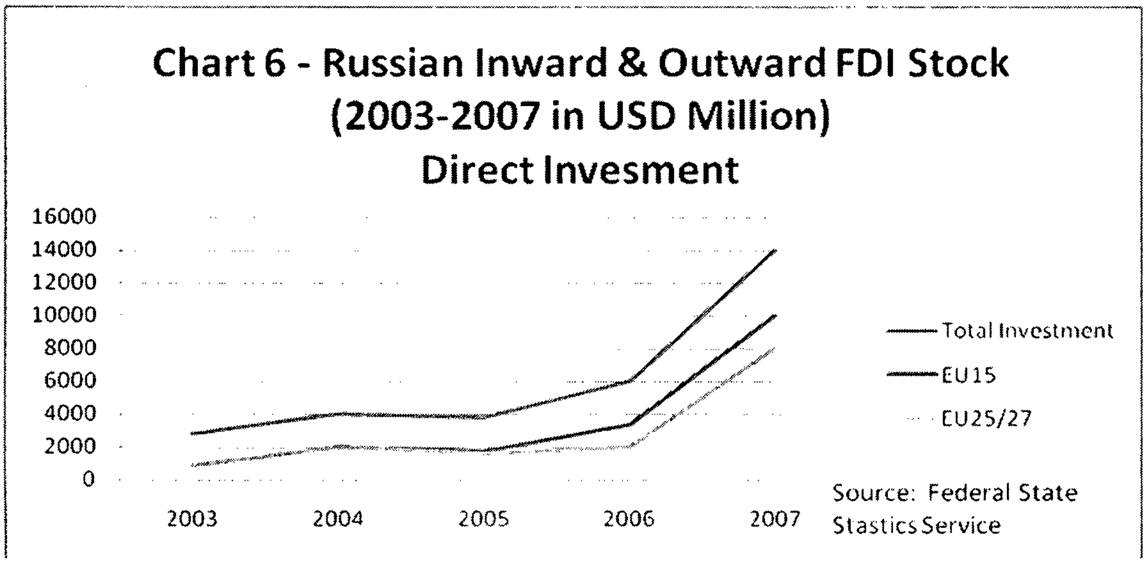
1): 2003 – Netherlands, 2004 – Netherlands & UK, 2005 – Austria, Netherlands, UK, 2006 – Austria, Germany, Luxembourg, Netherlands & UK, 2007 – Austria, Netherlands & UK

2): 2004 – Cyprus, Lithuania & Netherlands, 2004 – Cyprus, Netherlands & UK, 2005 – Austria, Cyprus, Lithuania, Netherlands & UK, 2006 – Austria, Cyprus, Germany, Luxembourg, Netherlands & UK, 2007 – Austria, Cyprus, Germany, Netherlands & UK

Most recently (Chart 6), FDI flows from Russia to the EU have increased substantially. However, as with trade flows, it is difficult to assess whether this is due to EU enlargement, i.e. a sign of the increasing attractiveness of the enlarged EU as a destination of FDI inflows, or a reflection of other factors, such as strong growth and rising wealth in Russia.

Turning to portfolio investment, over 65% of foreign portfolio investment in Russia was held by EU investors at end-2007. Cyprus accounts for the second largest share in the total stock (after the United Kingdom), confirming its role as a major offshore-banking centre. By contrast, portfolio investment in the EU by Russian investors has been limited. At end-2007 the EU accounted for slightly more than 8% of total portfolio investment abroad by Russian residents, with non-EU countries (the Virgin Islands and Ukraine) being the main destinations.





Even before the 2004 and 2007 enlargements, the EU was the most important source of "other" investment in Russia (mostly loans and trade credits) – at the end of 2003 the EU supplied at least 68% of this type of investment. Over time the EU share has continued to increase, reaching nearly 78% of the total stock of "other" investment in Russia at end-2007. Luxembourg has been the main source of "other" investment since 2004, accounting for a share of 25.5% at end-2007. "Other" outward investment rose significantly with EU enlargement, since Cyprus is the main destination for this type of investment by Russian residents (50.9% of the total stock at end-2007), followed by the Virgin Islands (22.1%) and Austria (6.8%).

Flows in the form of remittances are not a crucial position in the Russian balance of payments. In 2004 the ratios of gross remittances (i.e. the sum of out- and inflows) to imports of goods and services, as well as to FDI, were below the levels seen in other emerging market and developing economies .The same applies to remittances received, expressed as a percentage of Russian GDP (World Bank 2006). Net remittances are a negative item in the Russian balance of payments, as Russia has become a migration destination for citizens of other CIS countries (World Bank, 2006) Moreover, outflows of remittances could also reflect financial support provided by Russian residents to Russian minorities living abroad.

With enlargement, the EU has become a more important source of remittances fl owing to Russia. Remittances fl owing to Russia from the EU account for roughly one-fifth of total remittance inflows .Transfers of remittances from Russia to the EU are of much less importance, even though they increased slightly in absolute terms with recent EU enlargements. Thus, Russia is a net recipient of remittances from the EU. However, this reflects two different trends, namely a net inflow from the EU15 countries, but net outflows to some of the countries that recently joined the EU. In conclusion, the EU is the largest investor in Russia and its weight has further increased, both in absolute and relative terms, after enlargement. However, a substantial part of this investment originates from financial centres, indicating a reinvestment of Russian capital. At the same time, there has been a rise in Russian investment in the EU, albeit from low levels. While this is in line with considerations made in the literature concerning the impact of economic integration on investment by non-member countries, the dominance of financial centres as destinations for

Russian foreign investment calls for caution in linking the recent trends to market size effects which are related to enlargement.

Deepening EU-Russia economic relations requires negotiations on a wide set of issues beyond the current mandate of the WTO. Consequently, the EU and the Russian Federation should start negotiations on a WTO bilateral agreement on trade and investment. The underlying criteria for this agreement should be that it is based on economic criteria, on reciprocity and it should involve the broadest product coverage possible both in goods and services, and promote cross-border investments based on national treatment. With this in mind the agreement should include the following key elements: Talks on trade in goods should liberalise substantially all trade without a priori exclusions. Second, Non-tariff barriers should be effectively tackled, starting with a standstill for all new barriers as of the start of negotiations. Third, Negotiations on services should cover all sectors and modes of supply and be based on a negative list. Fourth, Negotiations on cross-border investments must be based on national treatment and a negative list of exemptions, building on but also honouring existing bilateral agreements. Fifth, Mechanisms supporting foreign direct investments should be promoted in projects of mutual interest. Sixth, Intellectual property rules are crucial and signing up to all major international conventions and robust enforcement regimes are a minimum. Seventh, negotiations must address regulatory barriers, setting a course towards regulatory convergence - around transparent, predictable, proportionate and fact-based regulation and international approaches to standards.

As companies should be able to compete with each other on a level playing field,
relevant competition policy elements must be included in the agreement. Also, the negotiations should be based on the disciplines of the WTO Government Procurement Agreement, but given the complex system of exemptions it contains, the EU-Russia agreement should include further disciplines as well. Though the WTO is the trade rule-making body par excellence, the EU Russia bilateral negotiations should also be a tool to ensure best practices in trade policy implementation, particularly in trade facilitation and bilateral customs cooperation. A new agreement will only be valuable to growth and competitiveness if it includes binding and effective dispute settlement and mediation mechanisms. Effective consultation mechanisms should also be established to facilitate

cooperation between the business communities, the Russian government and the EU on industrial policy and investment promotion. The consultation mechanisms should be operational during negotiations on the issues under discussion and during the implementation of the Agreement on the whole range of issues affecting the interests of the business communities.

Common Economic Space

The core institutional framework governing EU-Russia relations is the Partnership and Cooperation Agreement (PCA) – a 10- year extendable agreement that entered into force on 1 December 1997. At the St. Petersburg Summit of May 2003, the EU and Russia decided to formalise their cooperation with reference to four common spaces (Common Economic Space, Common Space of Freedom, Security and Justice, Common Space of External Security, Common Space of Research, Education and Culture). In 2005 each common space was further formalised into a Road Map, setting out the specific objectives and actions in order to put these common spaces into effect. The overall objective of the Common Economic Space (CES) is to create an open and integrated market between Russia and the European Union (EU), reinforcing their economies based on the principles of non-discrimination, transparency and good governance. A key element of this process is the dialogue conducted on the higher policy level, taking into account the business dialogue conducted within the EU-Russia Industrialists' Round Table (IRT).

The 2005 Road Map on the EU-Russia CES determined the objectives and the actions to be taken in sixteen policy area concerning six broad economic policy areas; these were: general issues of trade and economic cooperation, trade facilitation and customs, telecommunications and transport networks, energy, space and environment. On institutional level, implementation is ensured through sectoral dialogues between the EU and Russia covering the above chapters of the CES. Until now, the Terms of Reference have been signed and the sector dialogues have been launched in most of the aforementioned areas, while an informal dialogue is ongoing on competition related aspects. Besides improved communication and better understanding of the regulatory environments between the EU and Russia, concrete outcomes are not yet visible, though in some cases they are expected in the medium or long term. At this point, the EU and Russia seem to be far away from the key policy goal – the creation of an open and integrated market between them.

PROGRESS TOWARDS A COMMON EU-RUSSIA ECONOMIC SPACE

General issues of trade and economic cooperation Regulatory dialogue on industrial products

The main objective of this policy area is the development of harmonised and compatible standards, regulation and conformity assessment procedures. The relevant actions to meet this objective include support for the effective implementation of the WTO TBT (technical barriers to trade) agreement, establishment of regulatory dialogue, including a consultation mechanism and support for the reinforcement of institutional capacity with respect to technical regulations, standardisation, accreditation, conformity assessment, metrology and market surveillance. The terms of reference in this area were signed in December 2005, and dialogue is launched in six out of the eight established sectoral subgroups.

Progress in dialogue is *average* both in terms of issues and priorities set by the sectoral groups and in terms of practical results. More precisely: *Positive steps* in cooperation and understanding on regulations have been made in the subgroups related to automobiles,
the textile industry, ICT, radio and telecoms, conformity assessment and standardisation.
Secondly, *Limited, or no progress,* is exhibited in the sectors of electronic equipment and machinery, pharmaceuticals (due to a limited commitment from the Russian Ministry of Health), forest-based industries, construction products (due to no appointment from the Russian side) and medical devices (because neither side has identified any urgent issues).
As Mr. Khristenko (Russian industry minister) and Mr. Verheugen (EU commissioner for enterprise and industry) considered in their July 2007 meeting in Moscow, dialogue should become more operational and lead to practical results.

In response to this guidance, the subgroups were asked to prioritise their activities by identifying the two or three most important problems facing their industrial sectors and making joint recommendations for their solution. The key priority for this policy area remains effective support to Russia for the development of technical regulations in the sectors covered by the dialogues.

As far as reinforcement of the institutional capacity of Russia is concerned, a *positive development* is the country's full partnership in CEN (European Committee for Standardisation) and eligibility to apply for associate membership in the CENELEC (European Committee for Electro-technical Standardisation), while a number of Russian organisations are members of the European Telecommunications Standards Institute (ETSI). In terms of funding, Russia risks losing €3 m in support from the TACIS programme targeting the development of technical regulations and standards, since the project has not yet been signed by the Ministry of Industry.

