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**EU-Russia:
key dimensions of economic relationship**





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1. INTRODUCTION

Russia is the EU's biggest neighbour. The EU is Russia's most important trading partner. With the exception of the USA, Russia is 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 backbone of EU–Russia economic linkages is energy. Russia is the EU's main supplier of hydrocarbons and the Union is the main market for Russian hydrocarbons.

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'.

The Russian EU Strategy furthermore emphasises that partnership should be 'on the basis of equality without dividing lines'. This strengthens the general idea that true partnership should always be between equals: partners of similar size, importance and prestige. And naturally, 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.

This paper examines EU–Russia relations from an economic perspective. The relation therefore is, though important, asymmetric, what is outlined in Section 4. Section 3 discusses the energy dialog, examines key dimensions of the EU-Russia energy relationship. Section 4 outline the role of euro in Russia's foreign trade.

2. A relation of asymmetries

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.¹ 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 exports² 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 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. 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.³ Only

¹ 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.

² Net of intra-EU trade, average for 2000-2002.

³ 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.



the US shares Russia's vital hard security interests in these foreseeable future.⁴ 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'.⁵

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

⁴ 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.

⁵ For conflicting views see Shleifer and Treisman (2004) and Rosefield (2004).



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 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.⁶

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.⁷

⁶ 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.

⁷ 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.

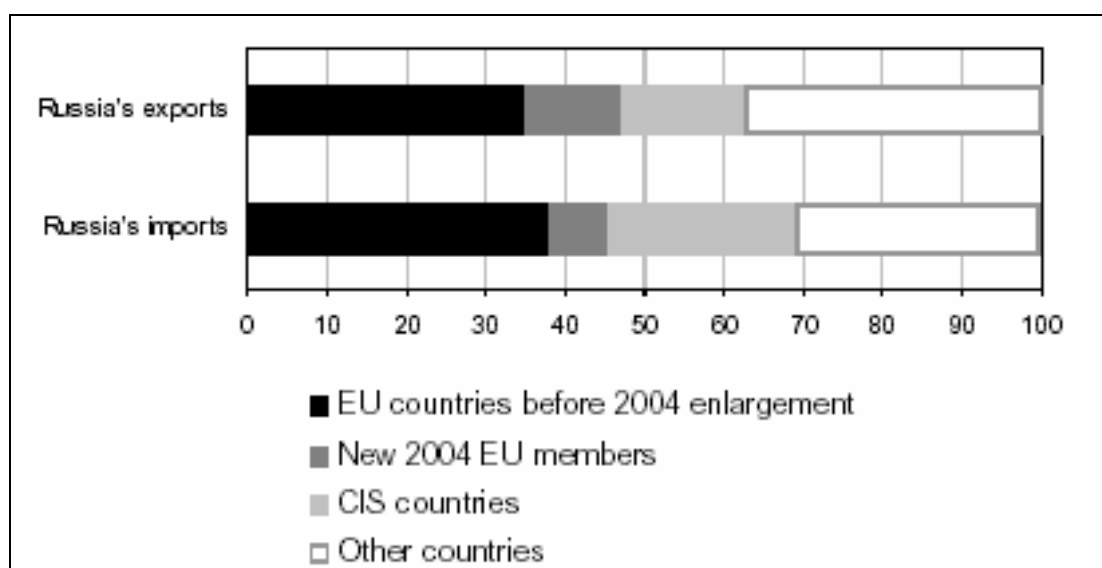


2.1. The trade relation

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,⁸ 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.⁹ 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.

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.

⁹ 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 2004*

Sources: State Customs Committee

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.

2.2.The EU countries are trading with Russia

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,¹⁰ 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. Among the new EU members, Lithuania is most dependent on Russian markets. In 2003 one tenth of Lithuanian exports went to Russia and

¹⁰ 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.



almost a quarter of imports came from Russia.¹¹ 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.

