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EU, Russia,
and Common Economic Space



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Pekka Sutela*

EU, Russia, and Common Economic Space

Abstract

Russia is, with the exception of the USA, the single most important outside country for the European Union. Still, it just account for a few percentage points of EU global trade, even less of EU outward investment. The Union, on the other hand, accounts for about one half of Russia's foreign trade. The relation therefore is, though important, asymmetric.

Institutionally the Union and Russia have been building their relation since the 1990's, but development was much enhanced by the northern and eastern enlargements of the Union on the one hand, and by Russia's "European Choice" as declared by President Putin. Still, developing the relation has not been simple, and in many instances this is caused by the underlying asymmetries of the relation. This paper outlines both the institutional and underlying economic basis of the relation and argues that it will remain a complicated one in the future as well.

Keywords: European Union; European Neighbourhood Policy; Russia/EU relations.

* Head, BOFIT (Bank of Finland Institute for Economies in Transition). pekka.sutela@bof.fi. The opinions expressed are those of the author and do not represent the views of the Bank of Finland. This paper draws upon the work of several of my colleagues, in particular Vesa Korhonen, who wrote the first version of Section 4. I have also benefited from comments by Hiski Haukkala and a number of civil servants who must remain anonymous. This paper has been long in the works. Previous versions have been published in Sutela (2003a) and Sutela (2003b). I have also discussed the ideas of this paper in various conferences and seminars, including in Oxford (St. Antony's College), Boston (American Association for the Advancement of Slavic Studies), St. Petersburg (Bertelsmann Stiftung) and Washington DC (Atlantic Council).

1 Introduction

The regular semi-annual European Union–Russia Summit on 25 November ended in failure. Already once postponed, the meeting was supposed to agree on roadmaps for the four so-called Common Spaces of cooperation between the partners, agreed upon in a preliminary way at the St. Petersburg Summit of May 2003. Obviously, the heady days of Ukraine's Orange Revolution, together with the more general problems of the relation, including the disagreement on whether the so-called frozen conflicts in certain post-Soviet states called for common action, contributed to the failure to find an agreement. But there were also unresolved issues concerning the road maps, reflecting not only the practical diplomatic difficulties in finding solutions in the short negotiation time available, but also reflecting deeper underlying factors marring the development of EU–Russian relations.

To ask whether Russia belongs to Europe or perhaps forms a peculiar Eurasian entity has long preoccupied philosophers and thinkers, both inside the country and abroad. The standard answer now is ‘yes, but...’. Historically a frontier country between Asia, Europe and Byzant, Russia, or at least its elites, has been an active participant in European matters for centuries. Still, Russia is a European country partly in Asia. The possibility of a modern Eurasian alternative is marred not only by globalisation but by the fact emphasised by Dmitri Trenin (2001) that it was already tried, and the USSR failed. As Sergey Karaganov, the Moscow policy advocate recently wrote, whatever the complexities of the process, in the long run there is no alternative to Russia's drawing closer to the European Union (Karaganov 2004).

In Western Europe voices that used to place the border of Europe along the eastern border of Poland are much less vocal today than they used to be in Soviet times. Still they exist, and echoes of a mind-set declaring the Eastern Slav countries non-European are heard even today. Religion, history or even geography does not suffice to define ‘Europe’. Hardly anybody would deny the Europeaness of Greece, an Orthodox Christian country, long under Ottoman rule. Part of Russia is geographically in Asia, but there is in most respects little to distinguish Khabarovsk and Kaliningrad. Culturally, Russia is more European than Turkey, another major country only partially in geographically defined Europe. Still, the latter is considered a future EU member; the former is not so regarded. Especially after an accession negotiations timetable has been agreed with Turkey, a continued definite closing of the European Union door to Belarus, Moldova, and Ukraine and in the end also Russia will be difficult if not impossible to defend, as difficult as this is to accept by many, including leading European politicians and civil servants. Concerning Russia, the matter of possible membership is more about sovereignty, politics and security than about economics, and therefore not of immediate concern in this paper.¹

Obviously, Russia is like all countries unique, perhaps more so than most. Its uniqueness stems from three facts. Firstly, geology has endowed Russia with many resources. Secondly, history and thirdly geography have given it a presence both in Central Europe, the Caucasus, and at the gates of Central Asia and in the Far East. History has also made Russia a former great power, endowing it with a variety of advantages and handicaps. But one thing is crucial. Being European is for Russia, as well as other countries, more a matter of wanting to be European than of some historically or geographically given. Being European is a matter of being willing to integrate by accepting

¹ Also bureaucratic decisions relay messages. Beginning in 2004, Turkey and the Balkan countries are handled by the EU Commission's Directorate General for Enlargement, the former Soviet countries by the Directorate General for External Relations.

– in principle and hopefully in practice as well – the rules and regulations of those organisations whose membership in fact defines what it means to be European. Russia, as obviously as any other candidate for membership in thus defined Europe, is basically obliged to adjust to pre-announced, albeit evolving, criteria. This need for unilateral approximation was recognised by Russia when signing the Partnership and Cooperation Agreement (PCA) with the European Community in 1994. Its Article 55 notes that ‘Russia shall endeavour to ensure that its legislation will be gradually made compatible with that of the Community’. There is no mention of an approximation of norms the other way round. Neither is a possible Russian involvement in deciding on such norms mentioned. The thinking behind the PCA is obvious. Russia was to be Europeanised without becoming a member of all institutions currently defining what it means to be European. But what is not a problem in the cases of states like Norway and Switzerland, who would become members of all such institutions as soon as they wished to do so, has been very much and increasingly a problem in the case of Russia.

There is no evidence that the commitment thus made by Russia has had any practical consequences. No Russian legislation has to the best of my knowledge been passed during the years after signing the PCA for the express purpose of ensuring approximation to EU norms. But neither, presumably, have there been cases of intentionally passing legislation that runs counter to EU norms.²

Today's Russia, more self-assured than the one that negotiated the PCA, is not satisfied with the idea of unilateral approximation. It would like to see the PCA renegotiated or abandoned, and emphasises the need for an equal partnership, though not in issues relating to what Russia calls The Near-Abroad and the EU Common Neighbourhood. There, Russia would rather cooperate with the EU in very limited ways indeed. Russia also calls for a role in at least some EU decision-making, somewhat along the lines of the NATO – Russia Council. Such goals might seem understandable, were they not based on a misreading of realities, including the way in which an international organisation like the EU functions. Karaganov (2004) and others – Bordachev (2004), for instance – argue that in the absence of a membership perspective, unilateral approximation of EU norms makes little sense, and that is the reason why the PCA should be renegotiated. There is thus a basic dilemma.

Whether Russia aims at membership or not, the country remains European, and EU norms and values, together with the norms and values of the OSCE and the European Council, to both of which Russia has committed itself as a member, define the rules of being European. Norway, a non-member by choice, has actually been more diligent than most EU members in adopting the *acquis*. For Norway, this is a matter of benefiting from single rules. For Russia, not being willing to do that is either a matter of sovereignty and prestige – possibly a reflection of seeing norms and values differently now than in the 1990's. Either way, Russia's ability to benefit by integrating, and therefore the welfare of the Russians, is the loser.

There have been two indirect routes via which Russia's norms have been brought immensely closer to the EU *acquis* than Soviet legislation ever was. Recently, much legislative work has been done to ensure conformity to WTO rules, with which EU norms and directives are closely aligned. More generally and over more years, Russia's post-communist transformation as a whole has naturally brought it closer to EU norms. But a

² As a member of the European Council, Russia has adopted a large number of obligations concerning, e.g., democracy and human rights. This paper, however, concentrates more narrowly on the economy.

conscious policy of fulfilling the obligation taken on in 1994 has been conspicuous by its absence.

Neither has the path of Russian development been a smooth one. During President Putin's second term, Russia still remains at a crossroads. Looking at the matter from an economic point of view, either it develops into a more ordinary European market economy or these developments will be hampered by attempts to develop a more authoritarian polity. In the modern world – differently from the times of inventing the Soviet-type growth machine based on a high investment ratio and politically set industrial priorities implemented through planning – both of those aims cannot be reached simultaneously. This is not changed by the successes of certain Asian countries in adopting the basics of the Soviet growth model a few decades later, while remaining within the broad confines of a market economy and also without indulging in the political extremes of the Stalinist state. Russia very much faces the risk of becoming an excessively resource-dependent country, a type of economy with which an authoritarian polity is consistent. If that risk could still be avoided, the emphasis would need to be based on the creativity, initiative, flexibility and openness needed for an innovation – and service-based economy. That would be consistent with European norms and values.

In the 1990's Russia – that is its elites – more or less knew what it wanted to leave behind. The Soviet system had little support left among politically relevant groups. But the goal could only be described in the most general of terms. Saying that one wants Russia to 'become a normal country' is a perfectly understandable reaction to the abnormalities of the Soviet regime, but still rather begs the question in terms of developing a modern societal and economic model.

Most leading European specialists on the Russian economy have at some point in time argued that Russia should be provided an external policy anchor by promising it membership in the EU if and when it fulfils the same membership criteria as any other accession country. This argument assumes that the prospect of membership would be both desirable and realistic enough to provide such strong incentives that would make a crucial difference in committed policies. This is open to several doubts, some of which will be discussed below. Naturally, Russia might decide to approximate at least parts of the *acquis* even without planning to apply for membership. Though one might query the existence of strong incentives for the approximation of rules over which one has even no future say, this solution was a key part of the PCA agreement. It has been repeatedly advocated by a small number of Russian policy experts and also at a time adopted by President Putin. In 2001, Putin and the EU's Romano Prodi declared the goal of a Common European Economic Space (CEES), which includes the idea of selective adoption by Russia of the EU *acquis*. In 2003, at the St. Petersburg EU–Russia Summit, a total of four spaces – areas of cooperation – were defined. In addition to what is now called the Common Economic Space (CES),³ they include, second, external security, third, security and home affairs, and fourth, research and education, including cultural aspects. In the EU view, the four spaces form one whole, *de facto* substituting for the PCA, and defining the EU–Russia relation as *sui generis* among all of the EU's neighbourhood relations.