With regard to Russia's accession to the WTO (World Trade Organization), which is in principle accepted and supported by the EU, Brussels can gain further leverage, provided that Moscow will understand the benefits of joining WTO. To date, there are two hindrances that should be surpassed: the view within a big part of Russia's political and economic elite that adopting and adapting to WTO rules and regulations will harm the current system of monopolies in specific sectors of the economy (i.e. energy) and force them to open up their market; and Moscow's unwillingness to join WTO as a result of the August 2008 events in Georgia, given that Tbilisi's approval, which is needed, is doubtful. Europeans need to indicate to all their Russian counterparts the benefits of such development and, at the same time, use this opportunity to raise problems with export duties on timber that hurt especially Swedish, Finnish, and Polish companies. However, the recent economic crisis might have a further negative effect on Russia's willingness to become member of the WTO, in the sense that Moscow is probably looking for the creation of new more balanced global economic mechanisms that will not be controlled solely by the West.

According to Constantinos Filis and Mona Papadakou future progress in this area requires: *Integration of policy making principles and process* in the sectoral working groups, such as *prioritisation* of the industry-specific issues and problems, *elaboration* of joint recommendations for the solution of the identified problems (as already suggested) in order for the dialogue to become more *operational*; Secondly, *Promotion of commitment, participation and representation* in the dialogue from both sides, based on identified priorities. Thirdly, Raising *awareness* within the sectoral stakeholders and *enhancing consultation* on sectoral regulatory and technical issues; Fourthly, Encouraging further participation of Russian public and private organisations in standardisation institutions, initiatives and dialogues; and finally, *Utilization* of the funding opportunities in the context of the ENPI (and TACIS) through projects enabling the reinforcement of the institutional capacity of the Russian services and organization.

Public procurement

The objective of this policy area is to develop transparent, competition-based systems of public procurement at all levels including mutual access to tender databases. To this end, the CES roadmap suggests the establishment of a dialogue, which was launched in July 2006 in Moscow, where the terms of reference were also agreed. The dialogue seeks to promote the gradual convergence of Russia's public procurement regime with EU directives, increase transparency and due process, and discuss the regulatory principles of procurement .In terms of progress in this area, positive steps have been taken by Russia in the reform process and access to state tenders, but there is still the need for further amendments to the law.

The main problem of the Russian public procurement system remains the lack of transparency

Intellectual, industrial and commercial property rights

This policy area aims at the improvement of the legislative and law enforcement systems for the protection of intellectual, industrial and commercial property rights in order to enhance competitiveness and improve investment climate through the approximation of regulatory systems with the highest international standards and agreements.

Intellectual property rights (IPR) remains among the key obstacles to the accession of Russia to the WTO (Katz &Ocheltree, 2006). The most recognized deficiencies of the Russian IPR protection problem include counterfeiting and goods piracy (e.g. optical discs), Internet piracy and the legislation (Civil Code). All of these issues, including border controls, have been subject to the regulatory dialogue which was launched in March 2006, but has not yet led to specific, tangible outcomes.

Competition

The competition policy area aims at the approximation of competition legislation systems and the strengthening of implementation of competition policy by the parties. The relevant actions towards this objective include cooperation of state bodies responsible for the elaboration and implementation of competition policy, harmonization of legislation, and elaboration of common approaches to principles, including sanctions and judicial procedures, dialogue for the creation of effective informal means of cooperation in investigation of cases of infringement of competition law with transnational effect. In terms of **legislation**, Russia's new law of 2006, in which the Commission had significant input – including the incorporation of increased penalties for competition infringement in 2007 – approximates Russian legislation to EU acquis on competition. However, some differences still remain.

Cooperation of the state bodies so far includes regular meetings and dialogue between the European Commission and the Russian Federal Anti-monopoly Service (FAS), as well as participation in and organization of conferences. FAS has also proceeded into *bilateral cooperation agreements* with the Office for the Protection of Competition of the Czech Republic, the Office of Competition and Consumer Protection of the Republic of Poland, the Finnish Competition Authority, *memorandums of cooperation* with the Competition Council of the Republic of Latvia, the Competition Councils of Romania and the Office of Economic Competition of the Republic of Poland and a memorandum on mutual understanding with the Swedish Competition Authority.

Investment

Dialogue in this area has been established since October 2007, when the first meeting took place and the memorandum of dialogue was signed. The main objectives of dialogue include:

- improvement and simplification of the administrative and regulatory environment for investments;
- development of mechanisms to enhance transparency and predictability;
- discussion on the barriers to investment, identification of means for closer cooperation on the promotion;
- liberalization and protection of investments and identification of the means to enhance cooperation with relevant financial institutions.

Investment inflow in Russia has risen up to 8.3 times between 2002 and 2006, and reached €23 billion, or 3% of GDP. Net FDI (foreign direct investment) went from negative to positive in 2006, at €5.6 billion, while net FDI and portfolio investment exceeded €15 billion. By September 2008, 80% of the total FDI inflow into Russia originated from EU-based investors, while a large proportion of these flows (about one third) relates to the repatriation of Russian capital from former EU tax havens such as Cyprus, Luxembourg, the UK's Virgin Islands. In any case, the large and increasing volume of investment capital from the EU makes investment policy a necessary and fruitful area for cooperation both in terms of technical assistance and support from the EU side, as well as on a higher political level for the improvement of framework conditions for the establishment of foreign capital in the Russian economy

Financial services (banking, insurance, securities), accounting/auditing and statistics

Russia's financial system faces chronic problems related to specific deficiencies and dysfunctions of its banking system and capital market in general. The current framework imposes additional uncertainties on foreign financial companies that operate in the country, and it does not facilitate foreign investment and entrepreneurship. If there were more banks from the EU, investors would feel safer: they may well have done business with these banks before. So perhaps we should consider the partial integration of the banking system, in the sense of exchange of information between banks. This would render feasible
the facilitation of transactions between banks and citizens, as well as the monitoring system we mentioned. This might also act to limit to some extent the influx of Russian money into EU countries for laundering.

Interregional and cross-border financial cooperation

Since 1991, the European Commission has contributed €2.7 m for technical assistance to Russia facilitating transition phase. Under the new programming period and given the significantly improved fiscal position of the Russian Federation, financial cooperation will be targeted to meet specific objectives following the Roadmap to the four common spaces, and is carried on the basis of co-financing by the EU and Russia.

Trade facilitation and customs

Rapid growth in trade volume between the EU and Russia has sought for immediate actions and programmes to confront emergent problems and issues, as well as to facilitate the unhindered movement of goods and services and advance institutions and procedures. According to the World Bank's Doing Business Report for 2008, Russia still scores very poorly as far as trading across borders is concerned (Russia is ranked 155th out of 178 countries).

Trade facilitation and early warning mechanism policy dialogue and consultation were launched since August 2006. The main ***objectives*** in this area are discussion of measures having a significant impact on EU-Russia trade and agreement on measures aiming at the promotion of consultation with the business community and they are simplifying trade related administrative and regulatory environment. In addition to policy dialogue, the Commission promotes trade facilitation through ***projects*** such as the ongoing project on modernization of the transit system and the simplification of customs procedures. Customs procedures and regulatory and administrative frameworks remain a key strategic priority and significant policy area for the promotion of the CES. In terms of dialogue, the Commission is in continuous close cooperation with the Russian Federal Customs Service (FCS).

Border issues and congestion at border crossing points constitute central elements of customs cooperation, calling for effective solutions. The main reasons for border congestion are the rapid growth of EU-Russia trade, the insufficient infrastructure at some of border crossings at the EU side and burdensome procedures and inefficient customs clearance on the Russian side. The *joint strategy* agreed in April 2007 set three priorities to confront customs border issues: reforms in Russian legislation and procedures for customs, a pilot project on exchanges of pre-arrival customs information and development of border crossing infrastructures.

Energy

Energy is without doubt among the most crucial issues for the creation of the EU-Russia CES, not to say for EU-Russia relations in general. The fact that Russia is the basic energy supplier and hydrocarbon transit hub for the EU, along with the fact that the establishment of natural gas transit and supply networks called for bilateral and multilateral agreements between Russia, the EU and other non-EU countries, has necessarily brought the management of the issues related to energy to a high political level. Thus, much of the progress with reference to the declared objectives and goals is subject to political negotiations and agreements managed by governments. Disparate interpretations of the term "energy security", as well as a failure to differentiate other problematic areas – such as broader geopolitical rivalry – from energy security, have resulted in a vicious circle of standoffs and reciprocal accusations that perpetuate a climate of distrust. For its part, Russia is using this state of affairs to promote its interests around the globe, while also controlling the game at home by keeping the largest energy companies and pipelines under state control, and thus dictating the rules of competition and increasing the Kremlin's clout in negotiations with foreign investors. At the same time, Moscow wants to diversify its exports to the benefit of Asian markets, with the possible ulterior motive of playing its basic energy "partners" – that is, the EU, China and India – off against one another: Russia's stated intention of earmarking 30% of its oil exports over the next 15 years for Asian buyers, if materialized, will drastically limit its exports to the West by stoking East-West competition for greater access to Russian energy reserves, the Russian leadership essentially hopes to attract investments, but mainly on its own terms.

However, Europe today is a more favourable market for Russian gas as EU-Russia energy policy cooperation is by far the area where the EU's ability to act as a single entity against an external front is most heavily tested, while it also threatens its potential to apply a common energy strategy internally by promoting the use of alternative forms of energy. Europe, on one level, is trying to forge a cohesive, common energy policy vis-à-vis Russia, but has so far been unsuccessful, not least because a number of EU member states are very heavily dependent on Russian natural gas. In fact, the respective energy monopolies in the EU states are pursuing privileged partnerships with Gazprom – negotiating one on- one agreements and closing long-term contracts in order to secure the provision of maximum quantities of natural gas to their domestic markets – thus hindering Brussels' efforts to avert a hostage situation, in which Russia will be holding the gun. The emergence of oil- and natural gas-producing "champions" as key states in the energy community has heightened European concerns regarding state intervention in the rules regulating the international energy market. The fact that 79% of global oil production rests in the hands of state-controlled companies bears out these concerns.

Furthermore, Russia's reliance on strong bilateral energy relationships with European states further divides the EU and precludes the formulation of a common energy policy vis-à-vis Russia. On another level, Brussels is trying to persuade Moscow to open its market, as lack of investment in gas exploration and development, especially in the Far North and East Siberia, may result in Gazprom's inability to meet supply targets in the next decade, while the optimum use of gas exports by the Kremlin to pressure Ukraine and to an extent Moldova clashes with the EU's preference for their development. Russia already controls a significant portion of natural gas exports from Turkmenistan, Kazakhstan, and Uzbekistan, with an additional stake in Algeria and, potentially, Libya. The geopolitical headache for Europe now in a particularly unfavourable position is that now Iran and Qatar have been added to this list via the cartel idea. North Sea reserves are reduced, and Chinese companies have established a firm foothold in African energy assets. So, we are talking about quantities vital to satisfying European needs. Given also Azerbaijan's limited capabilities, the EU's options are dwindling. A further concern in Europe's effort to diversify its energy suppliers, namely Russia, is that the latter enjoys a comparative advantage in the former Soviet space facilitating the finding of common denominators by the political and business elite, whereas the values and – mainly – democracy that Brussels promotes are incompatible with the priorities – the rationales and practices – of the regimes in Azerbaijan, Kazakhstan, Uzbekistan and Turkmenistan. Moreover, due to the limited political presence of Brussels in the region (failure to undertake specific commitments, etc.), there is a sense among the regimes of Central Asia that at critical moments, the EU will not be there for them and that in general they will not have the full or – mainly – effective support that they would need from Brussels if they were to opt for a stand-off with Moscow. This state of affairs is more or less borne out by the case of Georgia, which looked to the US as its sole "protector" but did not receive any tangible support during the crisis of August 2008.