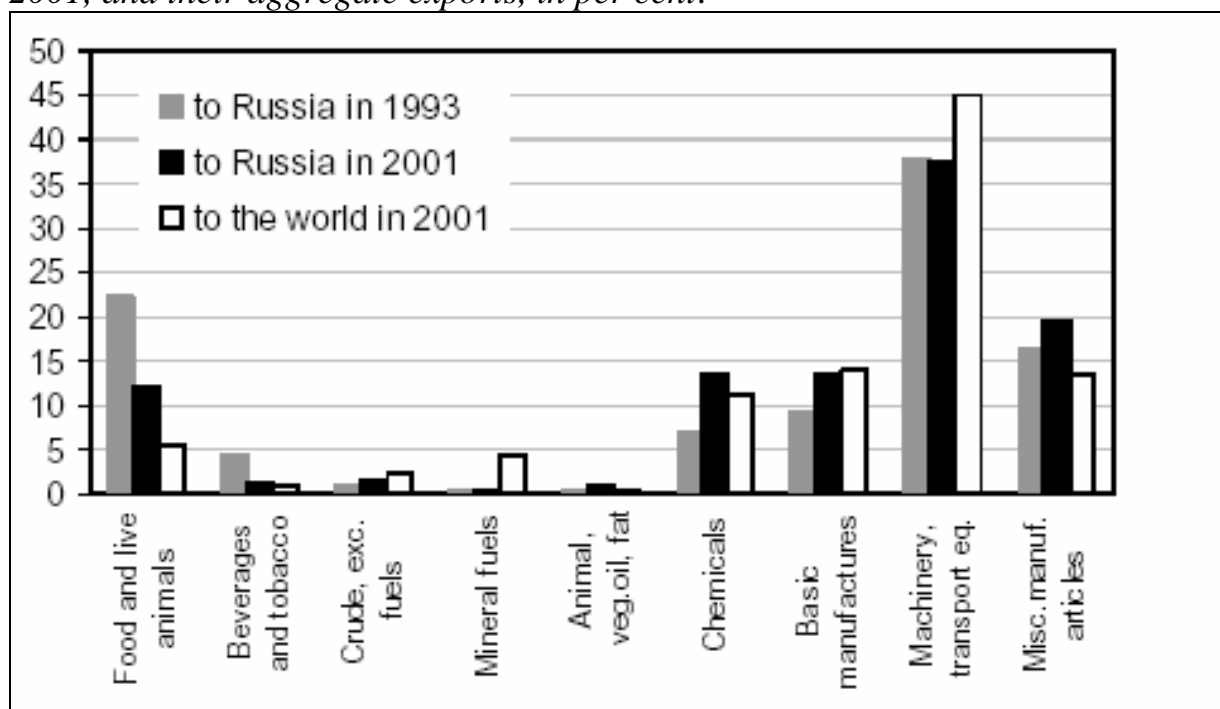
Looking at the euro area, Russia's trading partner role is naturally similar to that for the whole EU. In 2000–2003, Russia took 2.9 per cent of euro-area exports of goods and services, and its share of euro-area imports of goods and services was 1.4 per cent.¹² This compares with export and import shares 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. Among this class, clothes took 6.8 percentage points in 2001. The share for the whole world was just 3.0 per cent.

¹¹ 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.

¹² 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.