³ Terminology is a complex issue, also because the EU has the habit of changing it ever so often, and because the use of different languages creates its problems. Thus, the CES should be neither confused with the European Economic Area (between the EU and Iceland, Lichtenstein, Norway and Switzerland) nor with the Single Economic Space (planned between Russia, Belarus, Kazakhstan and Ukraine). Neither should the CES be discussed with the standard terms of trade and integration theory: it is neither a free-trade area nor a customs union, but something else.

In the negotiations for the November 2004 EU–Russia Summit, the Union stuck to the unity of the four spaces. There was, as far as is known, actually little disagreement on the first space, that of the economy, and hardly any on the fourth space. An agreement on these two spaces was thus within reach. Russia duly wanted to separate the four spaces. But in the EU view that would have led to cherry picking, foreclosing almost any possibility of future progress on the more problematic spaces. In particular, Russia was unwilling to admit that the EU might have legitimate security and other interests in those countries that have, after enlargement, become the Union's New Neighbours: Belarus, Moldova and Ukraine.

Whether Russia is seen as a potential EU member or not, the great foreign policy challenge facing the Union after Eastern Enlargement concerns what first came to be called 'Wider Europe'. In the version put forward by Prodi, the former Commission President, the countries of Wider Europe – from Murmansk to Marrakech, as he famously said, hurting both the Russians and the Moroccans – are not seen as potential EU members. They are neighbours with whom the Union must have good working relations. Romano Prodi has even said that the countries of Wider Europe would share with the EU 'everything but institutions'. Presumably, he means participation in existing EU institutions.

Possibly because of the overly generalising connotations of the Wider Europe concept, it was soon dropped. The terminology now used is that of the European Neighbourhood and European Neighbourhood Policy. A specific European Neighbourhood and Partnership Instrument is being planned, with some difficulty, for the EU budget period of 2007–2013. Cooperation with the European Neighbourhood should be financed from this instrument. At the same time, the Union has negotiated with different partner countries Action Plans setting out in some detail the road maps for unifying legislation and regulation. The plan for the four spaces should be the Action Plan for Russia.

This paper looks at some of the issues of EU–Russia relations from an economic perspective. In Section 2 it outlines the asymmetries that mar the development of the EU–Russia relationship. Sections 3–5 outline Russia's current economic relations with Europe, and Section 6 charts EU's Russia policies so far. Section 7 looks at the evolving thinking on the CES, and Section 8 discusses the impact of EU's Eastern Enlargement on Russia. Finally, Section 9 concludes by asking what Russia might and should do next and in the longer-term perspective.

2 A relation of asymmetries

Russia is, after the USA, undoubtedly the single-most important country for the EU, not so much economically, where Japan overwhelms Russia, but politically and security-wise. Both the EU and Russia see their relationship as a 'strategic partnership'. What this means in practice is never made explicit in detail, but the existence of a strategic partnership – different from any temporary cooperation – would seem to suggest the presence of shared values,⁴ common interests and mutual understanding. 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

⁴ As operationalised in the Council of Europe and other treaty obligations which Russia has also taken onto itself. Whether partnership should indeed be based on common values has been sometimes debated

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.⁵ 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 of global exports⁶ and 0.3 per cent of total gross foreign direct investment inflows.

Russia is not only much poorer than the EU. Its regional differences are also much wider. In 1998, per capital production in Ingushetiya was one-fifth of the Russian average. In Tyumen per capita production was 3.8 times the national average. Ingushetiya's income

within the Union. While the proponents of the 'value-free' approach argue that as Putin's Russia does not in fact share European values, it is at best a useless diversion of time and interest and at worst either an illusion or an obstacle to useful cooperation to keep raising the issue of the infringement of values in Chechnya and elsewhere. The opposite view, argued recently forcefully by Schuette (2004), underlines that a 'value-free' approach would not only foreclose possibilities of influencing Russian behaviour, but would also open the door to a naked cynicism that would in the end be in nobody's interest. While he also admits that it has been never made clear whether European and more general Western values are identical or not, he notes that the standard list of common European values in EU – Russian documents has included democracy, the rule of law, human rights and a market economy. But sometimes the list has been shorter, sometimes longer. The May 2001 Summit document also included a hint that there might be a conflict with the common values declared and the Russian situation on the ground.

⁵ For 2002, the World Bank gives a market exchange rate per capita gross national income of USD 2140 and a PPP income level of USD 7820 USD, which compares with the world average and is above the USD 6750 given as the Latin American and Caribbean average.

⁶ Net of intra-EU trade, average for 2000-2002.

level is thus just a small fraction, about 4 per cent, of that in Tyumen. The richest level-2 region in the EU, Hamburg, was just 4.4 times richer than Epeirus, the poorest one. To take another example, as late as in mid-2001 there were 30 mobile phones per 100 Moscow residents, and 2 per 100 in the rest of the country. Currently, however, this disparity is narrowing, as Russia as a whole is undergoing a 'mobile communications revolution'.⁷ But still the metropolises lead the way.

Finally, the discussion above has left aside political asymmetries. 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.⁸ 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.

Russia is in size and income levels thus roughly comparable to such middle-income level countries as Argentina and Brazil, also countries with a wide difference between market exchange rates and estimated purchasing power parities. All these countries also have huge income differentials, with Brazil having in 1997 a Gini index of 59.1, while Russia's index in 1998 was almost as high at 48.7. Further, as such countries tend to suffer from economic (and political) instability, financial crises, oligarchical capitalism and corruption, the argument has been made that Russia has, since the centrally managed Soviet system started to collapse in the 1980's, become a 'normal country'.⁹

Russia shares, indeed, many similarities with other large middle-income countries, especially resource-dependent ones. Still, the comparison should not be taken too far. The three already mentioned sources of Russia's uniqueness are pertinent to the economic linkages between the EU and Russia.

To repeat, first, Russia has a unique geography. The country stretches from the geographical heart of Europe – suitably measured, the geographical center of Europe is in Lithuania, just tens of kilometers from the Russian border in the Kaliningrad region – through the Caucasus and borders of Central Asia to the Pacific Ocean. Second, geology has also endowed Russia with the greatest natural resources of the world, giving it not only huge energy and mineral reserves, but also, for instance, 40 per cent of all long-fibre wood in the world.

The impact of geography has been amplified by past policy decisions. The pattern of Soviet industrialisation implied that between 1928 and 1989 the average Soviet citizen moved to live in a place one centigrade colder (Hill – Gaddy, 2003). At the same time, the

⁷ The mobile phone penetration ratio for the whole of Russia was expected to rise to close to 50 per cent by the end of 2004 and to reach two-thirds by the end of 2006.

⁸ But in terms of soft security, the EU does recognise the importance of, in particular, the Caucasus, which is also covered by the European Neighbourhood Policy. This is one of those regions where the EU would like to co-operate with Russia for security purposes, but, as mentioned, Russia in 2004 quite absolutely declined to do that. These are issues in constant motion.

⁹ For conflicting views see Shleifer and Treisman (2004) and Rosefielde (2004).

average Canadian made a similar move to a warmer environment. Small as the difference may seem, the implied costs of this 'Siberian Curse' are extremely high, especially when one remembers that not only climate, but also transport costs over a huge landmass are involved.¹⁰

Third, Russia is unique in the modern world by being an economically small country which has a recent past as a superpower. The USSR was economically a growth machine based on an extremely high investment ratio and centralised allocation of resources according to political priorities that differed in a major way from those that a market economy with private property and democracy would have had. There was a tendency to autarchy, heavy and military industries were extremely prominent, and services and consumption were relatively neglected. Much of the production capacity, human capital and even institutions created by the Soviet system still exist. Much of this inheritance – including the 'Siberian Curse' just referred to – should be scrapped, but this has been impossible for a variety of reasons, including social and political ones.¹¹

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,¹² 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.

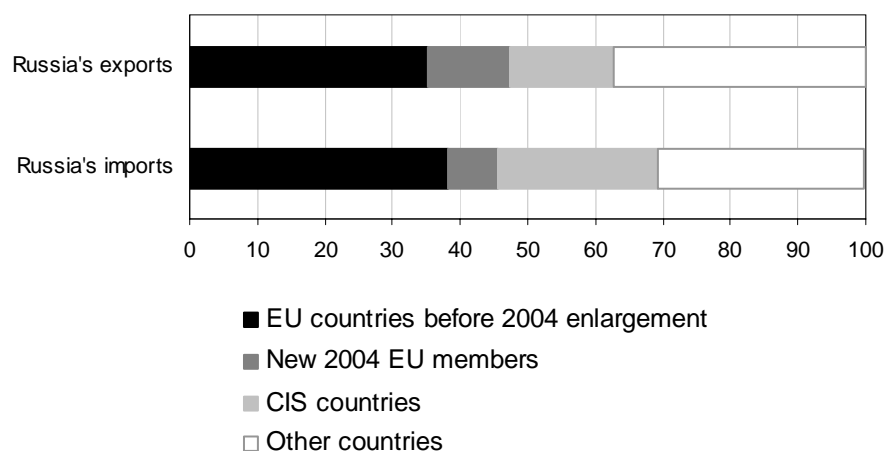
¹⁰ Russia relies to an extent larger than most countries on rail transport. Only in 2003 did it become possible to drive a car from Kaliningrad to Vladivostok.