Dependencies concerning energy deliveries between Russia and Europe are, however, not at all one-sided. Europe is a secure, reliable, high-paying customer for Russia. Gazprom's sales to Europe account for 65% of the enterprise's revenues although in terms of quantity they represent only 35% of total deliveries. No new projects (Shtokman, Yamal-LNG etc.) have been moving forward in the energy sector for some time, as the current Russian economic model does not facilitate their implementation and Gazprom capital investment in recent years has been channelled into areas other than gas production. The rapidly growing Russian economy will increase its demand for energy, which might have delimitating effects on Russia's export possibilities, prompting it therefore also to search for additional resources – and the danger is in competition with the EU. Foreign investment and – in some cases – Western know-how is needed if Russia is to fulfil its future obligations. All this entails interdependence, but nevertheless, the downside of the situation for Moscow is that the EU will have more leverage if the partners in Brussels can reach a consensus on a clear, cohesive stance in their dealings with Moscow. Solidarity within Europe is needed (at least in a crisis situation), but it should be followed by renewed efforts to find alternative forms of energy that are friendlier to a long-suffering environment.

In view of the aforementioned state of affairs and developments, it is very unfortunate that the EU-Russia energy dialogue, in the context of the CES, exhibits limited progress as far as the objectives and actions determined in the 2005 Road Map are concerned

FACTORS INHIBITING EU-RUSSIA RELATIONS AND WAYS AROUND THEM

In contrast with the enthusiasm of the 1990s regarding the strategic cooperation between Europe and Russia, the current situation in their relations is widely perceived as a conflictual impasse marked by an increasing mutual alienation of the two parties. During the second term of Putin's presidency, EU-Russia relations reached a level of crisis. The economic agenda has been overshadowed by other international norms and geopolitical considerations. Moreover, multilateral relations (EU-Russia) have been overshadowed by bilateral relations due to the disparate interests of individual EU member states. Despite the current unfavourable conditions on the global stage, Russia's growth rate continued to accelerate in 2007- 2008, at 8.1%, while economic interdependence between Russia and the EU is rising as a result of extensive economic (trade, energy, financial) transactions. This fact renders cooperation and coordination of strategies and policies a necessary condition for the future economic progress and stability of both areas, and provides a strong incentive to overcome current impediments. From the EU point of view, the inhibiting factors are both structural and historical/psychological in nature:

The nation state actor opposed to the integration Process

The two areas are governed by different policy cultures. On one hand, Russia is an actor with a leadership and autocratic past, and on the other hand, the European integration programme has no historical precedent and is based on a liberal functionalist project. The disparate political and economic interests of the 27 EU member states vis-à-vis Russia hinder any effort to speak with a single voice. Russia prefers making agreements on a bilateral level, considering that this better promotes its own interests. This state of affairs is a strong incentive for the gradual development of a unified voice on Russia, and EU member states need to consult and share views more regularly regarding Russia in order to iron out their differences and absorb the shocks within the EU, while not externalizing their political and economic relations.

Multilateral and bilateral framework of negotiations

Some EU member states are more cautious about enhancing cooperation with Russia due to historical links. There are other member states, however, that – through bilateral agreements – have evolved into very important economic and trade partners for Russia. The difficulty is thus the issuing of joint communiqués – one that would satisfy both camps in the EU. The August 2008 events in the Caucasus are a case in point, showing how complicated it is for the EU to speak in a single voice on Russia. In the end, though, the extent of EU action in the wake of the recent crisis in the Caucasus, despite differences between member states concerning what the stance on Russia should be, might serve as a guide to relations with Russia from this point onwards. It is imperative that Europe adopts a common policy and approach so that a common perception of European interests can be formulated. A further issue that deserves careful attention is that other countries also impact EU-Russia relations. So Europe will have to follow a policy that serves its own interests exclusively, and not those of other powers.

History as a significant factor

History plays an important role, and concerns Russia and certain EU member states that have negative historical memories involving former Soviet republics. It is of particular significance that this issue has been intensified by the recent events in the Caucasus. Russia's aggressiveness heightened concerns as to its real role and its credibility. Regardless of whether some countries take a more practical approach to their relations with Russia, it must be made clear that respect for Europe's basic principles and values – as well as the creation of a regulatory framework – is necessary if the present climate of suspicion is to be reversed so that an atmosphere of trust between the two sides can be cultivated and developed.

It is quite apparent that countries once within Russia's sphere of influence are trying to reduce their overall dependence on Russia, whether in the political, economic or trade sectors. In contrast, there are other states that are moving in the more realistic direction of ensuring their interests on a purely practical level, free of ideologies and historical complexes. The American factor also plays a decisive role and cannot be ignored. The designations of "New" and "Old" Europe coincide precisely with autonomous partners or dependent variables in Euro-Atlantic relations. The inhibiting parameters for the Russian side set out below create incalculable losses for economic cooperation at a time when the Russian market could well offer its vast potential to attract foreign investments. Many of the factors below discourage European investments.

State protectionism that seals off certain markets

As Russia operates as a state actor, its protectionist structures are more effective and greater in number that those in the EU multilateral framework, wherein every move is the product of glacial intergovernmental negotiation. In the energy sector, as well as in other vital sectors of its economy, Russia has imposed state control, discouraging investments. Certain strategic sectors of the Russian economy are closed markets, and are thus not open to foreign direct investment. One example is Yukos: forced into bankruptcy, the company's assets were used to benefit Rosneft and Gazprom, the two Russian energy giants.

Economic patriotism inhibits the potential for investment by the EU or other countries in these strategically important sectors. Such Russian practice has the collateral impact of depriving Russia of the investment capital needed to optimise the performance of these sectors. As the demand side of the energy market seems to be more dynamic than the supply side, Russia is gaining new confidence as fossil fuels are the source of both increased revenues and geopolitical leverage. Russia not only refuses to comply with European demands concerning the opening of its energy market, but is also making an aggressive effort to secure its interests in the corresponding European market. Russia needs to open its markets, but the EU has first to persuade Moscow that it does not aim to control the strategic sectors of its economy. Economic relations in all sectors have to be built on a framework of mutuality.

The normative environment

Due to the lack of a regulatory framework and transparency prevalent in the Russian market, the ease or difficulty with which investments can be made depends on personal relationships. Local or regional approval of a given investor suffices for investments to be made. But in the marketplace, healthy competition requires rules. Most transactions and deals are made via informal and/or interpersonal relations. The issue at hand is the virtual annihilation of any risk factor calculation due to the normative unpredictability of the market. The economy's dependence on specific persons rather than on institutions inevitably creates a climate of uncertainty and insecurity for the investor. At this juncture it is important to point out that while there is no system of rules for investments there is another system (within circles of Putin's network) that has absolute control over investments. Unfortunately, it is clear that while there are a host of investment opportunities, the politicization of business perceptions and the centralization of the Russian economy by the political system are undermining the country's potential. The attack on Yukos and its owner, Khodorkovsky, for example, was presented as a crackdown on the oligarchs. "Yet it created a new, more powerful and less visible caste that began to play a dominant role in the economy. The share of crude-oil production controlled by state and semi-state companies doubled. Growth in oil output, which before the Yukos affair had been running at about 9% a year, slowed to just 1% by the end of 2007" as mentioned in the article Smoke and Mirrors.

The new Russian president Dmitry Medvedev supports the imperative need to free the Russian marketplace from ideology and accept more free market regulations, and this is very encouraging, especially if he succeeds in achieving political independence. Medvedev's liberal views are typified by something he said in a speech to the East Siberian Krasnoyark Economic Forum on 15 February 2008: "Russia in the next four years should focus on four I's: institutions, infrastructure, innovations, and investment."

Informal or black economy and corruption

Problems present in the legislative and other regulations (import duties, import licences, certification, border duties, etc.) and the lack of cash flow and information for enterprises, result in a bad business climate. Other inhibiting factors include widespread corruption, bureaucracy, and intervention in the juridical system, lack of technical and manufacturing infrastructure, an underdeveloped wholesale and distribution network and a prevailing lack of trust in institutions the CES project. Market developments and actors, on the other hand, can tangibly influence the priorities, as well as the constraints, in this process. Increasing interdependence between the two economies exercises additional pressures for development and progress in economic policy and cooperation. The EU and Russia are already economically interrelated due to the high and increasing flows of energy, goods, services and capital. To a large extent, the two economies supplement one another. Russia needs Europe's investments, technology and markets, and Europe needs Russia's energy supply and market, while both seek energy and security. Europe pays the highest prices for Russian energy products and is the source of a large portion of Russia's revenues. Political will and commitment in Russia for the promotion of the necessary structural and institutional reforms will determine the velocity of movement towards meeting the targets set for both countries under the CES programme.

Russia's incorporation into multilateral structures may also function as a platform for governmental reforms. Russia's accession to the WTO will mean monitoring of its financial and currency mechanisms. In order to gain the greatest possible benefits from international partnerships and cooperation, Russia needs to further liberalise its economy and improve the existing legal and institutional system, dismantling lawlessness and discretion.