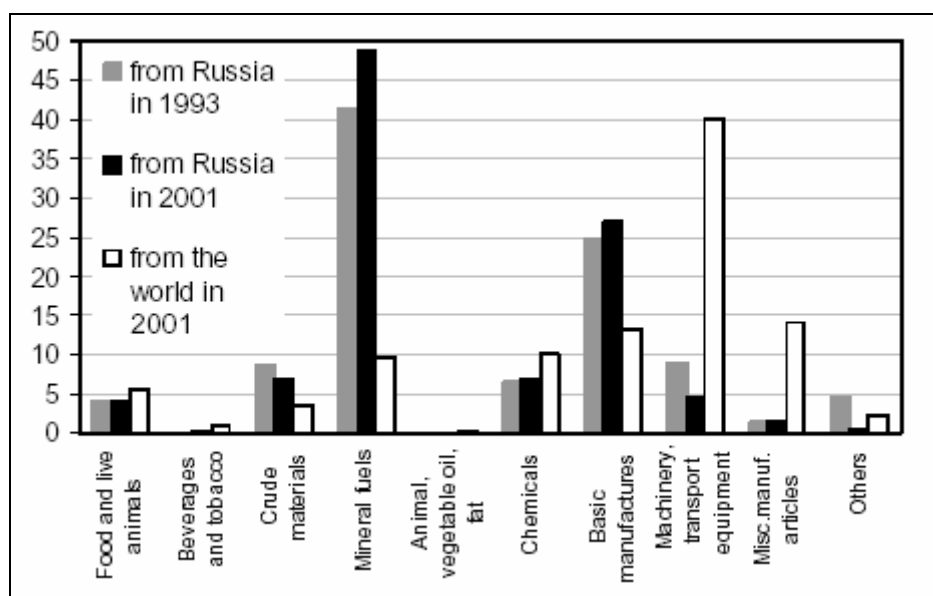
Chart 3 gives the same comparison for Russia's exports to 31 industrial countries. The picture of Russia's trade pattern becomes complete. Russia mainly exports fuels (almost half of all exports in 2001) and metals (21 per cent in 2001, included in Class 6). This adds up to about 70 per cent of all industrial 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.The energy in EU-Russia relation

3.1.The EU-Russia energy dialogue

The EU-25 imports 50% of its gas and 30% of its oil from Russia, while Russia exports more than 50% of its energy to EU-15. 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 2004. 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 2004 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 2004 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.

The EU-Russia energy dialogue was launched in 2000 in the context of an increase in energy prices and, consequently, the publication of the EU's Green Paper on Energy Security. This dialogue reflects a recognition that Russia and the EU are natural partners in the energy sector and have mutual interests in enhancing the continent's energy security. Its main objective is to provide a forum to discuss questions of common interest in the energy sector and to bind Russia and the EU into a closer relationship. It also aims to contribute to security of energy supply and energy demand; foster cooperation on energy-saving measures; rationalise production, transport infrastructures and electricity connections; facilitate investments; and improve relations between producer and consumer countries.

Senior officials on both sides were appointed to oversee the dialogue.¹³ Working groups meet regularly;¹⁴ and a Technology Centre was established in November 2002 to exchange information and promote new energy technology to speed up the development of Russia's oil and gas sectors. The centre has organised roundtable discussions on exploiting Russian reserves and improving Russian oil refining. During the second half of 2005, the UK Presidency of the EU sought to prioritise the energy relationship and add new dynamism to the dialogue. To this end, a Permanent Partnership Council (PPC) meeting was held on 3 October 2005 at which plans and aims were agreed, and an implementation framework established. This has helped to structure the relationship by creating a broader set of interlocutors.

¹³ Victor Khristenko, Russia's Deputy Prime Minister (now Russian Minister for Energy and Industry) and François Lamoureux, Commission's Director General for Energy and Transport.

¹⁴ Working groups address energy strategies, technology transfers, investments and energy efficiency.



In a move that has been welcomed by officials on both sides, the dialogue now encompasses Russian and EU business and political authorities, which are represented in four thematic groups: investment, infrastructure, trade and energy efficiency.¹⁵

The energy dialogue has acted as a forum for tackling problems, with positive results, opening the way to European investment in the Russian energy market. As a European Commission Communication on this issue declared: “Frank and open discussions have already permitted substantial progress to be made”, and the dialogue has developed into a true partnership, offering wider prospects which go beyond the narrow questions of energy trade.¹⁶ The EU has been at pains to point out the strong common interest in the energy sector, and it has repeatedly confirmed that Russia has been a reliable supplier and has always respected agreed dates, amounts and prices, even during periods of internal political turbulence or dramatic world developments.¹⁷

For its part, Russia has sought to be a cooperative partner and there have been no signs that it is using its energy resources as a lever over the Union – indeed, EU officials and experts agree the opposite has been the case, pointing out that Russia has never suggested curtailing its energy supplies to the Union, in particular to the EU-15.¹⁸

The Union also believes that the energy dialogue has helped to integrate the energy market through a number of measures, including the interconnection

¹⁵ Joint EU Presidency and European Commission Press release on the EU ‘Russia Permanent Partnership Council on Energy’, London, 3 October 2005. http://www.europa.eu.int/comm/external_relations/russia/summit_10_05/ip05_1218.htm. Interviews: Moscow, Brussels, London, June, July, October 2005 & January, February 2006.