¹¹ One explanation for the difference between the post-socialist economic performances of Russia on the one hand and the new EU member countries on the other focuses on this. Though all these countries share a past as Soviet-style centrally managed economies, the system was endogenous to Russia while being exogenous to the Central European and Baltic countries. Making a clear cut with the past has been difficult in Russia also because in terms of power the USSR was the greatest achievement of Russia ever. This difference has been amplified by the fact that the overarching and politically widely shared goal of 'returning to Europe' has provided the new members with a strong, consistent and workable external policy anchor. Russia, without a membership perspective in the EU and organisations like NATO, has lacked that anchor, and neither IMF programmes nor prospective WTO membership have been strong enough incentives to compensate.

¹² Russian customs statistics are exceptionally unreliable for two main reasons. In the case of several countries, Finland among them, statistically recorded exports into Russia are about twice in value compared with imports into Russia according to Russian customs statistics. It is believed that differences in country of origin treatment only explain a minor part of the difference. Most of the difference is due to double invoicing and other avoidance of tariffs and taxes. Second, the customs statistics do not include an estimate of informal small-scale shuttle trade by tourists and traders. In contrast, the Bank of Russia adds an estimate of informal imports into balance of payments statistics, but does not publish country-specific statistics for trade. For 2003, the estimate for informal imports amounted to almost one quarter of total imports, similar to 2002. There are also clear incentives for tariff and tax avoidance in exports, but export statistics might in principle be more reliable due to the concentrated structure of Russian exports. The use of mirror statistics of trade partners does not solve all the problems involved.

¹³ It should be noted that Russian foreign trade and payment statistics are prepared/compiled and published in US dollars, though the US trade share in 2003 was just a couple of per cent. This primarily reflects the role of the USD in global oil trade.

Chart 1. Russia's main trade partners in 2003



Sources: State Customs Committee

Looked at another way, it is worth noting that in trade ratio terms, Russia is not a closed economy. According to customs statistics, Russia's exports of goods and services amounted in 2003 to 35 per cent while imports amounted to just 24 per cent of GDP. Exports to the EU were slightly more than 10 per cent of Russia's GDP. This is in international comparison an exceptionally high degree of dependence on a single foreign market.

Seen from the EU side, the picture is completely different. Russia's share in aggregate EU world imports (excluding intra-EU trade) has fluctuated since 1995 around 3-5 per cent. In the EU's world exports (again excluding intra-EU trade) the share has been even lower, at around 2-3 per cent. The average annual growth of the EU's world exports in 1996-2003 was 6.9 per cent and that of world imports 7.7 per cent. For trade with Russia, the figures were 9.4 and 11.6 per cent, correspondingly. Overall, trade with Russia has thus grown faster, from a very low level, but there have been fluctuations as well, not least because of oil prices and the 1998 Russian crisis.

The trade relation is thus **asymmetric** as well. Russia is highly dependent on EU markets. The EU only trades little with Russia. Russia is the EU's fifth trade partner after the USA, Switzerland, China and Japan.

Russia's minor trade role is particularly visible in EU trade in services. In 2002, only 1.5 per cent of this trade (imports + exports) was with Russia. This contrasts with the role of the USA, whose share was 37.5 per cent. There is a huge difference between Russian and US economic structures.

Two further observations are called for. First, while the EU's world trade is basically balanced, there has been a major deficit in EU–Russia trade since 1999. In 2000, imports to the EU from Russia were twice as large as exports to Russia from the EU. The Russian surplus has since declined somewhat in relative terms, but it remains large. Second, Russia's share in EU trade reached its lowest recent point in the post-crisis year of 1999, when it hit 3.3 per cent in imports and just 1.9 per cent in exports. But the recovery in trade levels was fast. It is notable that during 2002-2003 EU exports to Russia increased by 8.9 and 8.5 per cent, while the EU's world exports changed by +1.2 and –2.2 per cent correspondingly. The fact that Russia has during the last five years emerged as one of the

fastest growing economies globally, together with China and India, is now beginning to be seen in EU foreign trade.

Which are the EU countries trading with Russia? The largest one in imports is by far Germany, with a 14 per cent share. In exports, Germany again leads, followed quite closely by the Netherlands and Italy. But this does not imply that these nations, major traders, would be dependent on trade with Russia. In 2001 among 31 industrial countries,¹⁴ Finland was the country relatively most dependent on the Russian market. 5.7 per cent (up to 8.1 per cent in the first half of 2004) of Finnish exports of goods went to Russia. Finland was followed by Turkey (2.9), Poland (2.8), Greece (2.8) and Germany (1.6 per cent). France, for instance, only sent 0.7 per cent of its aggregate goods exports to Russia.¹⁵ Among the new EU members, Lithuania is most dependent on Russian markets. In 2003 one tenth of Lithuanian exports went to Russia and almost a quarter of imports came from Russia.¹⁶

If one compares exports to Russia with GDP, not with total exports, the picture changes somewhat. Finland again tops the league of 31 industrial countries, with exports to Russia amounting in 2001 to 2.2 per cent of GDP. But now Finland is followed by Hungary and the Czech Republic, both with a share of 0.9 per cent. Exports to Russia are just 0.5 per cent of the German GDP. Russia's exports to Germany were in 2003 2.3 per cent of Russia's GDP.

Looking at the euro area, Russia's trading partner role is naturally similar to that for the whole EU. In 2000–2003, Russia took 2.9 per cent of euro-area exports of goods and services, and its share of euro-area imports of goods and services was 1.4 per cent.¹⁷ This compares with export and import shares of 2.0 and 1.4 per cent for the Czech Republic, 2.1 and 1.8 per cent for Hungary, 2.1 and 2.8 per cent for Poland, and 1.3 and 2.1 per cent for Turkey. As a euro-area trading partner, Russia compares with Hungary or Norway.

Asymmetry not only characterises the size of trade flows, but also their commodity composition. Chart 2 compares the structure of exports of 31 industrial countries to Russia in 1993 and 2001 with that of their world exports in 2001. Though the role of food exports to Russia has declined, it is still large. The low share of mineral fuels is natural, given Russia's resources, but the high share of chemicals in industrial country exports to Russia points to the prevalence of low value-added goods in Russia's resource-based production. This is also a factor behind the high figure for miscellaneous manufactured articles (SITC 8). Among this class, clothes took 6.8 percentage points in 2001. The share for the whole world was just 3.0 per cent.

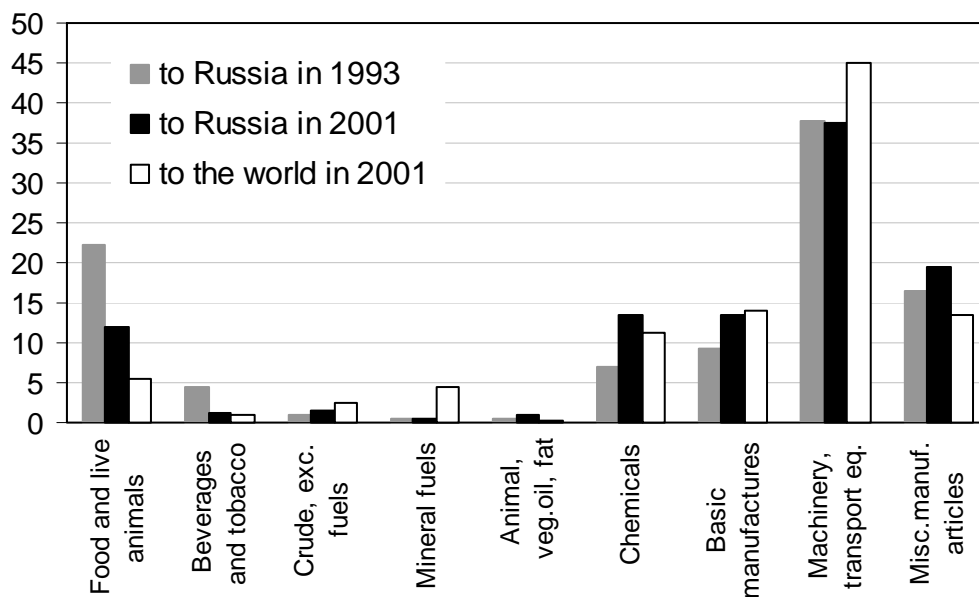
¹⁴ OECD countries, mainland China, Hong Kong and Taiwan. See Kotilainen et al (2003). Figures from this source are not based on the net of intra-EU trade.

¹⁵ There is a real possibility that Russia will soon emerge as the biggest trading partner of Finland. With 13.8 per cent of total Finnish imports, it already is the foremost import country. In exports, it comes after Sweden and Germany (with 11-12 per cent of total Finnish exports). Though exports to Sweden continue to grow, those to Germany have recently declined. If the Russian economy continues to grow, the rouble appreciates in real terms, the economy continues to open to imports, and the geographically proximate Northwestern Russia from St. Petersburg through Moscow continues to grow faster than Russia as a whole, the prospect of Russia catching up with Sweden and Germany as a Finnish export market is very real.

¹⁶ The share of Russia in Lithuanian exports used to be higher. Lithuania has been a major channel of used cars from Western Europe to Russia. Cars have been bought in euros and sold in USD. In 2003, due to the euro/USD exchange rate shift, the profitability of this trade declined steeply. The high share of Russia in Lithuanian imports is explained by the crude oil needs of the Russian -owned Mazeikiu oil refinery.

¹⁷ Net of intra-euro area trade.

Chart 2. The structure of exports of 31 industrial countries to Russia, 1993 and 2001, and their aggregate exports, in per cent.