Common Economic Space & EU Financial Tools for Russia

At first sight bilateral trade and investment relations between Russia and the EU are making great progress in the last few years. Russia's share in the EU27's total external trade in goods doubled between 2000 and 2008. In 2008 Russia was the EU27's third most important trading partner after the USA and China, accounting for 8.0% of EU27 exports and 11.4% of EU27 imports (see Table 1). The EU27's 2008 trade deficit in goods with Russia was 72,816 million EUR, hence almost double that of 2000. However, a positive from the EU27 side is that exports were growing more intensely than imports from Russia. The increase in bilateral trade was continuous, whatever the political situation and bilateral relations between the EU and Russia were. Even during the year of Russian- Georgian conflict trade was growing. Only the global financial and economic crisis changed that positive tendency and the first half of the year 2009 shows the first year-one year decrease of trade in the last 10 years. One can conclude that politics and security issues do not have any strong influence on the trade, but that is not true. Especially when we compare statistics since the beginning of the Common Economic Space initiative with before, it seems that the positive first moments of the initiative helped businesses to strengthen the cooperation. Unfortunately, the positive signals are slowly changing in the last 2-3 years and the current political "crisis" can also have negative effect on business and trade. So the question of what to do with CES initiative is very urgent today. If the EU wants to break the "thickening ice" in political and security relations with Russia support for the CES is of critical importance. Because nowadays both of them, the EU and Russia, are thanks to the growth of trade and investment very dependent on the trade and business sectors, not to speak about the special "dependence" in the field of energy. Such dependence is obvious from the product structure of their bilateral trade. Half of EU27 exports to Russia in 2008 were machinery and vehicles and another quarter were other manufactured articles, while energy accounted for two thirds of imports. To spell it out, the main EU27 exports to Russia included motorcars, medicine, mobile phones and aircraft , while the main imports included oil, gas and coal. Both sides are also becoming more dependent in the area of investment. EU27 Foreign Direct Investment (FDI) in Russia has grown in recent years, rising from 10.8b EUR in 2006 to 21.6b EUR in 2008, while Russian direct investment in the EU27 increased from 1.4b EUR in 2006 to 9.2b EUR in 2007, but then because of World financial and economic crisis turned to disinvestment of 0.4b EUR in 2008. Even not speaking about the global financial and economic crisis, there are many problems in economic relations between Russia and the EU. Worsening of political relations especially has already had negative impact on economic relations, e.g. in the area of investment, and many investors and businessmen are uncertain about current development of relations and political and economic stability. And the worst is that the CES initiative is also suffering from the freezing of political relations. Even since May 2003 (the St. Petersburg EU-Russia Summit) the EU and Russia are trying to find ways for closer cooperation, with the main idea being the creation of an open and integrated market between the EU and Russia on a very broad scale with the ultimate goal of a free trade area. Today, however, we can conclude that creation of the Common Economic Space between Russia and the EU is going very slowly, and a free trade area seems to be a more distant reality these days than it was a few years ago. There are several reasons to draw such a conclusion. Firstly, since the beginning of the process Russia has been slow to respond to EU proposals for implementation of the CES road map, probably due to a reluctance to move fast in areas implying economic liberalisation and probably also due to a different view of the whole process. The EU's expectations were probably had too optimistic, while Russia began to be cautious and perhaps afraid of losing control of the process. It was probably also due to the unpreparedness of Russia's political elites and also its state administration for reforms and for sharing/implementing "western values" in Russia. The EU is aware of the slowdown of the process, e.g. a*ccording to the EU-Russia common spaces progress report (2007)* "some progress is being made on various facets of the regulatory dialogue, and discussions are ongoing on agriculture, fisheries and veterinary issues. But progress in other areas is not seen." Secondly, the EU connected a lot of the agenda under the CES to Russia's accession to the WTO as the EU hoped that the bilateral trade agenda would be mainly determined by Russia's WTO accession and the corresponding bilateral and multilateral commitments to liberalisation. But Russia's real interest in joining the WTO is doubtful and the prospect of Russia's accession to the WTO is still not clear even today. Not to speak of Russia's current initiative to create a customs union with Kazakhstan and Belarus that could even delay its WTO integration process for many years. So there is real question if the EU is not being too naïve in just waiting for Russia's WTO accession. Uncoupling the CES process and WTO accession could in today's situation be a positive move. Even if Russia creates a custom union with Kazakhstan, Belarus or even with Ukraine, that could be a good move towards a regional approach of creating the CES not only with Russia, but with the whole region located to the east of the EU. Thirdly, a weakening of the mutual trust on both sides is evident, and not only in politics. Russian policy-makers have announced on many occasions that the diversification of the economy is one of their major objectives, and that they will continue to pay attention to establishing a more predictable and transparent environment for business and investment. However, Prime Minister Putin and the Russian state apparatus is continuing to reassert more state control, both direct and indirect, over the economy, especially in strategic sectors such as energy, aluminium, steel, automotive, machine tools and aerospace in the last years. And the risk is that the current and already palpable tendency towards state control of the strategic sectors of the economy will be extended to the more dynamic sectors. Not to speak of the negative experience in the energy crises of 2006 and the beginning of 2009 that raised many questions of Russia's policy making and coupling foreign policy aims with business.

Fourthly, the EU is rather too optimistic in its approach based on the assumption that Russia needs the EU. Of course, the EU is an important market with its imports of raw materials, notably energy. The EU is also a major investor in Russia, accounting for almost 80% of cumulative foreign investment, giving the EU an important interest in the continuing development of the economy, and the EU also hopes that Russia will need European investment even more in future, given Russia's quest for diversification and modernisation. The recent financial and economic crisis has underlined how acutely Russia needs to modernize and diversify its economy. But there are also other players especially China, the USA, and rich "oil" countries that compete with EU investment in Russia today.

Fifthly, until today EU-Russia business cooperation (as well as EU programmes in Russia) faces some major barriers that are related to the low accessibility of the Russian market, e.g. government bureaucracy, the poorly established rule of law and corruption affect such areas as establishing a business, tax collection, dispute settlement, property rights, product certification and standards, as well as Russian customs clearance. But it's evident that is very difficult to incorporate topics like corruption, rule of law in the political dialogue between the EU and Russia, not to speak about Russia's (un)willingness to carry out reforms in these areas. A similar area is environmental issues, though the EU-Russia summit on 18 November 2009 made some positive progress in the climate change agenda.

Last, but not least, is the structure and progress within the current dialogue. The Roadmap on the Common Economic Space that was adopted at the EU-Russia Summit in Moscow on 10 May 2005 set out a number of principles and priority activities/dialogues on the following trade-related issues: Investment dialogue, IPR dialogue, Public Procurement Dialogue, Regulatory Dialogue on Industrial Products and Industrial and Enterprise Policy Dialogue, Energy Dialogue, Competition Dialogue, Macroeconomic and Financial Services Dialogue, Trade Facilitation and Customs Dialogue. Most of the dialogues are based on the idea that Russia is encouraged to align its legislation with the EU acquis where appropriate and to take measures to facilitate trade in general. Russia is also encouraged through the dialogues to improve its investment climate and customs matters as well as to implement convergence with EU standards in many areas.

However, progress is very slow and some dialogues have very weak results. The idea seems to be very good: transferring of norms, standards, know-how to Russia should little-by-little introduce a new managerial and business culture to the Russian economy and everyday life, and so help Russia transform herself. The problem is how to speed up the process and how to assure Russia's politicians that Russia will benefit from it. The EU made some positive changes in the last years in its approach to Russia and it is a positive sign that Russia was more deeply involved in the programming of the EU policies towards Russia. It also seems that the priorities that are set up are well targeted. The EU Country Strategy Paper for Russia (2007-2013) stated these specific objectives within the CES:

• bringing down barriers to trade and investment, trade facilitation (including customs aspects);

• enhancing the competitiveness of EU and Russian enterprises;

• boosting cooperation on energy, energy efficiency and transport;

• improving protection of the environment, including against radiation, and maritime safety;
• tackling climate change, in particular through the Kyoto Protocol;
• reinforcing principles of non-discrimination, transparency and good governance through the promotion of political and economic reform;
• developing cooperation in outer space (including satellite navigation);
• introducing measures to support regional development, notably in areas with an urgent need for recovery.

All these priorities are surely very important. But the problem is with the implementation. The EU should look for ways to help Russia to improve implementation o agreed policies and measures. And the EU should also look for ways to motivate Russia to be more active and more involved in the whole process. Perhaps the EU should focus today on areas that are not so controversial and try to open doors by focusing on areas where there is a common positive attitude. Such an area could be dialogue on regulation.

Chapter 3

Cooperation in the energy sector. The Russia-EU Energy Dialogue.

Russia is the EU's biggest neighbour. The EU is Russia's most important trading partner and source of foreign investment. Yet EU-Russia relations have often suffered from discord over contentious issues such as trade quotas, rules on visas, the Kaliningrad enclave or human rights in Chechnya. So it is all the more important for both sides to identify areas of common interest. Energy is such an area. Russia sends more than half its oil and gas exports to the EU – which in turn relies on Russia for about 20 per cent of its gas and 17 per cent of its oil

The EU and Russia acknowledged the importance of this mutual dependency by launching a bilateral energy dialogue at their Paris summit in October 2000. The purpose, according to that summit's communiqué, is "to raise all issues of common interest relating to the [energy] sector, including the introduction of cooperation on energy saving, rationalisation of production and transportation infrastructures, European investment possibilities, and relations between producer and consumer countries." Chris Patten and Pascal Lamy, external relations and trade commissioners respectively, have suggested using the EU-Russia energy dialogue as "a blueprint for wider relations".

Russia's reserves also contribute the EU's energy security by enhancing the diversity of its supplies. Russia is considered important as an alternative source to potentially unstable Middle Eastern suppliers.3 This benefit of having Russia as an alternative is further supported by Russia's strong record as a reliable supplier to the EU, even during the Cold War (Monaghan,2004)

And a reciprocal relationship has indeed developed, whereby the EU-25 today imports 50% of its gas from Russia and 30% of its oil. More than 50% of Russia's energy exports go to EU, which has provided a large share of Russian income. This mutual relationship, particularly in terms of gas, is expected to grow.(Monaghan, 2004).

The progress of EU-Russia energy dialogue has been slow in the last decade. Out of the many reasons attributed to this the most important being energy is hugely important for the Russian economy. Even a government as reform-minded as that of President Vladimir Putin treaded carefully when it came to energy market reform. Second, the EU-Russia energy dialogue involves a host of participants that do not always see eye-to-eye. The Russian government and the EU may agree on the importance of bilateral co-operation. But the key players in this field are private or state-controlled companies that often have their own agenda. Third, the energy dialogue is not only, or even primarily, about country-to-country sales of oil and gas. It has many implications for national economic policies, in particular energy market liberalisation. Last but not least, the question of energy sector reform has become intertwined with other EU-Russian negotiations, in particular the ongoing talks on Russia's accession to the World Trade Organisation (WTO) and the fate of the Kyoto Protocol on climate change.

Trends over past decade have shown that the EU used both the WTO negotiations and the energy dialogue to push Russia to open up and deregulate its energy markets. At present, the gas market, including export pipelines, was entirely dominated by the state controlled gas giant, Gazprom, while the electricity market was in the hands of the UES power company. The Russian government was, in principle, committed to reforming both 'natural monopolies' by separating the production side from the transmission and distribution of energy.

EU's interest in Russian energy market is backed by several reasons. First, energy prices in Russia are only a fraction of their world market levels. The EU argues that this gives Russian exporters an unfair advantage, notably in energy-intensive sectors such as aluminium or fertilisers, and that therefore Russia should not join the unless it is prepared to raise energy prices. The issue of energy prices has become the biggest bone of contention in the negotiations over Russian membership of the WTO – and since the EU is Russia's biggest trading partner, it has considerable influence over the progress of those negotiations.

The second reason why the EU is pushing Russia on energy market reform is that there is a growing mismatch between the EU's own efforts to liberalise its energy markets and the supply of Russian gas through a monopolist, namely Gazprom. EU countries have committed themselves to fully liberalising their energy markets for industrial users by 2004 and for households by 2007. However, Russia supplies its EU customers under long-term supply contracts, many of which contain so-called territorial restriction clauses: even if one EU country receives more gas than it needs, it is not allowed to sell it on to its neighbours. The clauses are in breach of EU single market rules. They allow Gazprom to sell gas to different

EU countries at different prices, and they prevent the EU from developing a functioning EU-wide gas market. The Commission has been negotiating with Gazprom on this problem and reports some progress.

A third reason is that the EU fears that as long as Gazprom remains in sole charge of Russia's gas, Russian supplies may not keep up with rapidly growing EU demand. Gazprom's output has been more or less flat for the last decade, as the company has failed to invest sufficiently in the development of new gas fields. Meanwhile, Russia's privately-owned oil majors sit on huge gas fields that they do not exploit commercially because Gazprom does not allow them access to lucrative export markets(Grant and Barysch,2004).