¹⁶ . Communication from the Commission to the Council on Energy Dialogue, 13 December 2004. www.europa.eu.int. EU-Russia Energy Dialogue, 5th Progress Report, November 2004. www.mosnews.com. ‘Putin, Blair Positive on Russia-EU Ties’, 4 October 2005. www.technologycentre.org.

¹⁷ Summit Press Release ‘Russia-EU Energy Dialogue Synthesis Report No.1, September 2001’, 4 October 2005. www.europa.eu.int.

¹⁸ Interviews with EU officials, June & July 2005.



of electricity grids; agreement on regulatory principles for internal markets and long-term supply contracts; and enhanced cooperation in the nuclear energy field and in advanced energy technologies.

However, problems and differences remain, and the two sides have differing interpretations of the relationship and their priorities. Russia seeks support to modernise its energy sector and protect itself, while the EU wants Russia to reform and open up its market by creating a more positive business climate.¹⁹ It is clear that EU-Russia energy cooperation is a ‘greater glue’ to certain other paradigms.²⁰ One of the challenges in the near future will be to organise a proper, representative and coherent EU-Russia energy dialogue.

Progress since 2000 has been mixed. There have been some notable successes, for example the establishment of a technology centre in Moscow in November 2002 and the start of several pilot projects for energy savings. But on many of the more important issues – pipelines, gas supply contracts, electricity sector restructuring and nuclear fuel supplies – the two sides continue to disagree.

There are several reasons why progress has been slow. First, energy is hugely important for the Russian economy. Even a government as reform-minded as that of President Vladimir Putin will tread carefully when it comes to energy market reform. Second, the EU-Russia energy dialogue involves a host of participants that do not always see eye-to-eye. The Russian government and the EU may agree on the importance of bilateral co-operation. But the key players in this field are private or state-controlled companies that often have their own agenda. Third, the energy dialogue is not only, or even primarily, about country-to-country sales of oil and gas. It has many implications for national economic policies, in particular energy market liberalisation. Last but

¹⁹ D.Lynch *Russia Faces Europe*, Chaillot Paper No.60, Paris: ISS, 2003, p.65. In fact, as Lynch points out, both sides are demandeurs in the negotiations.

²⁰ www.clingadael.nl/ciep



not least, the question of energy sector reform has become intertwined with other EU-Russian negotiations, in particular the ongoing talks on Russia's accession to the World Trade Organisation (WTO) and the fate of the Kyoto Protocol on climate change.

The EU uses both the WTO negotiations and the energy dialogue to push Russia to open up and deregulate its energy markets. At present, the gas market, including export pipelines, is entirely dominated by the statecontrolled gas giant, Gazprom, while the electricity market is in the hands of the UES power company. The Russian government is, in principle, committed to reforming both 'natural monopolies' by separating the production side from the transmission and distribution of energy. The EU is interested in Russian energy market reforms for several reasons. First, energy prices in Russia are only a fraction of their world market levels. The EU argues that this gives Russian exporters an unfair advantage, notably in energy-intensive sectors such as aluminium or fertilisers, and that therefore Russia should not join the WTO unless it is prepared to raise energy prices. But everyone in Russia, hether they are pro- or anti-WTO, regards this as an unreasonable demand. The issue of energy prices has become the biggest bone of contention in the negotiations over Russian membership of the WTO – and since the EU is Russia's biggest trading partner, it has considerable influence over the progress of those negotiations.

Both sides appear to have softened their stance to some degree. Russia no longer refuses to discuss energy prices in the framework of WTO talks. And the EU no longer tries to set a firm target for domestic Russian energy prices. "We have shifted our position, we no longer insist on EU energy prices for Russia," said Richard Wright, the EU's ambassador to Russia in May 2003, at a Helsinki seminar organised by the 'Russia in a United Europe' committee. "What the EU asks is that prices of energy to industrial users should be above loss-making levels. The trouble now is that we don't know at what price Gazprom sells gas at a loss."