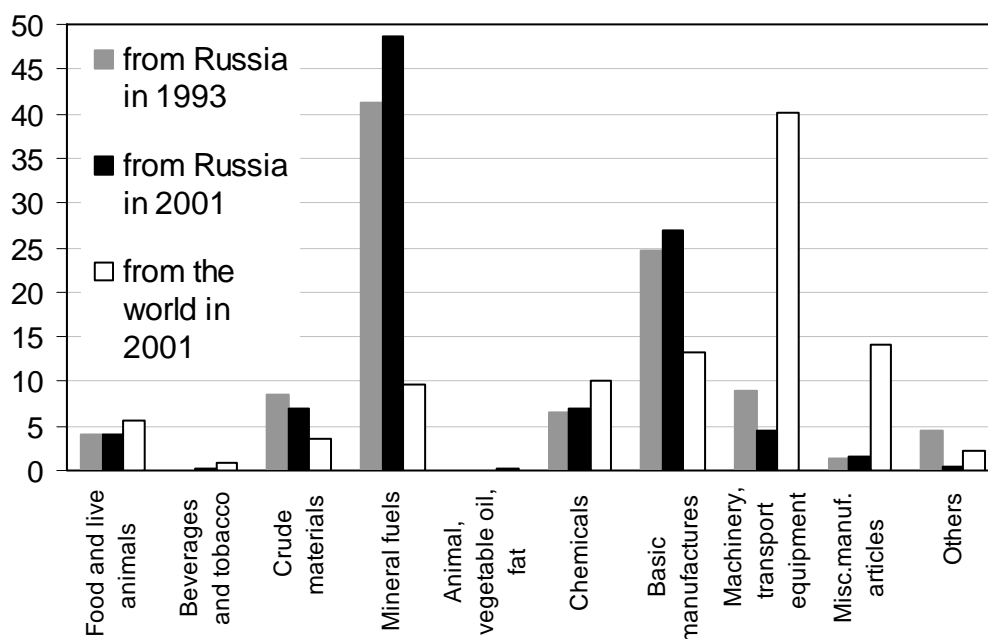


Source: Kotilainen et al, 2003.

Chart 3 gives the same comparison for Russia's exports to 31 industrial countries. The picture of Russia's trade pattern becomes complete. Russia mainly exports fuels (almost half of all exports in 2001) and metals (21 per cent in 2001, included in Class 6). This adds up to about 70 per cent of all industrial country imports from Russia, while the figure for imports from the world is just 14 per cent. Including other crude materials and chemicals, the conclusion is that almost all Russia's exports are energy and raw materials or based on them. There is extremely little intra-industry trade, which dominates in trade between advanced countries.

Peculiarly, this trade structure is often said to reflect the complementarities of the EU and Russian economies. Therefore, it should form a firm base for mutually beneficial economic relations in the future as well. It is true that Russia will in any scenario remain dependent on commodity exports for some time to come. Maintaining and increasing their production must be a Russian policy priority. But actually both Russia and the EU need to see Russia's production and trade structure evolve. Russia, because otherwise it will not become a modern society; the EU, because we would like to be able to import advanced Russian goods, services and investment.

Chart 3. The structure of imports of 31 industrial countries from Russia in 1993 and 2001 and the world in 2001, in per cent.



Source: Kotilainen et al, 2003.

Russia's foreign trade sector has in contrast actually turned more resource-based in the 1990's. This is in particular seen in the declining share of industrial country imports of machinery and transport equipment from Russia. 40 per cent of all industrial country imports consist of such commodities. In imports from Russia, this share is just over 4 per cent, down from 9 per cent in 1993. Indeed, one has to argue that though Russia's recovery since 1999 has taken the country to high growth figures, recent years still comprise a period of recovery. No major new, internationally competitive Russian high value-added manufactured or services-based export commodities seem to have emerged. Even the famed Russian arms exports amount to just 4–5 billion USD annually, go mostly to only two customer countries, are to a large degree based on sales of licenses, and consist of upgrades of weapons systems already developed during the Soviet years.

3 Energy

The backbone of EU–Russia economic linkages is energy. In 2002, 53 per cent of Russia's oil exports went to the EU, representing 16 per cent of total EU energy consumption. In terms of the total EU consumption of oil and oil products, the market share of imports from Russia has tended to rise in recent years, from 15 per cent in 2000 to over 21 per cent in 2002. On the other hand, 62 per cent of Russian natural gas exports arrived in the EU, representing 20 per cent of total EU natural gas consumption. Clearly, there is a high degree of mutual interdependence.

Table 1. Russia's market share of EU-15 oil imports: 1999-2002, per cent.

	1999	2000	2001	2002
Crude oil	15.0	15.0	17.8	21.1
Oil products	35.1	34.6	35.8	36.0
Total	17.8	17.6	20.3	23.4
Total (mln tons)	89.0	92.7	109.2	124.9

Source: The European Commission

Further, the demand for Russian energy in the EU will increase. The EU is aiming at a natural gas-based energy strategy. Reserves in the EU area are, however, being depleted, and major European gas producers like Britain and the Netherlands will emerge as net gas importers within a few years. Though there are alternative sources to Russia – probably the biggest ones in Central Asia, behind long transport distances – it is evident that for the EU energy strategy to be realised, Russia's role as a supplier of gas should grow further. The issue is whether Russia will be able to increase its exports to the degree necessary to satisfy not only European, but increasingly also Asian and perhaps American consumers.

Among European countries, Germany is the biggest importer of Russian gas, which covered 35 per cent of all its domestic consumption in 2001. There are minor European countries situated close to Russia, like Finland, the Baltic countries, Slovakia, Bulgaria and Romania, which cover up to 100 per cent of their gas needs from Russia. Italy, with a 2001 Russian share of 28 per cent of all domestic consumption and France, with a 27 per cent share, are also among the major consumers. As a share of gas imports, Germany's dependence on Russia in 2003 was 44 per cent; that of France 24 and Italy 31 per cent. Not surprisingly, many commentators detect an impact of such high dependency ratios in the claimed unwillingness of many Europeans to publicly criticise Russian domestic and foreign behaviour, though this does not seem to be the case with some of the countries most dependent on Russian oil and gas exports.

Russia's oil production peaked at 569 million tons in 1987–88. Production then declined, largely because domestic demand declined while exports were constrained by pipeline capacity and other reasons, hitting the bottom of 293–298 million tons in 1995–1999. Since then, production has increased by close to 10 per cent annually. Still, with production at 412 million tons in 2003, Russia has even in the best of cases years to go before the 1987–1988 level is reached.

The much-applauded surge of the privatised Russian oil industry thus fundamentally remains a case of recovery. Undoubtedly, there have been many productivity improvements as technology, management and know-how have been imported. Oil companies report a steep decline in production costs. The much-debated question is, whether oil production in Russia is on a sustainable growth path. Soviet-era exploration, pumping and piping left much to be desired. Reserves may therefore be notably larger than generally reported. Indeed, during 2004 a number of Russian oil companies reported much higher estimates of their reserves. On the other hand, some analysts argue that privatised Russian oil companies have excessively concentrated on boosting current market value and

have tended to neglect exploring for new fields. State-controlled companies may have done more to open new fields, but their overall productivity performance is undoubtedly more modest.

This is a matter of concern, as Russian oil is in increasing demand, and not only in the EU. China and Japan have both lobbied for a pipeline from Siberia eastward to satisfy their needs. The USA has expressed interest in a pipeline to the northern harbour town of Murmansk. The issue is whether there will be a sufficient supply for these, as well as European needs. Analysts disagree, whether oil output is constrained by pipeline capacity, or whether output limitations are constraining the construction of pipelines. Overall, there is little doubt that a major policy shift and very high investment is needed in the Russian oil industry, if it is to maintain a production increase beyond the next several years (Dienes, 2004; Hill, 2004). Even then, Russia's foreseeable production volumes are very probably not sufficient for all the competing needs now in sight. The ability of Russia to rationalise its domestic energy use and thus free resources for export is a major question mark. Another is, whether the business environment for the Russian energy sector will improve so that the very major investments needed to develop in particular Eastern Siberian and Arctic fields will be forthcoming in the next few years.

Combining EU forecasts on oil needs with the Russian Energy Strategy forecasts on production and export capacity, Götz (2004) concludes that only a minor part of Europe's increasing oil needs can be covered from Russia. Four fifths should be covered from other sources. Therefore, contrary to many expectations, Europe would become relatively less, not more dependent on Russian oil.

The Russian Energy Strategy, passed in its current form in 2003, anticipates the continuing increase of production, even if at a modest pace. In its earlier versions, the strategy has been unable to forecast the recent fast growth of Russian oil production. An alternative forecast by Wood Mackenzie (2004), reflecting a view that recent growth is not sustainable, expects oil output to decline after 2010. The gap between European (and other) expectations and Russian supplies would, therefore, grow even bigger.

Table 2. Russian oil and natural gas in European markets, 2000-2020.

	2000	2020	Increase
Oil			
EU-30 net imports (mln tons)	428	600+	about 180
Imports from Russia (mln tons)	128	160	about 30
Russia's share, per cent	30	27	17
Natural gas			
EU-30 net imports (bln m3)	200	500	about 300
Imports from Russia (bln m3)	134	165	about 30
Russia's share, per cent	67	33	10

Source: Götz (2004)

Recently Viktor Khristenko, the Russian Minister for Industry and Energy, delivered what should be regarded as the current official view on future oil output (Doklad, 2004). He expects that with higher prices, Russian oil production will continue to increase at progressively modest rates until at least 2020, when output would be either slightly lower (if the price is 25 USD per barrel) or slightly higher (if the price is 35 USD per barrel) than in 1987. Concerning oil exports, Khristenko's picture is somewhat different. Exports would increase until 2010 and stabilise afterwards, at either about 330 million tons (with the lower price forecast) or about 365 million tons (with the higher price forecast).