Russia's Hydrocarbon Resources & Their Sustainability:

Russia's discovered and projected reserves are considered to be among the largest on earth, Russian gas reserves are calculated to be approximately 47 trillion cubic metres; a quarter of the world's total; estimates suggest oil reserves in excess of 100bn barrels (Grace, 2005). High expectations about Russia's capabilities as an energy producer have been further raised by a major increase in production and export since the late 1990s, particularly in oil. The IEA projects that Russian production will be approximately 10.4mbpd in 2010 and 10.7 in 2020 – the Russian Energy Strategy projects 8.9-9.8mbpd in 2010 and 9.0-10.4 in 2020. For gas, the IEA projects that Russian production will be 655 billion cubic metres (bcm) in 2010 and 801 in 2020. Again, the Russian projection is lower, however: at 555-665bcm in 2010 and 680-730bcm in 2020 (Kim, 2005).

In fact, Russia's ability to continue to produce and export gas is a source of concern. There is a mounting concern on high dependence on small number of very large fields. it does mean that the energy sector is fragile and vulnerable to accident. Given this dependence on a few large mature fields, some predict the quick depletion of Russian oil and gas reserves. Gennadi Shmal (2005) stated that Russia's energy exports are in danger and soon Russia will lose its export capacities. He mentions that the only solution lies in establishing a wide programme of geological exploration and tapping of new deposits.

The EU-Russia Energy Dialogue:

The EU-Russia energy dialogue was launched on the initiative of Presidents Chirac and Putin and the then-Commissioner Prodi, in the recognition that Russia and the EU are natural partners with mutual interests in the energy sector and continental energy security. The objective was to provide a forum for the discussion of all questions of common interest in the energy sector and bind Russia and the EU into a closer relationship. Working groups have met regularly to address energy strategies, technology transfers, investments and energy efficiency. A Technology Centre was established in November 2002 for the exchange of information and the promotion of new energy technology to support Russia in accelerating the development of the oil and gas sectors.

The UK presidency of the EU Council during the second half of 2005 sought to prioritise the energy dialogue and add new dynamism to it. Plans and aims were agreed and a framework for the achievement these plans established at a Permanent Partnership Council (PPC) meeting, held on 3rd October 2005. This imbued the dialogue with more structure, broadening it to include a wider set of interlocutors with vested interests, including business and political authorities from both Russia and the EU. These are represented in four thematic groups, focusing on investment,
infrastructure, trade and energy efficiency. Officially, the dialogue is considered to have produced positive results acting as a problem solving forum and opening the way to European investment in the Russian energy market.

Political Problems in the EU-Russia Energy Relationship :
Outside the specific energy dialogue the relationship is beset by a lack of confidence on both sides. Indeed, diversification, one of the key tenets of energy security, may begin to undermine the EU-Russia relationship, as both seek to diversify away from each other in an effort to enhance their energy security. On the EU side, two main problems lie behind the calls for greater
diversification of hydrocarbon supplies, particularly away from Russia. First, some have argued that the EU's dependency on Russian energy undermines its ability to negotiate with, and particularly to criticise, Russia.(Hill, 2005). The argument runs that whatever

reservations they may have about political developments in today's Russia, the Europeans have a "strong incentive to be tactful" because of its energy dependence on it.
Second, unease has been voiced in many quarters that the EU could find itself increasingly at the mercy of an ever more authoritarian Russia which might use its control over a large share of the EU's energy imports as a diplomatic lever by threatening to turn off the taps to blackmail it. Such anxieties have been aggravated by the comments of some prominent Russians about Russia's rise as an energy superpower and the benefits accruing to Russian foreign policy by dominating the energy sector.

Problems also plague the EU-Russia dialogue on electricity. Russia is increasingly keen on linking its own electricity grid to that of the enlarged European Union. This would enable UES, the electricity monopoly, not only to sell surplus electricity to EU consumers, but also to make up for temporary shortages in its own market by importing power from the EU. .(Barysch, 2004) The EU says that in order to sell into the European market, Russia must apply EU-level standards of competition, nuclear safety and environmental protection – which of course it does not – and that it must get rid of the 'unfair' subsidy that UES receives in the form of cheap Russian gas from Gazprom

The dialogue on oil is less politically charged, partly because Russia has already privatised and liberalised its oil industry. Here, discussions focus mainly on how to attract EU investors to the Russian oil sector. The EU has long pushed Russia to establish a workable framework for production sharing agreements (PSAs).

These are commonly used in emerging market economies to make the legal and tax environment safe for large-scale investments in natural resources. The absence of a functioning PSA framework is only one reason for the dearth of foreign involvement; potential foreign investors are deterred by uncertainty over property rights, while among Russians there is widespread hostility to the idea of selling the country's riches to foreigners.

Another obstacle to private investment, not only in oil but also in the gas sector, is the state's firm grip on pipelines. Transneft, the state owned oil pipeline monopolist, has failed to invest enough in new export pipelines to keep up with rapidly rising oil output. Russia's oil majors are complaining that lack of pipeline capacity is impeding their plans for expansion and investment.

From the EU's perspective, the lack of investment and openness in the Russian energy sector is worrying The EU predicts that by 2020 it will need to buy an additional 300 billion cubic metres of Russian gas a year, to meet growing domestic demand. But Russia's own energy strategy foresees additional sales to the enlarged EU of only 30 billion cubic metres a year by 2020, while it projects increasing amounts of gas going to the fast-growing Chinese market and the US. The EU therefore has a large stake in the development of the Russian energy market. The two sides have identified a number of projects of 'common interest', such as the development of the giant offshore Shtokman gas field in the Barents Sea, and a new gas pipeline under the Baltic Sea.(Roland, 2004). But so long as the Russian state retains a firm grip on the sector there is unlikely to be a great deal of fresh investment from EU companies.

There are several possible reasons why progress under the energy dialogue has been slow. First, the dialogue has become intertwined with other EU-Russia negotiations, in particular the WTO accession talks and Russia's refusal to ratify the Kyoto protocol. Second, the EU-Russia energy dialogue involves a host of participants that do not always see eye to eye. The Russian government and the EU may agree on the importance of bilateral co-operation. But the key players in this field are private or state-controlled companies that often have their own agendas. Third, the energy dialogue is not only, or even primarily, about country-to-country sales of oil and gas. It reaches deep into national economic policies, and in particular presses the Russians on energy market liberalisation. It is yet another example of how mutually beneficial co-operation is perceived as intrusive by the Russian side(Barysch,2004).

The energy sector is central to the future economic security and development of both Russia and the EU, and is a central element of the EU-Russia relationship. It is a dimension that is of real importance, rather than concocted political desire. It would severely undermine the energy security of both the EU and Russia if the relationship began to drift apart in the search for more superficially reliable sources. Concerns about Russia's reliability cannot be dismissed out of hand. But problems must be more accurately pin-pointed. It is of real importance that the language moves away from notions of "dependence" on the other and producer vs. consumer: the relationship is a mutual one, with benefits as well as down-sides for both(Monagham,2005). Continued effort must be made by both sides to establish and develop the dialogue and confidence building measures and also the economics and technicalities of the relationship and broaden the range of those with a vested interest – both business and state – to enhance its progress.

Energy is the challenge and the solution

Russia is today the EU's foremost external supplier of oil, gas and coal. This relationship between close neighbours is entirely logical and mutually beneficial, given the substantial energy reserves in Russia and the reliable and growing market in the EU for imported energy. Clearly any relationship between close neighbours has its ups and downs, and it is evident that the recent past has not been one of the easiest periods in EU-Russia relations. The energy sector is both a key part of this challenge and a major part of the answer.

The responsibilities for the recent bumpy patch are shared. Within Europe, there are those who criticise Russia for an alleged strategy of 'disaggregation' – striking bilateral deals with individual EU member-states – in an attempt to prevent the development of a common EU energy policy. However, in reality, Russia has been exploiting the inability of the EU member-states to speak with one voice. Russia's perceived strategy is in fact the mirror of the EU's weakness, not the cause of it.

For the EU, the key to its security of supply is market integration and solidarity. Individual EU countries would worry a lot less about their dependence on Russian supplies if there was an effective integrated EU-wide energy market, with all the necessary physical interconnections to encourage a policy of full solidarity.

Indeed, the solidarity principle is one of the cornerstones of the Lisbon treaty and applies specifically to the energy sector The EU is fortunate to be surrounded by three of the current major gas exporters – Russia, Norway and Algeria. But reserves for future production of natural gas are mainly concentrated in Russia and the Middle East. Therefore, Russia is and will remain our key supplier. However, the challenge is to bring Russian gas to the market.

Russia's reserves are geographically distant from markets – be they European or other – and are located in climatically, if not geologically, challenging environments. This necessitates huge capital investment and it is here that the EU has major concerns. The concern is about Russia's ability – not willingness – to deliver sufficient quantities of gas to the EU in the future. The Europeans worry about a forthcoming supply crunch, given the very significant growth in internal Russian gas consumption and a perceived lack of investment to develop new production sites.

By 2030, gas imports into the EU could rise by another 200 billion cubic metres (bcm) a year, from around 300 bcm today. At the same time, the most recent forecasts from Russian experts are for an increase in gas exports of some 100 bcm per year by 2030 to all destinations, including Asian markets. Given these unavoidable physical limitations and given that a reasonable diversification of supply and demand is always, in all sectors of the economy, a prudent policy, the EU is looking to diversify its supply sources for the necessary additional quantities from countries such as Egypt, Qatar, Nigeria and Libya. This does not mean that, in practice, the EU wishes to diversify away from Russia, it is just to ensure that future demand is fully covered. Natural gas has been a lynchpin of the EU-Russia relationship for many decades and will remain so.

For Russia, the revenues from its gas exports to the EU, along with that of its oil exports, have been fundamental in underpinning the rapid economic growth of the past few years.

For the EU, the 42 per cent of gas imports and 30 per cent of oil imports that originate in Russia clearly underpin Europe's energy security and sustain its economic growth. Hence the rationale for a deep strategic energy partnership. Energy can be a tool for integration and not a weapon that feeds distrust and opacity. One often hears both in the EU and in Russia that more 'reciprocity' is required. Unfortunately, this term means different things to different people. In Russia, it means equality in end results, that is to say, asset swaps of equivalent financial or commercial value; for the EU, it means commonly agreed principles and access to markets and investments – a level playing field, with the end result being left to free competition. So for the EU, reciprocity in the Russian sense of asset swaps can be a step in the right direction but not an end in itself. A recent example of this difference of approach can be found in Russia's new law on foreign investment in strategic sectors.

While clarifying the investment situation, there is a risk that the overly restrictive nature of the law with respect to third country companies could result in a slowing down of foreign investment in the Russian oil and gas sector. If energy output declines as a result, the loser will not just be the EU consumer and EU companies, but also the Russian state and Russian citizens who will not reap the full benefit from taxes and other revenues resulting from the current high international hydrocarbon prices.