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

The clauses are in breach of EU single market rules. They allow Gazprom to sell gas to different EU countries at different prices, and they prevent the EU from developing a functioning EU-wide gas market. The Commission has been negotiating with Gazprom on this problem and reports some progress. A third reason is that the EU fears that as long as Gazprom remains in sole charge of Russia's gas, Russian supplies may not keep up with rapidly growing EU demand. Gazprom's output has been more or less flat for the last decade, as the company has failed to invest sufficiently in the development of new gas fields. Meanwhile, Russia's privately-owned oil majors sit on huge gas fields that they do not exploit commercially because Gazprom does not allow them access to lucrative export markets.

The Russian government undoubtedly understands the issues at stake. In an April 2003 working paper, the European Commission reports that during a round table attended by Russian ministers and EU commissioners in December 2002, the Russian delegation "underlined that they take as a reference some elements of the EU model for the reform of their own energy market, notably the separation of the transportation function from production." But the Russian government may shy away from radical reform for political reasons, especially since it faces a parliamentary election in December 2003 and a presidential one in early 2004. Gazprom itself appears staunchly opposed to any suggestion that



it should be broken up or give independent gas producers access to its pipeline network. Industrialists, as well as UES, fear that higher gas prices could render them uncompetitive. But some insiders remain optimistic. Mihail Khordokovsky, chief executive of Yukos, Russia's largest oil company, is one of them. "The market will deregulate and independent producers will get access to the system," he predicted at the Helsinki seminar. He said that independent producers – such as his own company – would help to increase exports "and take perhaps 20 per cent of the export market."

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

The dialogue on oil is less politically charged, partly because Russia has already privatised and liberalised its oil industry. Just like the US, the EU is keen on diversifying its oil imports away from the volatile Persian Gulf region. Russia and other producers in the former Soviet Union offer themselves as a natural alternative. Russia has failed to install sufficient new export capacity in the form of pipelines and tanker terminals. Russia's private oil companies have suggested a number of new projects, including a pipeline to Murmansk, a deep water port in the Russian far north which would serve as a hub for exports to the US and the EU, and another pipeline to the fast-growing Chinese market. However, Russia's state-owned pipeline operator, Transneft, is loath to give up its monopoly. The Russian government sees the potential benefits of drawing private investment into the oil transport infrastructure. But it also likes the



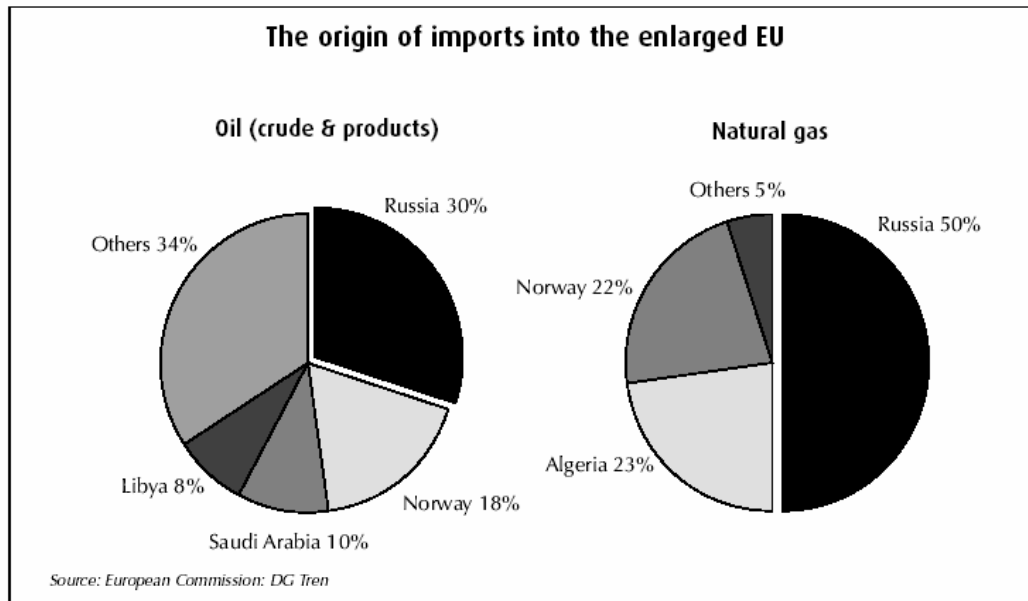
influence it wields over the powerful oil barons by controlling the export routes through Transneft.