At the moment, 93 per cent of all Russian oil exports go to Europe, including the CIS (Doklad, 2004). Khristenko expects that share to decrease to 64 per cent, as the shares of America and Asia are expected to increase (from 1.4 to 18 and from 5.6 per cent to also 18 per cent, correspondingly). This might mean that Russia's share in EU oil imports might not decrease, as in Table 2, but neither would it increase, at least not by much.

Though most of Russia's oil industry has been privatised, the state has maintained close controls by two main means. Oil (and gas) deposits remain under state ownership. Companies are given long-term utilisation rights under very detailed contracts, breaches of which can be easily evoked, if deemed necessary. The state has also been adamant in maintaining the pipeline monopoly of Transneft, a state-owned company. As the case of the pipeline boycott of Ventspils, an important oil terminal in Latvia, has shown, it can be used for political purposes. A third tool of controls, tariff and tax policies, has been coming into increased use, as it is widely believed that the energy sector did not contribute sufficiently to government revenue. Arguably, the increased taxation of the energy companies has been the major fiscal achievement of the Putin presidency (Hill, 2004). On the other hand, increased fiscal dependence on oil revenue works both ways (Kwon, 2003).¹⁸ Various developments in 2004 seem to imply that Russian energy companies, worried about increased taxation and uncertain property rights, are restricting their investment and perhaps increasingly engaging in capital exports. And finally, the state is now both increasing its ownership share and taking a more active owner's role in energy industries.

In contrast to oil, gas output basically remains a monopoly of Gasprom, a state-controlled company.¹⁹ In spite of widely shared expectations based on the presumed availability of oil and gas reserves, gas production has been slow to recover. Like the interest in oil, there is much additional interest in the use of Russian gas. This includes a plan to build a liquefied natural gas (LNG) plant around Murmansk for exporting both to the USA and Western parts of Europe. Plans for the Northern European gas pipeline, running at the bottom of the Baltic Sea to Germany and further, were supposed to be put under a Russia–EU co-financed feasibility study, but this failed to take place.²⁰

¹⁸ The Russian stabilisation fund grew fast in 2004 and is expected to reach almost 5 per cent of GDP by the end of the year. As this is beyond the current ceiling after which the fund is supposed to be used for various purposes, a debate on the rationale for the fund has been rekindled. Basically, the fund is currently for fiscal purposes. The Norwegian fund, in contrast, is a huge investment vehicle, reaching in 2004 a full 100 per cent of GDP. Most stabilisation funds in the world, like those in Latin America, are very modest in size and should be regarded as failures.

¹⁹ With the acquisition of Rosneft, a state-owned oil company, Gasprom also became a major player in oil. This was recently enhanced by Yuganskneftegas, the Yukos production company. Gasprom is also spreading its interests in other energy-related branches ranging from electricity to the construction of nuclear power stations. Clearly, it is being developed into a very major vehicle of Russian government policy—both domestically and abroad.

²⁰ Gasprom dragged its feet procedurally so long that the EU finance instrument was no longer available. Presumably, they want full control of the study.

Russia's gas reserves are extremely rich. However, there has been, for a number of years, a major gap between the EU gas import intentions as presented in energy policy documents and Russian export expectations. The EU calculates to need at least 70-80 billion cubic meters of additional imports from Russia. The new Russian Energy Strategy, passed in 2003, assumes that Russian gas exports to Europe (including Southeast Europe and Turkey) could rise from around 127 bcm in 2002 to 160–165 bcm per year by 2020. A gap in expectations thus exists (Table 2). It may be that the EU must satisfy almost all of its increased gas needs from sources other than Russia. One might, however, note again that the earlier versions of the Russian Energy Strategy have been – concerning in particular oil – excessively conservative in their output expectations.

European energy companies, some of which have low reserves, partly in the declining North Sea fields, have a long-standing interest in Russia. The Sakhalin Energy Investment Company Ltd, of which Shell owns 55 per cent, has been producing since July 1999. The company now plans to invest some 10 billion USD in further production of both oil and gas, including a major LNG plant. Shell also has other announced plans, and recently also a major find off Sakhalin, while BP is forming – seemingly successfully though not without difficulties – TNK-BP, the world's tenth-largest private sector producer of oil and gas. Other European companies are also involved. Thus, the French Total has acquired 25 per cent of Novatek, a gas company. The Norwegian Statoil has – together with the American ChevronTexaco – signed a memorandum of understanding on developing the Barents Sea Shtokman gas field. In this field, the situation evolves continuously. Overall, foreign investors have generally been able – at least up and until the final fate of the company becomes clear – to convince themselves that the Yukos case is a separate incident, not likely to be repeated. Still, progress is slow, not only due to politics but also because of the sheer scale of decisions involved.

Recognising the importance of mutual dependence in the energy sector, Russia and the EU have been involved in an Energy Dialogue since 2000. One issue in the dialogue is the extent to which European companies might participate in covering the huge costs – ranging from some USD 150 to 250 billion – that are estimated to be necessary for maintaining and increasing Russian energy production levels.

There is, in addition to the discrepancy between official Russian and European expectations on energy flows, a deeper problem involved. The economic linkages between Russia and Europe are often seen in terms of complementarities: one side can supply what the other needs. An exchange of energy and raw materials against advanced commodities is thus envisaged. As already hinted at, this is hardly the way to truly integrate Russia with Europe – or to diminish Russia's excessive resource dependence.

4 Investment

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 (Table 3). This means that the EU FDI stock in Russia was in 2002 just 10.8 billion euros.

Table 3. Russia's share in EU-15 outward foreign direct investment in 1997-2002, bln. EUR.

	1997 ECU	1998 ECU	1999 EUR	2000 EUR	2001 EUR	2002 EUR
Extra EU	109.8	218.8	307.1	403.0	257.8	130.6
<i>of which</i>						
OECD (non-EU)	75.0	172.9	237.6	330.3	180.0	84.9
accessing countries	6.0	9.8	12.1	19.9	16.3	16.1
Russia	1.7	0.3	1.3	2.0	2.1	2.2

Source: Eurostat

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.²¹ 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.

²¹ Russian national accounts are subject to a large degree of uncertainty. In a country with a high degree of cash dollarisation (and an increasing use of the euro), financial flows are difficult to track. It has been argued, for instance, that recorded savings ratios are seriously biased upwards, as acquisitions of foreign currencies may be recorded on a gross basis, not the net of use of foreign currency. Given the uncertainty underlying trade statistics, any balance of payments statistics must obviously be uncertain as well.

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.²²

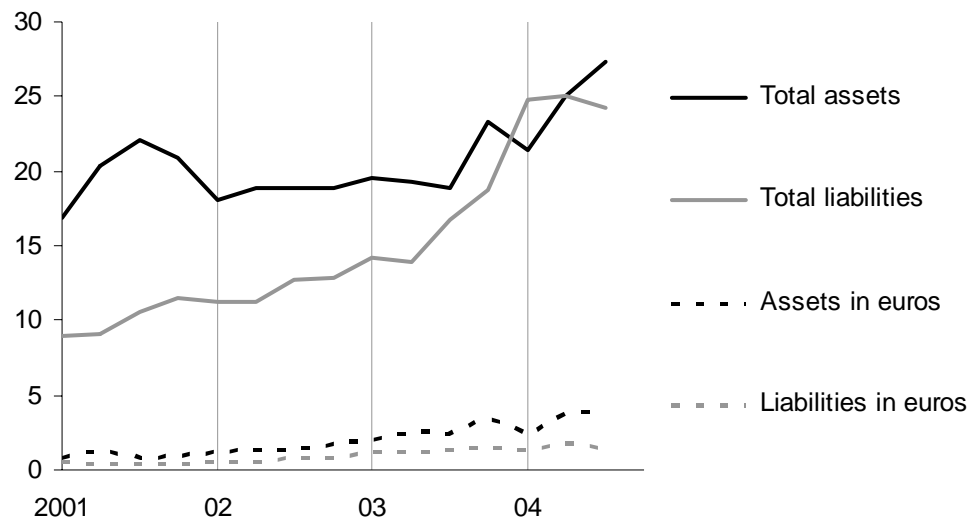
5 The euro and Russia

The US dollar has played a prominent role in Russia as a currency of external trade (both in payments and pricing), sometimes domestic trade, domestic bank saving and cash saving, official foreign exchange reserves, domestic interbank and other foreign exchange markets, banks' foreign liabilities and assets, and international bond issues. The dollar remains the overwhelming currency, for instance, of foreign exchange deposits of residents at banks, which account for one quarter of all bank deposits. This is also true of foreign exchange cash holdings, which according to CBR data were 40 per cent larger than rouble cash in circulation at the start of 2003. During 2003, the weakening dollar proved a less desirable cash asset, but in the beginning of 2004 the value of cash dollars still amounted to 85 per cent of that of rubles. Russia's foreign trade and balance of payments statistics are published in US dollars.

Nevertheless, the euro has gained notable ground in Russia in many respects. It accounts for some 30 per cent of foreign exchange reserves, 20 per cent of foreign cash sold by banks to households during the first 8 months of 2004 and 22 per cent of foreign cash imported by banks in Russia during the same period. The share of the euro in foreign assets and liabilities of the Russian banking sector has also increased during the past two years, albeit not very fast. In 2003–2004, the share fluctuated from 10 to 15 per cent of assets and from 6 to 9 per cent of liabilities.