Increasing interdependence between the EU and Russia on the European continent is natural and should be evaluated positively in the light of security of supply and security of demand, but it has to be balanced in terms of market access. Turning to the issue of energy infrastructure, Russian and European companies have undertaken several important projects designed to enhance our common energy security. These should not be seen as competing projects bearing in mind the additional gas imports that that the EU will require. There should be enough gas demand for all of them – the question is whether there are sufficient supplies. One of the most contentious is the Nord Stream gas pipeline, which is expected eventually to transport 55 bcm of gas by 2015. The results of the environmental impact assessment under the ESPOO convention9 should answer a number of the concerns that have been raised about this pipeline. But it is also important to project clearly where the gas to fill the pipeline will come from. The gas must not be diverted from existing pipelines so as to avoid giving any impression that Nord Stream will give Russia commercial or even political leverage over the current transit countries. Linking Nord Stream more clearly to the development of Shtokman (a giant, as yet undeveloped gas field in the Barents Sea), for example, could go some way to allaying these concerns. But there are several other unresolved questions surrounding infrastructure. An example is the supply of oil through the northern Druzba pipeline to the Mazeikiu refinery in Lithuania, which Russia cut off in mid-2006. The impression has unfortunately also been given in several instances that Russia has taken some decisions on infrastructure in a pre-emptive manner and not always according to purely commercial, environmental or safety criteria.

The achievements of the Energy Dialogue

All these issues are discussed in an open way in the framework of the EU-Russia Energy Dialogue, including in the three thematic groups where the EU member-states, the Russian government, industries from the EU and Russia, and the Commission all play a crucial role.

Some experts have suggested that there is a lack of progress. To answer this comment, it is important to begin by underlining that the dialogue is pragmatic. It adopts a bottom-up approach in identifying key issues of common interest that can be built upon.

There are no big political declarations, but work is being done and steady progress is being achieved. The Energy Dialogue's list of successes is much more extensive than this. It has contributed to: Russia's ratification of the Kyoto protocol – a major success given that without the ratification of Russia, Kyoto would not have come into force; enhancing maritime safety for the transportation of heavy oil by tanker; solving competition problems. In particular, the EU and Russia, while recognising the value of long-term contracts for gas as essential for securing project financing and guaranteeing future demand, have suppressed the competition-restrictive territorial destination clauses; re-emphasising the fact that there are no quantitative limits for imports of Russian fossil fuels into the EU; comparing energy strategies to understand likely future supply and demand trends, and achieving a closer synergy of policies and measures; promoting contacts and exchanges between the EU and Russian energy industries; co-operation through workshops and seminars on subjects such as gas flaring reduction, renewable and energy efficiency; completing the feasibility study on linking the European UCTE electricity grid with Russia's EPS/UPS grid; and establishing regular 'permanent partnership councils' on energy in the framework of the Partnership and Co-operation Agreement.

Therefore the EU and Russia are mutually dependent in the energy sector. The structure of the overland energy transportation network on the European continent is a clear attestation of this fact. And this will not change. Russia will remain the key energy exporter into the EU and the EU will remain the key energy market for Russia.

Chapter 4

Dutch Disease

From 1999 until the 2008 financial crisis, the improvement of the economic situation in Russia was impressing. GDP growth averaged 7% per year in real terms, consumption increased and the unemployment rate steadily fell. This economic record was driven by rising resource prices that led to windfall gains of export revenues. There is, however, the fear that the Russian economy may become too dependent on the energy sector and not sufficiently diversified. This perceived risk influenced the monetary policy, which aimed at preventing the nominal appreciation of the rouble by accumulating foreign exchange reserves.

Many countries endowed with natural resources suffer from the Dutch disease. On the one hand, the increased profitability in the resource sector due to higher resource prices attracts labour and investments out of the manufacturing sector. Hence, the sectors linked to natural resources, as well as the services sector, for which the demand increases in response to higher income, become more attractive. On the other hand, the propagation of increases wage across all sectors as well as the increased demand for the domestic currency and the resulting appreciation of it make the manufactured goods more expensive and, hence, less competitive in the home and world markets. Both effects contribute to a de-industrialization process that makes the economy extremely dependent on the resource sector and may reduce the growth potential

After the 1990s, marked by disorganization of the economy and the crisis of 1998, the macroeconomic stabilization and the improvement of the economic situation have been impressive. From 1999 until the financial crisis of 2008, GDP growth averaged 7% per year in real terms, while consumption was also increasing, and the unemployment rate was steadily falling.

According to IMF and OECD forecasts despite a slowdown of the economy related to the international crisis, GDP is expected to grow again from 2010. For Russia, this generated a windfall rise in export revenues and a huge inflow of 'petrodollars'. This created an upward pressure on the domestic currency and, therefore, over the last years the main goal of the

Russian monetary policy was to prevent the nominal appreciation of the rouble. Vdovichenko and Voronina (2004) found empirically that after 1999, the major efforts of the Bank of Russia were aimed at affecting the exchange rate smoothness and level, rather than the inflation rate. Moreover, as claimed by Dobrynskaya (2008), monetary policy in Russia was asymmetric, with appreciations smoothed while depreciations were accommodated. The Central Bank of Russia itself admitted officially in its policy guidelines that over the recent years it "constrained rouble appreciation in order to help maintain the competitiveness of Russian goods on international and domestic markets" and that "the policies of the Bank of Russia and the Ministry of Finance (the administrator of the stabilization fund) throughout the period 2000-2005 kept the rouble's value 8.5% cheaper than its equilibrium value".

In order to prevent the appreciation of the rouble against a basket of currencies, the Central Bank of Russia accumulated foreign currency reserves. The resulting growth in the money supply, although partially absorbed by the stabilization fund, contributed to high inflation in Russia. Moreover, as the US dollar was depreciating against the euro, to maintain the basket, the rouble depreciated against the euro in nominal terms. This contributed to imported inflation, as the Euro area is a major exporter to Russia. In recent years, such policy led to a large real appreciation of the rouble instead of nominal appreciation. This is illustrated in Figure 2, which presents the dynamics of the real and the nominal effective and bilateral exchange rate indices of the rouble until 2006 (normalized to 1 in January 1999).

The rationale for the exchange-rate targeting, as claimed by the government and big monetary authorities, was to maintain the competitiveness of the domestic manufacturing industries. The common belief that rouble appreciation in nominal terms, leading to higher export prices, might result in a slower and insufficiently diversified economic growth in Russia, being excessively dependent on the energy sector, is the main official reason why the Central Bank of Russia pursued this policy.

Empirical research does suggest that countries with large natural resource wealth tend to have a lower long-run real GDP growth than comparable countries without natural resources, and that they may suffer de-industrialization driven by a loss of competitiveness in manufacturing industries due to the appreciation of the domestic currency. Sala-i-Martin (1997) and Doppelhofer et al. (2004) perform empirical tests of cross-country data and classify natural resources as one of the most robust variables which negatively affect countries' economic growth. Sachs and Warner (1997) also find a negative relationship between resource abundance and growth, which applies more to oil than to other natural resources. However, their panel includes many countries with political instability or other governance issues, which could also explain the lack of economic growth.

As observed in a number of resource-exporting economies, an exogenous rise in resource prices leads to a windfall increase in export revenues that creates pressure on the value of the domestic currency. In turn, manufacturing declines. This phenomenon is known as the Dutch disease.

The fear that Russia may suffer the Dutch disease and the uncertainty concerning the possible impact of the rouble appreciation on production and employment in the domestic manufacturing sector are the main reasons for the significant foreign exchange interventions by the Russian Central Bank.

The Dutch disease hypothesis states that higher wages in the resource sector attract labour from other sectors, thus reducing employment in the manufacturing sector. This may be accelerated by a loss of competitiveness in the manufacturing.

One of the factors that contributed to such an improvement is the situation in the world market for natural resources. After a plunge in 1997-1998, the crude oil price showed a significant upward trend with the resulting increase from 10 to 100 US dollars per barrel between 1999 and 2007. Since then, the price has been highly volatile, but it still remains significantly higher than at the beginning of the 2000s.

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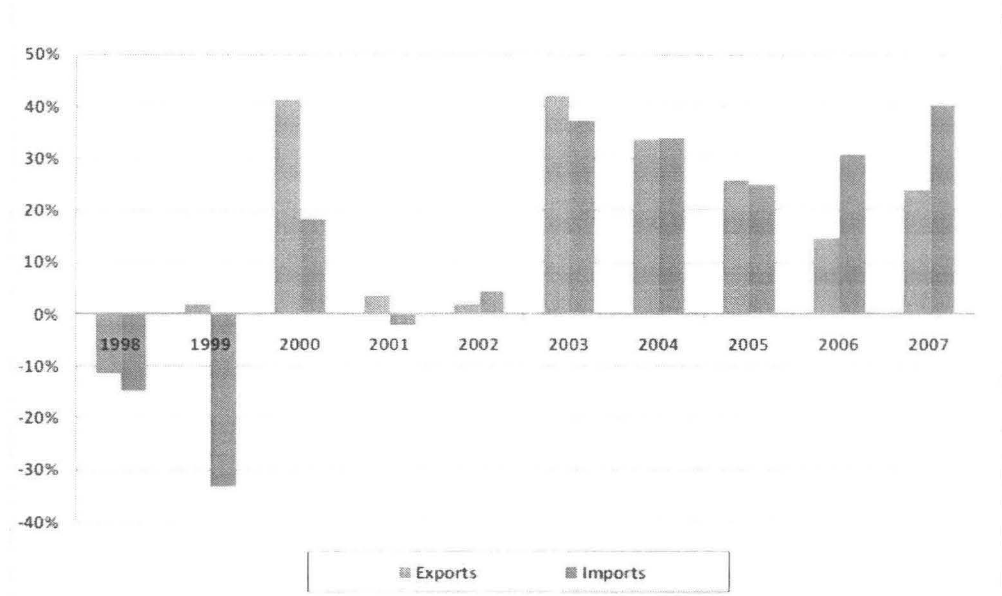
possible impact of the rouble appreciation on production and employment in the domestic manufacturing sector are the main reasons for the significant foreign exchange interventions by the Russian Central Bank. Several papers have tried to determine whether Russia is sick with the Dutch disease. Although they find some symptoms of it, the disease cannot be confirmed (e.g. Oomes and Kalcheva, 2007). For countries in transition or which have faced recent structural changes, it could be even more difficult to analyse the symptoms of the Dutch disease. For instance, while the real appreciation of the rouble is obvious from the data and is somehow linked to the rising oil revenues (as it is confirmed empirically by Sosunov and Zamulin, 2006), there are other factors which might have contributed to such appreciation. In particular, the appreciation may be partially due to the rising domestic productivity relatively to trading partners (the Balassa-Samuelson effect). Indeed, productivity gains have been large in Russia, in particular in the manufacturing sector. For instance, labour productivity in the manufacturing sector more than doubled between 1999 and 2007 in Russia (+114%), whereas labour productivity in the total economy increased by 15.4% in the United States and by 6.1% in the Euro area over the same period. Furthermore, the hypothesis that rouble appreciation has affected the industrial production negatively yet needs to be confirmed. Indeed, in spite of the appreciation of the rouble in nominal terms, which is far less significant than in real terms though, the production in Russian manufacturing industries continued to grow significantly until mid-2008.

However, the question remains whether industrial growth could have been less pronounced had the Central Bank of Russia not limited the nominal appreciation of the rouble. The issue whether there is a potential threat of deindustrialization if the exchange rate allowed to float freely is also important for the future of Russia. This question is not easy to answer, as trading off nominal appreciation for inflation can produce similar effects on the international competitiveness

RUSSIAN IMPORTS AND EXPORTS AND THE INTERNATIONAL COMPETITIVENESS

Table 1 shows the growth rates of Russian export and import in 1998-2005. Russian exports rose from 2000 to 2005 at a higher pace than imports. Therefore, the trade balance improved in spite of the appreciation of the rouble, which occurred continuously over this period.