In the oil sector, the EU-Russia energy dialogue has focused mainly on improving the conditions for European investment in the Russian oil sector. The EU has long pushed Russia to establish a workable framework for production sharing agreements (PSAs), which are commonly used in emerging market economies to secure the legal and tax environment for large-scale investments in natural resources. Russia has been dragging its feet. It claims that the recent decision by BP to commit almost \$6 billion to its Russian ventures is proof that PSAs are not needed. The EU insists that PSAs are still essential for high-risk projects, such as off-shore oil exploration. To lure more European money into the Russian oil sector, the EU is also working on a scheme that would insure EU companies against losses stemming from the weakness of Russia's legal system. In the past, EU companies have lost significant sums because their Russian partners have used local courts and prosecutors to gain control of the Europeans' investments. Two issues have recently moved to the top of the EU-Russian energy agenda and threaten to hold up progress in other areas. One is the import of nuclear materials from Russia. The EU's current rules do not allow the Union to buy more than 20% of its uranium from non-EU suppliers. Since some of the accession countries are highly dependent on Russian nuclear fuel supplies, enlargement will push the EU above this threshold. The Commission wants to amend the relevant legislation so that the Union can increase its imports of Russian Uranium. But some EU governments, influenced by corporate lobbying, have prevented the Council of Ministers from giving the Commission a mandate to change the rules. This has upset the Russians, who are understandably keen to increase their exports of uranium.

For its part, the Commission is concerned about Russia's refusal to ratify the Kyoto Protocol on climate change. It argues that Russia could benefit from participating in emissions-trading schemes. The Commission is also miffed



about the lack of Russian interest in the several pilot projects that have been established on energy conservation. As the Commission working paper observes, “the combination of low energy prices in Russia and an undemanding Kyoto target for the first commitment period (2008-12) means that energy efficiency and energy saving have not been given a high priority.”



The obstacles for a well-functioning energy partnership remain formidable. But self-interest on both sides is likely to sustain the dialogue in the coming years. The energy relationship is simply too important for either side to drop the dialogue. In the long run, if the dialogue makes progress and proves its value to all parties, it could become formalised in an EU-Russia energy treaty. Some Russian and Commission officials have floated the idea of a treaty that would cover rules on investment, security of supply, competition, technical co-operation and free circulation of energy. The energy dialogue has the potential to link the EU and Russia through solidarités de faits – the term used by Jean Monnet, the EU’s founding father, to describe how countries could become bound together through collaboration on concrete issues.



3.2. Energy security

There is a key foreign policy dimension to energy security, given that much of the EU's energy is provided by sources outside the Union and transported through other non-member states. Much of the recent high-profile comment on energy security has focused on the reliability of producers, and seems to posit producer and consumer in opposition to each other. However, seeing energy security as a 'producer vs. consumer' issue implies mistrust and is detrimental to understanding the complexities of energy security, which are affected by a more dynamic series of relationships.

As the 2006 G-8 summit showed, the distinction between 'producers' and 'consumers' is not all that clear – Canada, Russia, the US and the UK are all both leading producers and consumers, as is China.