²² One example is the Armenian Medzhamor nuclear power plant, built in a seismically sensitive place. The EU had been negotiating with the Armenian authorities on the closure of the plant against a major financing package for developing other energy sources, when it was announced that RAO UES, the Russian electricity company, had acquired it.

Chart 4. Foreign assets and liabilities of the Russian banking sector, quarterly from 1 January 2001 to 1 October 2004, bill. USD.

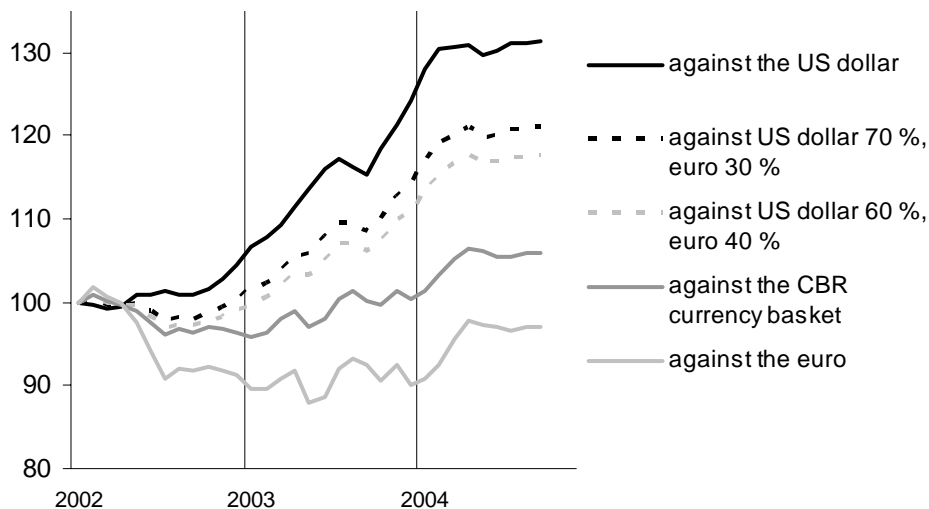


Source: Bank of Russia

Under its managed float policy introduced after the 1998 crisis, Russia has at least primarily continued to follow a dollar-based exchange rate policy. Most Russian exports consist of dollar-based commodities, while the euro area plays a major role in imports. This and a dollar-based exchange rate policy is obviously a somewhat problematic combination, especially given recent and foreseeable fluctuations in the euro-dollar exchange rate.

The Bank of Russia and other economic authorities have referred to the rouble relation with a basket composed of the currencies of a number of Russia's trading partners. There have also been public indications that exchange rate policy might well shift towards benchmarking the rouble against a basket composed of the US dollar and the euro. Russia may already have taken actual steps in this direction. Over the past two years, the rouble real exchange rate against the dollar has been an uphill run but a more stable stroll against a possible currency basket.

Chart 5. The rouble real exchange rate (January 2002 = 100).



Source: Bank of Russia

6 EU–Russia relations: institutional development

The USSR was of two minds about European integration. On the one hand, the European Community was seen as an economic base for NATO. It was thus seen fundamentally as a hostile organisation, in early thinking also as the base for future German expansionism. This attitude made it impossible for European neutrals to join the EEC. On the other hand, there was also the idea that European integration might in the end alienate Europe from the USA by changing the balance of economic power. Therefore, European integration might actually be in Soviet interests, and ways should be found to use it for driving the famous wedge between Europe and the USA. But the former viewpoint tended to dominate strongly: European integration was seen essentially as a negative development. This viewpoint also limited the possibilities that Russia's Eastern European subordinate allies had for approaching the European Community.

Only in 1989 was an agreement on trade and cooperation between the USSR and EEC signed. The agreement was out of date from the very beginning, but at least it implied *de jure* recognition of the EEC by the USSR. The Soviet underlying thinking remained simple: the EEC was a free trade area, perhaps with some basically unimportant architectural additions.

In 1994 Russia and the EU signed a Partnership and Cooperation Agreement (PCA), which, however, due to the first Chechen war, only came into force in December 1997. The PCA covers a broad range of cooperation. Under it, Russia received Most-Favoured-Nation (MFN) status, whereby no quantitative limitations are applied except on exports of certain steel products, representing less than five per cent of bilateral trade. It aims at free trade sometime in the future. It was soon made explicit that steps in that direction would not be taken before Russia's WTO accession. Also, as already pointed out, it sets out the idea of Russian approximation of the EU *acquis*. A large variety of institutions for cooperation have been established on the basis of the PCA. A Summit Meeting is held twice a year, under each EU Presidency. It has been queried whether this is not too often,

as at least various proposals, perhaps also papers signed as evidence of progress in cooperation, might be expected from each formal Summit. Such summitry pressure all too easily leads to various initiatives, which never leave the realm of virtual cooperation. As initiatives remain without implementation, a later Summit will add another, just to imitate the actual progress lacking in the cooperation. If more summits were informal, such pressure might well be less. Also, Russia would have fewer opportunities to push for concessions by threatening to withdraw from a Summit. More recently, this seems to have been learned, and future Summits may well be satisfied with less paperwork.

There also used to be a Cooperation Council at the foreign ministerial level, meeting once a year. At the May 2003 St. Petersburg Summit, it was transformed into a Permanent Partnership Council, a clearing house for all issues, which can meet in a variety of ministerial compositions. Foreign ministers meet twice a year, political directors of foreign ministries four times a year. A Political and Security Committee with the Russian ambassador in Brussels, meets monthly. Furthermore, there are expert meetings and eleven expert-level subcommittees covering economic and trade relations, legal and internal affairs, political dialogue and any number of other fields. They are supposed to meet twice a year. Following well-established canons of international diplomacy, there was an early tendency toward ever more subcommittees being established, as potential topics of cooperation emerged, without anyone knowing how to proceed. More recently, the subcommittees have had problems meeting, as the Russian interest to attend has often been low. Political dialogue is naturally pursued in a number of other forms as well. The institutional framework of cooperation is certainly 'dense' (Schuette, 2004). It is probably safe to say that both sides are dissatisfied with the jungle of meetings that has emerged. The Russians not all that rarely show their dissatisfaction by not showing up at meetings, even when they are held in Moscow. The EU side tries to make more systematic efforts at clearing the forest undergrowth. By autumn 2004, the sub-committees had not met for a year.

In a peculiar way, the process of EU–Russia cooperation has reflected the quasi-Marxist order in which European integration itself has progressed. First, there is a political declaration of goodwill. Then, there is sectoral cooperation. At some point, free trade is established as the goal. Then the gates are slowly opened to the approximation of norms and rules of behaviour and also to the free movement of factors of production ('The Four Freedoms' in EU parlance). The process may finally reach further heights, perhaps culminating in membership in an organisation with state-like characteristics.

As regards the EU–Russia relationship, the phase of political declarations tends to be repeated. This is partly because the asymmetries discussed above make progress in agreed practical issues tardy at best. Partly it is due to the summitry pressure just mentioned. Finally, member countries may try to pursue their own agendas through new declarations that may lead to initiatives with concrete results. One example of such a member country initiative was the Northern Dimension (ND), a Finnish initiative of 1997.

The Northern Dimension seems to have had four major goals. The new member country wanted to leave its mark on EU policies. It also wanted Russia cooperation to remain on the EU agenda. There was a wish to give northern energy sources a higher priority in EU–Russia energy cooperation. Finally, the experience of Finnish-Russia grassroots cooperation since the early 1990's across the common border – until May 2004 the only one in existence – was offered as an example for any future EU–Russia borders. And indeed, the extent of cross-border cooperation in the north has been surprisingly large. Though often frustrating, this cooperation also has practical results that go beyond the important as such goal of simply having officials and civil society actors meeting and

talking to one another. Even this seemingly modest achievement is actually a major contribution to the opening up of the Russian society.

To facilitate the adoption of the ND as joint EU policy in the middle of an EU budget period, no new financial instruments were originally called for. Finance by the European Investment Bank for environmental projects did, however, later become part of the ND. To secure the support of other interested member countries, the concept was kept as an umbrella, which each interested presidency country could fill with its own contents. But, in fact, Finland has remained the sole member country actually interested in the ND, with Sweden giving some partial support.

In fact, the future of the ND is unclear. During negotiations for the next EU budget framework commencing in 2007, the question was again raised whether a special ND financing facility should be created. Even the Finnish answer has been in the negative, perhaps because the facility might have been embarrassingly small, if forthcoming at all. Probably, the ND will survive as a subheading of the European Neighbourhood Policy, financed through a European Neighbourhood Instrument.

It is easy to criticise the ND for being a vague slogan devoid of concrete contents, financing or institutions. This criticism is frequent in both the EU bureaucracy and Russia, as well as in several EU member countries, in particular the more southern ones. Academic criticisms have also been frequent. The argument, however, can be made that this critique somewhat misses the whole point of the ND. Seen against the above goals, the ND has actually been a success. Finland has, though only partly due to the ND, become a well-regarded member of the EU. The war against terrorism has ensured that Russia remains firmly on the international agenda, but that was not foreseen in the late 1990's. The Northern Gas Pipeline, if implemented, will contribute to the third goal. With the EU's Eastern Enlargement, the EU–Russia border has more than doubled in length. Estonia, Latvia, Lithuania and Poland share in that border. The Finnish experience, not only of having an EU external border with Russia but also of concrete grassroots cooperation across the border, should be highly useful to them. Naturally, the extent to which such experience can be utilised is a matter of political will and resources.

This does not mean to imply that all that has happened in EU–Russia relations since 1997 is due to the Northern Dimension. Certainly not. But the possibility cannot be excluded that by keeping Russia on the EU agenda at a time when that was less than self-evident, it at least did not prevent, was present and quite possibly did contribute.