Table 1 Export and Import Growth Rates



Source: CHELEM database.

Although exports of natural resources indeed constitutes the largest share of Russian exports and this share increased in 1999-2007, exports of manufacturing products grew as well, but at a lower rate. In sum, until the international financial crisis of 2008, the two main economic factors which supported the strong development of Russian industries were a booming internal demand, supported by the rising terms of trade and increasing export revenues, and a good performance of Russian products on foreign markets such as the Euro area and the CIS countries despite the increasing price of Russian products. Furthermore, although the disorganization of the Russian economy in the 1990s and the crisis of 1998 led to a deindustrialisation, Russia managed to revive quickly. The re-organization led to a "natural" re increase in the level of the industrial production. These factors appear to have had a higher impact on the economic development than the pressure on competitiveness created by the rising terms of trade. This led to the apparent paradox that in spite of the real appreciation of the rouble in 1999-2007, industrial production in Russia expanded, contradicting the Dutch disease hypothesis.

The institutional context and the political environment may have also played a role in these economic trends. The involvement of the government increased in some "strategic sectors", in particular in the energy and bank/insurance sectors, and foreign investments in these "strategic sectors" were subject to restrictions. This contributed to a slower growth in the energy sector. This situation was amplified by the fact that the scope of the "strategic sectors", as well as the rules for foreign investments into them, were not considered to be clearly defined, which led to uncertainties for foreign investors. Also, in the energy sector, the recent policy of some large Russian public enterprises was to make acquisitions outside Russia, rather than to develop the extraction of natural resources within Russia (OECD, 2006).These factors can partly explain the slowdown in the growth of the energy extraction in the recent years, despite expected profitability. Investments in most of the manufacturing industries, on the contrary, were not subject to such restrictions. The investment environment in these sectors improved significantly, as well as the perception of it among foreign investors. Thanks to high skills in the Russian labour market, as well as the relatively moderate costs of production, Russian manufacturing industries became more attractive for investors. The fear that the Russian economy may become too dependent on the energy sector and not sufficiently diversified has influenced monetary policy over the last ten years. This policy was aimed at preventing the nominal appreciation of the rouble in order to maintain industrial competitiveness

There were found some symptoms of Dutch Disease in Russia: there was a strong real appreciation of the rouble, real wages increased, employment decreased in manufacturing industries and rose in services sector. However, there was no sign of a deindustrialisation, what contradicts the theory of the Dutch disease. Indeed, industrial production increased significantly. Furthermore, the symptoms present in Russia can be the consequences of other factors than the existence of natural resources. The appreciation of the rouble in real terms came partly from the Balassa-Samuelson effect. The quick development of the services was partly due to the fact that services were not put forward during the Soviet Union times. The outflow of labour from the manufacturing industries resulted in inflow of labour in services sector rather than in the energy sector. The strong growth of industrial production despite the presence of some symptoms of the Dutch disease can be explained by different factors. First, a natural catching-up process after the de-industrialisation in the 1990s can explain partly the very high productivity gains in industries, and hence, that the production of the manufacturing industries increased despite a significant decrease in employment. Second, despite the real appreciation of the rouble, Russian products gained market shares in world trade, thanks to new market opportunities in the European Union and in the other CIS countries, and to the growing Chinese demand for some specific Russian products. On the domestic market, the booming internal demand also contributed to support domestic production. Third, whereas foreign investments in "strategic sectors", in particular, in energy and bank/insurance sectors, were subject to restrictions, investments in most manufacturing industries were largely encouraged. Hence, thanks to high skills and relatively low costs of production, manufacturing industries attracted a lot of investments (including foreign investments) and developed quickly. From 1999 to 2007, these positive factors were sufficient to support growth in manufacturing industries, mitigating the effects of the real appreciation of the rouble. However, the international economic slowdown in 2008 led to a contraction in the industrial production. In the longer term, the situation may be less favourable, depending on the weights of the different factors and the international competition both on the domestic and foreign markets.

Regarding monetary policy, since high inflation is a growing concern, the Russian Central Bank admitted in its policy guidelines for 2008 that, although in the nearest future monetary policy would be aimed at exchange rate targeting as before, it was going to switch to inflation targeting in the medium run, making the exchange rate floating more freely. The change in monetary-policy targets is going slowly though, as Russian monetary policy is confronted to different interacting effects, accompanied by a lot of uncertainties and difficulties in evaluating the situation in the longer term.

Chapter 5

Conclusion

The analysis conducted in this work reveals the positive development and a good pace of EU-Russian relationships – the fact often underestimated or downplayed in the academic literature. Acknowledging that a lot remains to be solved, the two parties share mutual interests, move toward the enhancement of this understanding and use the unique chance to expand economic ties.83 The EU seems to realize that promoting constructive economic relations with Russia on an equal footing is a chance to start speaking with one voice in the external arena. This is also an opportunity for the EU to acquire a stake in the growing Russian market, to secure its supplies of strategic energy resources and ensure its largest Eastern neighbor's stability and their more pro- European position. Russia, at the same time, seems to demonstrate a growing understanding of the potential economic benefits of successful economic partnership with the EU in terms of market access, overall improvement and modernization of the Russian economy as well as WTO accession. In this respect, the attempt to re-launch an ambitious and focused EU Russia strategic partnership seems to be a plausible goal for these dynamic relations. The tensions and unsettled problems of mutual relations seem to be the reflection of this 'strategic' character of EU-Russian cooperation.
There is an impression that the two giants are gradually starting to look at each other as good neighbours and partners. Although it may not seem to be a striking development, taking into account the atmosphere of mistrust and animosity, key characteristics of EU-Russian relations in the recent past, it appears to be a huge leap forward. Therefore, from this perspective, the prospects of EU-Russian partnership do not look as 'gloomy' and problematic as scholars sometimes presented them. Two giants have strong incentives to further their cooperation and find their own equal place in the common home.

In analysing Russian prospects of integration with EU it is observed by Sulamaa and Widgren (2002, 2004) that Russia (or more generally CIS) only derives a major benefit from CEES if it is indeed able to increase productivity through institutional reform, increased foreign direct investment and increased competition. But if too many Russian actors are not convinced of the country's ability to gain such benefit, there will be no benefit, and Russia will end up being more like Argentina than like Mexico in the Latin American liberalisation of the 1990's. Second, it is far from evident that the new Eastern member countries of the EU will benefit from the CEES. Third, also for older EU countries, the benefits will be concentrated on just a few members. Southern EU members may lose on a major scale. All these conclusions underline the existence of potentially very serious political economy problems in the further integration of Russia into Europe. It is not only a matter of whether Russia wants to integrate. It is a matter of whether it believes in its ability to reform so that integration will pay off. But different scenario calculations imply that the distribution of welfare gains and losses depends much on the kind of integration accomplished, in both the EU and Russia together. Not unexpectedly, new and southern members will have a key role in internal EU decision-making on future integration with Russia. So, what should Russia do to be able to profit from the potential benefits of integration? Crucially, as the above discussion has underlined, it must continue to reform itself. If the economic system described in Sutela (2003b) remains in place, Russia will not be able to manage the challenges of integration. If Russia fails to reform and grows at best modestly, it will be unable to face the huge challenges ahead. This would have very far reaching consequences. Second, as Hamilton (2002) emphasises, like all economically small nations, Russia must minimise the impact of geopolitics on trade relations. Small nations cannot afford to make economic decisions on political grounds. Russia must defend its interests, while recognising the facts of life. Russia's European strategy must be planned and implemented taking into account that the net benefits of further integration will not be distributed evenly.

Third, Russia must be better able to bridge the current chasm between lofty political slogans on 'the European choice' and the ever-recurring practical problems of bureaucratic arbitrariness and parasitism. This concerns the way in which Russian border authorities hinder normal commercial relations, actually forcing entrepreneurs to seek refuge in illegal or extralegal practices. Both erratic practices and overt extortion schemes must be abolished as part of a more general administrative reform. The need for this is generally acknowledged and legal measures have been taken, but so far practical results have been lacking. The gap between declarations and practice remains wide. This is also true in the case of normative approximation. Though Russia committed itself to making its legislation compatible already in 1994, there is no evidence that this has led to any practical consequences.

Fourth, there is an obvious need to devote more resources to the integration process.

The supreme Russian state leadership has repeatedly – in matters ranging from Kaliningrad to Chechnya – made demands the utter impossibility of which should have been easy to understand. At first sight, this could only be due to extremely bad advice. In practice these demands led to the postponing of nearly all meetings of the subcommittees established under the PCA, for instance, in autumn 2002 and again in 2004.

On another level, the preoccupation of Russian officials with WTO accession means that there is almost no one left to pursue cooperation with the EU. There are simply too few administrative resources. Also, Russian civil society remains in need of a huge amount of information on European matters Naturally, there is also an alternative explanation for Russia's tendency to demand the impossible. This was repeatedly the case also in the NATO enlargement process (Asmus, 2002). Russia may well think that demanding the impossible will at least bring another concession elsewhere. In the NATO case, this did not really succeed. Russia was unable to block NATO enlargement as both the Central European and Baltic candidates and NATO decision-makers, notably the USA, were persistent enough. On the other hand, a NATO–Russia permanent council was established, giving in fact Russia a veto right. The council, however, only handles a limited part of the NATO agenda. After this limited success, Russia has been demanding a somewhat similar EU–Russia council.

There is a crucial difference between NATO and the EU. While in NATO there is a single decision-maker of the last instance, this is not true of the EU. A twin strategy of demanding the impossible and at the same time going to the national capitals asking for something else in 'compensation' may well succeed in the EU case. So perhaps Russia is not acting out of ignorance, but out of understanding the EU. In that case, the EU should change itself or bear the consequences of its current character.

Fifth, Russia should indeed understand the highly peculiar character of the European Union without aiming to take excessive benefit from it. Attempts to play Europe against the USA were attractive during the Cold War, when there was a very clear antagonism. But now, this triangle should all be on the same side. Quite obviously, a weak EU is not in Russia's interests, at least as long as Russia pursues to any extent its goal of multipolarity.

Also, playing willing national capitals against the Brussels Commission may seem an easy option – and to a great extent it has been done – but in the end it will probably not work.

The EU is not an optimal organisation, but attempts to use its peculiarities against itself will not further integration nor will they make the Union any easier to cooperate with.

Anyone doing business with the EU also must accept its emphasis on contractual relations and legal approximation. Aiming at a CES-based veto right of any kind concerning internal EU matters will be futile at best.

Sixth, both the EU and Russia should take more seriously the asymmetric nature of the relation. In many respects, it is an asymmetry that we would rather not have. Denial is, however, not the proper reaction. In fact, Russia has already acknowledged various asymmetries in the PCA and the Northern Dimension. This is naturally also true of the Council of Europe which was not discussed above. One of the consequences is that Russia, for whom the EU is hugely more important than Russia is for the EU, should also take an active role in developing forms of cooperation, not just asking the Union for 'a clear signal on the strategy and specific points of' implementing the Common Economic Space.
Finally, if the starting point is accepted – as it must be – that EU–Russia relations must be based on shared values as well as common interests, the extent and form of the relation will depend on domestic Russian developments and their reflection in Russian foreign behaviour. Here, the prime question is how the inherent tension, probably even contradiction, of the twin goals of Putin's System – building a more authoritarian state and a more normal market economy – will work itself out during the years to come. Here the extent of the EU's impact will be modest at best.

Challenges for Russia's integration in the International trading system are manifested in many forms. Russia's integration in the global economy remains thin, despite its recent growth. Its main exports are hydrocarbons and metals. Both represented 64.7% and 16.1% of Russia's exports respectively in 2007. Its imports originate mainly from the EU, which provides Russia with the machinery and equipment needed in Russia's recent economic boom Its hydrocarbon based economy gives it an important weight in the global economy (Russia is the world's 10^{th} largest economy), but its reliance on raw commodities only underlines the country's structural weaknesses. In its last *Global Competitivess Report* 2008-2009, the World Economic Forum highlights, that:Russia's main strengths are its large market size and improving macroeconomic stability partly thanks to windfall oil revenues. However, to improve its competitiveness further, the country must tackle a number of structural weaknesses. Private institutions get poor marks, with corporate ethics in the country placing Russia 112th overall on this indicator. In addition, goods and financial markets are inefficient by international standards (ranked 99th and 112th respectively).
Its weak economic integration is matched by a weak institutional and legal integration in the current international economic order.

First and foremost, Russia is not a member of the WTO. It applied to the GATT, which subsequently became the WTO, in 1993. Yet it still has not joined. In the early years of the Putin presidency, the government made serious moves to undertake reforms and negotiate market access with its main trading partners. Russia reached a bilateral accession protocol with the European Union in 2004, and its protocol with the United States in late 2006. Yet the remaining multilateral negotiations and the likelihood of a Georgian veto to Russia's accession point to a relatively long road ahead for accession. Kremlin support for WTO accession waned after 2003-2004, as the domestic policy climate tilted towards greater intervention in the economy. The massive capital flight that followed the Georgian war this summer and Russia's ensuing emersion in the global credit crisis have, however, led to more conciliatory tones from the Kremlin and statements that it wants to join the WTO. However, high uncertainty remains on the willingness of the Russian government to go further in WTO accession. Russia's absence in the WTO renders it difficult to assess its trade regime, since the transparency provided by WTO-exercises such as the Trade Policy Reviews is absent. However, a few indicators give a rough idea of Russia's situation. The World Bank's *Doing Business 2009* report ranks Russia 161st out of 181 countries in its "Ease of Trading Across Borders" index, which measures in priority customs procedures and trading costs. The new *Global Enabling Trade Report* by the World Economic Forum gives Russia an overall rank as 103rd out of 118 countries. In the criterion "market access", Russia ranks 99th, in "border administration", it ranks 92nd, in "transport and communication infrastructure" it ranks 60th, and in "business environment" it ranks 114th.

Russia's absence in the WTO further deprives its trading partners of fundamental predictability in the government's trade policies. Signalling an absence of commitment to international rules of commerce, and giving free reign to arbitrary protectionist measures, this outsider status is bound to deter investment into Russia, which, it must be recalled, took off only recently, and during an unprecedented oil boom. With no recourse to the WTO's dispute settlement body, there is no possibility of trading partners and investors having access to an authoritative and independent ruling and receiving a guarantee that it will be respected afterwards. Russia is not member of any bilateral or regional free trade agreement beyond the *Eurasian Economic Community* and the *Single Economic Space* set up under its leadership with former CIS members. These agreements have not been fully implemented and contain serious carve-outs.

History appears to indicate that deepening globalization in the second half of the 20th century and especially in the past two decades has contributed a great deal to unprecedented political and economic changes in the global context. Globalization is usually associated with more openness of the countries involved in this process. It is a well-known fact that apart from closer cultural contacts between nations, globalization is connected with declining barriers to trade, migration, capital flows, foreign direct investment, and technological transfers.

Deepening economic integration between countries has entailed a more efficient allocation of resources in the world and reduction of transport costs, communication costs, and barriers to trade and investment. Fortunately, today the present political leaders of Russia have expressed an idea that Russia should participate more actively in the international economy. The process of further integration into the world economy is indispensable for Russia because it prepares the basis for the adoption of tested "rules of the game" and therefore contributes to enhanced stability in the country.

It is evident that increasing the role of Russia in the international arena and improving the standard of living if its citizens require a strong, dynamically developing economy, based on greater production efficiency, the creation of a new economic structure, and the modernization of the economy. Unfortunately, while imports cover a wide spectrum of manufactured goods, the trouble with exports is that they remain heavily biased towards energy and raw materials. Russia's endowment with energy sources and raw materials is regarded as a mixed blessing because it is said to have turned the country into a "raw material appendix of the West" and, more specifically, to have damaged the manufacturing industry ("Dutch disease").

Economic co-operation between Russia and the European Union represents a very interesting and riveting but at the same time knotty question. We should take into consideration that EU-Russia economic relations are based on the Partnership and Co-operation Agreement, which provides for trade liberalization and closer interaction One of the titles (the title № 7) of the PCA is dedicated to economic issues of bilateral relations

According to the article 56 of the PCA "The Community and Russia shall foster economic cooperation of wide scope in order to contribute to the expansion of their respective economies, to the creation of a supportive international economic environment and to the integration between Russia and a wider area of cooperation in Europe". Moreover the article provides for that the economic co-operation shall also imply the development of respective industries and transport; the exploration of new sources of supply and of new markets; the encouragement of technological and scientific progress; the encouragement of a stable human and social resources development and of local employment development; the promotion of the regional co-operation with the purpose of its harmonious and sustainable development. It is a well-known fact that Russia and The European Union have launched thematic dialogues on energy, space and science and technology co-operation as well as established a High-Level Group in an attempt to develop the concept of a common European economic space between Russia and the European Union. Russia should be able to develop its position as a prosperous market for EU exports and investments and a reliable source of EU energy supplies, as well as stable, predictable and co-operative partner for security in Europe. The European Union presumes that the main challenges facing Russia over the medium term are the effective implementation of the new legislation and to improve the investment climate in order to current economic growth sustainable. The EU should provide its full support to the Government's socio-economic reform programme and should concentrate on establishing the legal, institutional and administrative framework to achieve economic development through private initiative and market forces.

For its part, Russia attaches great significance to the bilateral relations in the context of the Russian further integration into the world economy. In 2000 the Russian Federation adopted the Strategy of the development of the relations between Russia and the European Union over the medium term (2000-2010), which defines the objectives of mutual relations. Russian "Mid-Term Strategy" towards the EU underlines the importance of "strategic partnership of equals, which does not limit sovereign rights of the Russian Federation as a world power". Many experts consider that such a stance contradicts the position of the European Union. While the EU expects Russia to become a politically stable partner, who will stick to the same standards as Europe, Russia needs the EU as an inexhaustible source of foreign direct investments and technologies, which does not interfere in home political problems of the Russian state.

The effects of the EU enlargement for Russia's economy are considered to be equivocal. They may be classified into three groups: positive, contradictory and negative. The positive effects of the enlargement are connected with the emergence of opportunities for Russian economic agents to interact with a more spacious and unified market of the expanded EU. The level of tariffs for imports of goods of Russian origin to the new Member States is expected to decrease from an average of 9% to around 4% due to the application by the enlarged EU of the Common Customs Tariff to imports from Russia. The EU confirmed that compensatory tariff adjustments accorded in the context of the EU enlargement through modifications of the EU tariff schedule would be applied on a MFN (most favoured nation) basis to the advantage of Russian exporters.

The Russian Federation will somewhat benefit from Central-East European countries adopting trade tariff preferences granted to Russia by the EU. Since preferences for Russia are mainly applied to final industrial goods the benefit will be not high.

The consequences of the enlargement will have an ambiguous effect on Russian external economic activities. The transition to the European Union's trade regime, mainly free from quantitative limitations for Russian import, will induce the CEE countries to abolish the existing quotas and other non-tariff protection measures in force for Russian import. It will expand export of some Russian goods (coal and calcium carbide to Poland, textile to Hungary, welded pipes to the Czech Republic, ammonium nitrate to several countries, etc.). However at the same time the new EU Member States will have to introduce some limitations, very harmful for Russian deliveries, stipulated by EU trade legislation, id est. import of rolled steel and nuclear fuel for nuclear power stations traditionally delivered to the CEE countries without trade limitations will be subject to quotas now.

Some experts believe that the enlargement will entail deplorable consequences for Russia since the EU accession of the CEE countries may further reduce Russia's CEE market share. The opening-up of the EU market for the CEE countries has led to a rapid growth of exports from Eastern to Western Europe: from 1990 to 2002 they grew by 4.5 times. As far as economic interaction with Russia is concerned, Russia's trade with individual CEE countries decreased from 1990 to 2002 by 3 to 5 times, while our partners' deliveries to Russia dropped by 8 to 10 times. Moreover the enlargement may lower Russian firms' competitiveness since free movement of goods, services and capital within the borders of the integration group will foster Western companies' advantages on the Central-East European markets

The participation of the new members in the EU Common Agricultural Policy (CAP) will cause negative effect on Russian economy. Anticipated modernization of agro-industrial complexes in these countries may augment the flow of cheap foodstuffs to Russia, which will deteriorate the position of Russian producers. On the other hand, evident EU CAP protectionism will narrow the chances of the Russian agricultural export to CEE countries and make Russian produce uncompetitive on their markets.

We should take into consideration the fact that many problems can be settled and solved in the framework of Common European Economic Space of the EU and Russia, which idea was suggested by the European Union and laid down in the final communiqué of the Moscow summit held by Russia's and EU's leaders in May 2001. It was agreed to establish a High-Level Group to elaborate this project, which envisages the creation of four common Russia-EU spaces (in the fields of economy; freedom, justice and the supremacy of law; external security; science, education and culture). The main purposes and objectives of this initiative are to promote conditions to boost trade and investment and to create an open and integrated market between Russia and the EU. In spite of the fact that the politicians intend to establish CEES already by 2007 the practical application of the adopted concept is viable only in the far future.

In 2002 the Russian Federation acquired the status of the country with market economy, and this fact will result in a lot of favourable consequences for Russian producers, will rule out discrimination and restrict some anti-dumping proceedings against Russian imports.

As far as Foreign Direct Investment is concerned Russia is acutely aware that it is essential to improve the investment climate, notably through a more effective protection of property rights, in order to attract more investment and know-how from abroad and to reverse the capital flight trends.(Borco 2003)

Russia is sure to enhance and promote economic co-operation with Europe. Today psychological rejection of Russia, which dominated in 1990s in the countries of the former Soviet bloc, is replaced by a pragmatic approach towards co-operation since Russia represents a huge market. For its part, Russia should develop ties with the European Union, because it pursues the goal to integrate into the world economy. According to some macro-economic studies, Russia will benefit from the EU enlargement. For example, recent scientific researches by the independent institute Brussels-based CEPS and Moscow-based RECEP have estimated that Russian welfare will increase as a result of the enlargement by just under 2%. Moreover, Russia is supposed to benefit from the substantial reduction in tariffs. Ultimately, the long-term economic effects of the EU enlargement are, to a significant extent, determined by the way co-operation priorities between Russia and the EU will be formulated and by the choice of the legal and organizational co-operation model for the nearest future. Furthermore, Russian authorities realize that instead of resorting to a complete reliance on exports of energy products, it is indispensable to restructure Russian economy paying more attention to the domestic manufacturing industry. One of the main results of Russia-EU relations is the transition from the initial, mainly declaratory stage to the stage of business co-operation.

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