The ND is not the only EU policy that started as a national initiative. The four spaces of cooperation were initiated by France and Germany.

Another intriguing development in EU–Russia economic relations was the granting of market economy status to Russia. This should be seen against the above-mentioned fact that there is always pressure for political signals. This may indeed well have been the reason why both the EU and USA, following a long-standing demand by Russia, gave it the status of market economy in 2002. This was first announced in May, and for the EU the decision took effect on November 7.

In addition to political symbolism, the practical importance of market economy status (MES) concerns anti-dumping and state support. For a non-market economy, where domestic prices cannot be regarded as reflecting true cost, the 'normal value' used to measure dumping – export sales at below-cost price – is defined in terms of costs and pricing of a comparable producer in a third country with market economy status. The newly won MES of Russia was therefore, quite understandably, initially often interpreted as meaning that Russian companies accused of dumping could argue their case on the basis

of actual costs and prices, instead of the EU applying proxy costs and prices from a third country.

But this, as was soon well understood, neglected the small print. The very same day Russia's MES took effect, the Council of the European Union published an amendment to the 1996 EU regulation on anti-dumping²³. Under the new guidelines, judgement in certain market situations – for example, where domestic market prices are artificially low or barter is common – will be based on a normal value derived from the company's actual production costs. If this fails, the costs will be adjusted or costs of similar companies in the same country or information from other markets will be used. Thus, as long as Russian energy, transportation, and raw materials costs are regarded by the EU as being 'artificially low', normal values can continue to be taken from another country. The USA follows a similar rule.

It is too early to tell whether any change – for better or worse – has taken place in practice. In fact, trade defense measures have affected only a few promilles of EU imports from Russia. Between November 2002 and October 2004 the EU only initiated two new anti-dumping cases against Russia, the USA just one. Perhaps the very small numbers are as such an indication. According to the EU, just three anti-dumping measures were globally imposed upon Russia during the first half of 2004. This equals the measures taken against Korea, Malaysia and Thailand, and trails far behind those against China (16 cases).²⁴

Overall, the EU had 147 definitive anti-dumping measures in force on 31 March 2004 (WTO, 2004). Of them, 32 concerned imports originating in China, followed by India and Russia (11 each). Of the total anti-dumping measures imposed between 1991 and 2003, 6.4 per cent concerned Russia, far below China, but basically on a par with Hungary, Japan and Thailand. The total number of anti-dumping measures in force has recently decreased, and was in early 2004 similar to the level in the late 1990's.

A further issue concerns Russia's WTO accession. The PCA goal of free EU–Russia trade is predicated on prior WTO accession by Russia. The EU naturally supports early accession but, given the importance and potential growth of EU–Russia trade, the EU view has been that member countries cannot – nor should other WTO members – lower the standards of accession. That would be unfair to other existing and future members of the WTO. It would amount to a watering down of existing rules of international trade and, by softening the best external anchor that Russian economic policies now have, it would also be detrimental to the future welfare of Russians.

The benefits that are expected from Russia's WTO membership include a common trade framework, lower tariffs and fewer non-tariff barriers to trade, improved market opening and stronger property rights. The Russian fears have obviously concentrated on infant and senile industry arguments. The voice of the Russian consumer, probably the greatest beneficiary of accession, has been little if at all heard in the debate. A recent IMF estimate is that accession might increase Russia's exports to WTO member countries by as much as 50 per cent, though part of this might well be trade re-orientation, not true trade expansion (Lissavolik – Lissavolik, 2004).

Russia first applied for WTO membership in 1993. Accelerated work commenced in 2003, and over time the expected date of Russian accession has shifted to around 2006–2007. Due to a lack of strong domestic pressure for speedy accession, Russian negotiators seemed long to work with no set deadline, but with a mandate to extract the maximum

²³ See [Official Journal of the European Communities](#) 7.11.2002.

²⁴ See www.wto.org/English/news_e/pres04/_pr387_e.htm.

possible number of concessions from negotiation partners. Both Russian pro-WTO businessmen and President Putin have argued publicly that Russia is in no particular hurry to finish negotiations before the economy is ready and the populace supportive. At least from the President's side, this may have been a negotiations strategy. He may in fact have been almost the sole driving force behind Russia's accession.

Not surprisingly, Russian energy pricing has been a major stumbling block in trade policy. Russia has protested that other WTO accession countries have not been asked to raise domestic prices to world market levels. For a big energy producer, low prices are deemed a crucial source of competitiveness. EU has countered that artificially low domestic prices form a 'particular market situation' and imply state support. In particular, domestic gas prices for industrial users were at issue. Russian industries use much gas to produce such export commodities as steel and aluminium, which have been repeatedly involved in anti-dumping and state support cases. The domestic gas price for industrial users has been as low as just one fifth of export prices.

Obviously, a compromise had to be found if Russia was to join the WTO. As announced between Russia and the EU in May 2004 – to the surprise of many commentators – it just included a commitment by Russia to let domestic prices gradually increase to a level covering costs, profits, and investment needed for the exploitation of new fields. The EU thus abandoned the call for world market pricing, and numerically the industrial gas prices agreed to for 2006 and 2010 are in line with Russia's own energy strategy. Russia, thus, had to give nothing on the issue. The credibility of even such a commitment will be an issue of contention. The issue has therefore been raised whether the EU diverged from its original demands to secure something else, perhaps Russia's ratification of the Kyoto Protocol.

If Russia emerged as the short-term winner on the industrial gas price question,²⁵ what did the EU gain? The details of the common understanding are not publicly known, as Russia still has to conclude some other bilateral negotiations, including with the USA. Still, the announced average tariff level for industrial goods is a low one at 7.6 per cent; actually lower than that agreed with China. The same is believed to be true of agriculture. Russia also made a number of undisclosed commitments in a large range of sectors including telecommunication, transport, financial services, postal and courier, construction, distribution, environmental, news agency and tourism. A long-time dispute on Siberian overflight charges was also ended, but only by 2013 in its latest phase. Overall, European industries have been quite satisfied with the agreement reached.

On 18 November 2004 Russia announced that it had reached bilateral agreements with Chile, Korea and Taiwan, and expected to reach agreements with the USA, Japan and the other remaining countries by April 2005. In that case, Russia might join the WTO in 2006. Another possible deadline would be the December 2005 ministerial meeting of the WTO. Even that, however, might be an optimistic goal, as negotiations on the liberalisation of services, particularly financial services, with the USA are in a very early phase.

²⁵ Short-term winner, as economically rational domestic energy prices would surely be in Russia's best interest.

7 Common (European) Economic Space

The 1994 PCA agreement already, besides setting the goal of a free trade area, also set the task of establishing ‘conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements’ – but notably not freedom of movement of labour (Article 1). Article 55 went further, arguing that ‘an important condition for strengthening economic links between Russia and the Community is the approximation of legislation. Russia will endeavour to ensure that its legislation will be gradually made compatible with that of the Community’. The article further enumerated fifteen areas, ranging from company law to the protection of life of humans, animals and plants, where approximation would be particularly important.

Uncertainty about Russian developments was deep at the time of PCA negotiations. A few years later, Russia had seen both the beginnings of possible growth and a financial crisis. The EU felt the need to rethink the situation, and the outcome was the 1999 Common Strategy of the European Union on Russia. It reiterates the goal of approximating norms, noting that ‘The progressive approximation of legislation and standards between Russia and the European Union, in accordance with the PCA, will facilitate the creation of a common economic area’. The spring 2001 EU–Russia Summit established a high-level group to elaborate the concept of a Common European Economic Space, chaired by Mr. Patten and Mr. Khristenko. The October 2001 Summit gave the group a mandate, the implementation of which was to be reviewed no later than October 2003. In its first progress report, to the May 2002 Summit, the group concluded that the CEES should focus on ‘regulatory and legislative convergence and trade and investment facilitation’. ‘Ultimately, economic agents should be able to operate subject to common rules and conditions in their respective fields of activity throughout the enlarged EU and Russia.’ The report also chose impact assessment, regulatory convergence and the consideration of ultimate objectives as the primary tasks for the period until end–2002. A number of key issues were duly studied in some detail, including impact assessment, regulatory convergence and numerous more technical issues. Among them are standardisation, technical regulations and conformity assessment, customs, public procurement; competition, certain services, certain industries and agriculture. Particular emphasis was placed on regulatory approximation and the removal of tariff and non-tariff barriers to trade and investment. The thinking in Brussels is that the burden of studies has been very much on the EU side.

As noted above, negotiators were tasked to come up with an outline of the CEES in practice in autumn 2003. The otherwise somewhat chaotic Rome EU–Russia Summit in November 2003 duly accepted a ‘concept paper’ for the CEES. According to it, the CEES means an open and integrated market between the EU and Russia, based on the implementation of common or compatible rules and regulations. It should ‘ultimately cover substantially’ all sectors of the economy, and shall be created ‘progressively and in stages’. The CEES shall eliminate obstacles and create possibilities for cross-border trade of goods and services, and the establishment and operation of companies as well as ‘related aspects of movement of persons’. In this way the concept paper stops just short of calling for the free movement of people. The main instruments to be applied are market opening, regulatory convergence and trade facilitation.

Following a Russian initiative and French and German efforts, the EU and Russia also called, at the St. Petersburg Summit in May 2003, for three other ‘Common Spaces’ in addition to the CEES: the space of freedom, security and justice; the space of common

external security; and the space of science, research, education and culture. In this connection, the CEES became the CES as 'European' was dropped from the name of this space. At the same time, the contents of the economic space were widened: CES also includes matters like energy and the environment.

In practice, as the PCA already said, regulatory and legislative convergence can only mean the approximation of the EU *acquis* by Russia. Obviously, Russia will not adopt wholesale the totality of the *acquis*, which would mean abandoning much sovereignty, and it is utterly unclear what good purpose would be served if Russia tried to adopt – for instance – Common Agricultural Policies. Neither is this demanded by the EU: 'we are not ... seeking to have Russia take on the whole of EU legislation'.²⁶ Russia aims, as emphasised above, at modernisation and competitiveness, and should evaluate the *acquis* accordingly. Neither will it commit to adopting all future *acquis*, as have the countries of the European Economic Area. It is still too much of a major country that often thinks of itself as a great power to do that. But as the EU takes half of Russia's exports, there should be an evident business interest arguing that Russia should approximate EU standards to the extent possible. This, in particular, is so if Russia is to be able to diversify its export structure away from excessive reliance on energy and raw materials towards high value-added industrial and service-based products, for which standards have a major importance.

It is unclear, however, whether incentives for the approximation of norms without the prospect of EU membership are strong enough to have a major impact on policy. A promise of possibly higher welfare sometime in the future is rarely sufficient to move policies, at least without strong supportive pressure from a society's elites. Also, adopting only part of the *acquis* may prove an illusory victory. Russian researchers (Mau and Novikov, 2002) have proposed that while adopting parts of the *acquis*, Russia should not subscribe to such parts as Common Agricultural Policies, labour legislation, ecology or social protection. This reflects a view that EU standards in such fields are either a luxury good for rich nations, or more fundamentally a detrimental state intervention in economic processes. On the other hand, Russia's access to European markets is hardly enhanced if it can be seen as engaging in ecological and social dumping. As already noted, related considerations have led some Russian advocates (Karagedov 2004) to call for abandoning the whole goal of approximating norms, instead demanding either to renegotiate or – if the EU is unwilling to do that – leave the PCA and negotiate a new basic treaty on Russia–EU relations. The thinking behind this is obvious and being felt more and more strongly: the PCA was a product of Russia's weakness.

The former EU Commission President Prodi, a former professional economist, presumably well understands the potential importance of external policy anchors. In a speech he emphasised that the goal of returning to Europe had been a key factor in the success of the accession countries. 'By holding up the goal of membership we enabled these governments to implement the necessary reforms. Only this prospect sustained the reformers in their efforts to overcome nationalist and other resistance and fears of change and modernisation.'²⁷ But he thinks that enlargement cannot continue indefinitely: 'we cannot water down the European political project and turn the European Union into just a free trade area on a continental scale'. Using an expression that was bound to raise fears of being left out of Europe in several capitals, Prodi claimed that 'the integration of the Balkans into the European Union will complete the unification of the continent'. Certainly, every European state which fulfils the Copenhagen Criteria for membership is entitled to

²⁶ Chris Patten and Pascal Lamy, *Financial Times* 5.12.2001.

²⁷ Speech in Brussels, 5-6 December 2002.

apply for membership, but that does not mean promising that they will be accepted, Prodi continued. Non-member neighbours could, as already mentioned, 'share everything with the Union but (presumably currently existing Union – PS) institutions'.²⁸ In Prodi's view, the CES with Russia could be an example of what this might mean in practice. The EEA, further on, means being as close to the EU as possible without being a member.

There is a worrisome possibility that the CES will just prove to be another instance of flashy political sloganeering, at which the EU has been so proficient. Such slogans have been more than once used by Russia to ask for the beef in the form of various concessions. Perhaps it is excessively cynical to see the CES as just another slogan, conveniently invented, partly in reaction to enlargement tensions and partly to paint over practical problems in relations. The need behind this initiative is real enough.

On the other hand, the CES clearly risks becoming entangled in the technicalities of trade policy. They have to be handled, but too much detail will sink the idea as a policy concept. To avoid these twin risks, either letting the CES become just another slogan or engulfing it in technicalities, the EU must notably improve its ability to form and implement genuinely common strategies of foreign relations. All thinking and action must proceed from an honest understanding of the fundamental asymmetries that exist, and in most respects will continue to exist, between the EU, Russia and the rest of Europe and its neighbours.

In April 2004 the EU presented Russia, ahead of the May Summit, a draft for the main lines of a joint EU/Russia Action Plan on the four common spaces. The draft, presented to Russia as a basis of negotiations, has not been made public. It is understood, however, that concerning the common economic space, it aims at an open and integrated market between the EU and Russia, and sees four main instruments for that: market opening (gradual removal of obstacles to trade and investment), regulatory convergence, trade facilitation and infrastructure network development. Presumably the draft goes into some detail on what that might mean in practice.

In November 2004, the planned EU–Russia Summit was initially postponed by some weeks on Russia's initiative. Though the Russian explanation was that this was because the new EU Commission had not yet been confirmed, it was widely understood that this was just an excuse. As already mentioned, there were disagreements of principle concerning both external and internal security. Russia again raised such issues relating to EU Eastern Enlargement that were already thought to have been resolved, including transit to Kaliningrad and the situation of Russian-speaking minorities in Estonia and Latvia.

²⁸ The alternative, obviously, is to interpret Prodi as excluding any sharing of any institutions. To a layperson that seems improbable, depending on what an 'institution' means. Possibly scholars within economics, with all the talk about formal and informal institutions, understand the word much more widely than those engaged in legal scholarship.

8 The impact of Eastern 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. The Polish January 2003 non-paper on new neighbours policy was an early indication of this. Calling for an Eastern Dimension of EU policies, it borrows more than a few ideas from the earlier Finnish initiative on a Northern Dimension.

In general, it remains to be seen whether the bitter historical experiences of the new members will dominate their attitude towards Russia, or whether they will concentrate on utilising the Russia-related economic possibilities opened up by their EU membership. In any case, one must probably expect stronger and more critical European voices in issues of human rights, freedom of the media, democracy development and the Chechen war. That may well further complicate the political triangle between the EU, Russia and the USA, and also increase the diversity of European views. For the time being at least, in any case, the new members have had a weak impact in the formulation of the EU's Russia policies. They have been much more vocal in political forums like the European Parliament. Sergey Yastrzhemsky, President Putin's Special Envoy to the EU, complained in November 2004 that the new members have formed a Russophobic bloc in the EU, trying to catch the initiative from such bigger EU countries as France, Germany and Italy.

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, Table 8). 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, Table 6). 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, Transdnestr, 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 (see, for

instance, 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.²⁹ 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, Russian 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.

9 Conclusion: what should Russia do?

The implications of the discussion above for the EU have hopefully been made clear enough: have a realistic view of the possibilities and constraints of the relation, learn from experience, set concrete goals, speak with one voice and evaluate what has happened.

But what are the conclusions for Russia? Does it pay for Russia to integrate with Europe? As a matter of principle, the answer is self-evident: for a European nation like Russia, there is really no alternative. The question is what kind of integration?

The dual path of free trade and the approximation of norms was sketched out in the PCA of 1994. It was not the only alternative. One can imagine an alternative consisting of various sectoral cooperation initiatives – ranging from the energy dialogue through ecology to security and home affairs – without the goal of free trade. But that was not the path chosen.

Freer trade is probably the most important single factor behind improved global welfare during the last two hundred years. Still, the benefits of freer trade do not come automatically, as the Latin American experience from the 1990's once again showed. Some countries – like Mexico – were able to move up the value-added ladder, while others – like Argentina and Brazil – stuck even more to a resource-based development path (Stallings and Peres, 2000). The problem in Russia is partially that ‘Generally nobody any longer believes in Russia that our markets should remain closed for foreign banks, insurance companies, telecommunications networks and translators. But our business circles are divided into a minority who are not at all afraid of market liberalisation, and a majority who think WTO accession should proceed through transition periods, temporary

²⁹ Later in 2004 Russia forbade imports of foods from a number of Baltic plants, arguing that they should comply to Russian, not only to EU, veterinary requirements.

restrictions and other measures which will soften the consequences of integration'.³⁰ More generally, as noted above, the effects of freer trade are in Russian discussions only seen through the interests of the producers, neglecting the impact on consumers.

Some of the estimates of export growth following further liberalisation are very high. Thus, Belyanin (2002) argues that EU exports to Russia have the potential to grow even by sevenfold, while Russian exports to the EU might just grow by 50 per cent. Thus, the impact could be asymmetric, reflecting the respective potential of the EU and Russia. Afontsev (2002) also points out that the ability to benefit from liberalisation depends on internal reform. In the most thorough study of this so far, Sulamaa and Widgren (2002, 2004) use the GTAP applied general equilibrium model to assess the impact of different CEES arrangements between the enlarged EU of 25 countries and Russia. Assuming a free trade area between the EU25 and Russia, and the continuation of deep integration in the EU, the impact is just slightly positive for the Russian GDP. But nobody loses in Europe in this scenario, which makes it politically easy to accept. For the Former Soviet Union, benefit accrues to such sectors as crops, livestock, textiles, apparel and other primary products.

What if deeper integration does occur between the EU and Russia? Assuming EU enlargement without deepening integration, and a global factor productivity increase due to the CEES, which is taken to increase both foreign direct investment and competition, the study finds much more pronounced benefits for Russian welfare. But almost everyone else loses. The losses of the southern members of the EU are big, and those of the accession countries even bigger, as Russia would be better able to compete in common products. Strangely, Finland is the only EU country to benefit under this scenario. The impact on the rest of the world is very small under any scenario.

Sulamaa and Widgren (2002, 2004) run through a number of different scenarios. These results are not final, but they do point out several important conclusions. First, 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.

³⁰ Konstantin Frumkin, *Nezavisimaya Gazeta* 11 December 2002.

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. Was that really the intent? 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.

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