This blurring of the difference between the two is particularly relevant for EU-Russia relations, because it highlights the importance of Russia's domestic market. Although growth in demand has been slow since the collapse of the USSR, experts predict that Russian domestic consumption will outpace that of the EU, and that Russian energy demand and consumption might grow by as much as 150% by 2030.²¹

This has several ramifications for the Union, because rising domestic consumption will absorb some of Russia's finite reserves. It also means that energy efficiency will become an even more important issue on the Russian energy agenda and in EU-Russia relations. In addition, if Russian domestic prices rise in response to demand, then the growing domestic market will become a larger and more attractive mainstay of Gazprom's sales. Since this

²¹ Interview with John Roberts.



will reduce Europe's ability to buy oil from Russia, the EU will no longer be Russia's main source of foreign currency²².

Moreover, these producers – who are often regarded as “unreliable foreigners controlling prices or access” – such as the Middle Eastern states and Russia, are not as untrustworthy as they might initially appear. They need the relationship as much as the consuming states. Most definitions of ‘energy security’ only describe it from the consumer's point of view, without looking at it from the producers' standpoint, even though this is a key element of the energy security debate.

As one expert has noted, most past interruptions of oil and gas supply did not occur after foreign producers cut off supplies to outside countries. Far more often, consumer countries reduced their imports because of sanctions and boycotts against oil-producing countries.

In addition, many of the interruptions in supply have resulted from domestic political and technical problems. In France and the UK, for example, industrial action (blockades) or technical problems resulting from a lack of investment, regulatory failures or cost-cutting have been responsible for cuts in energy supplies²³. It is also true, however, that over the last five years, there have been interruptions to supplies in the Baltic states, Belarus and Poland which were not caused by technical problems alone. Just as consumer countries need secure sources, producer states need secure markets and stable incomes.

This has three consequences for Russia. First, the Russian economy has been buoyed up by high oil prices, so a price reduction would have a major knock-on effect on the rest of the economy. Second, it would reduce the income from stable exports, such as those to Europe (from 2002-4, increasing oil exports

²² J.Stern The Russian-Ukrainian Gas Crisis of January 2006, Oxford: Oxford Institute for Energy Studies, January 2006.

²³ R.Skinner Energy Security and Producer – Consumer Dialogue: Avoiding a Maginot Mentality, Presentation to Government of Canada Energy Symposium, 28 October 2005. www.oxfordenergy.org.



were the main source of Russian GDP growth). A price reduction would also make transit costs more prohibitive, making Russia dependent on fewer markets. Just as having fewer energy sources undermines consumer security, so having fewer markets undermines producer security. For example, the high price of oil means that Russia can transport it to China by train, even though this adds an extra 5-7 Us dollars per barrel to the cost. However, should oil prices fall, this would no longer be economically viable and Russia would lose not only income but also a market until new pipelines could be completed.¹⁹ As these are expensive to build, a fall in the cost of Russian oil would undermine the financial case for construction. All this is significant for the EU-Russia relationship, because it helps explain why Moscow appears to be even more concerned about the future of the energy relationship than the Union.

There are a number of reasons for this. First, while the EU's internal market creates opportunities for Russia by creating the world's largest and most integrated energy market on its doorstep, it also generates anxieties.

Russian analysts believe that the European Commission will show "maximum tenacity and assume a hard stance" in safeguarding EU interests. Russia can only have a successful dialogue with the Union if the various Russian interests involved can reach a solid consensus on Russian interests in the energy sector.

This is likely to be difficult to achieve, with many questions left unanswered. What is the goal of Russia's energy policy in Europe? What are the limitations and risks involved? How can export revenues best be used for Russia's development?

Russian analysts argue that export priorities, routes, projected costs and sources of finance still need to be developed, as no detailed plans exist at present²⁴. This lack of consensus undermines the Russian negotiating position.

²⁴ L.Grigoriev & A.Chaplygina 'Looking into the Future: The Energy Dialogue Between Russia and the European Union', *Russia in Global Affairs*,



For example, the country's producers and transporters disagree: producers want to boost exports and have criticised Transneft, the pipeline monopoly, for its inadequate infrastructure. To deflect such criticism, Transneft has proposed restricting oil production and following OPEC's example by establishing state control over oil output²⁵.

Some Russian commentators have argued that the EU's objective in the energy relationship is to put pressure on Russia to reform its energy sector, particularly with regard to domestic prices. The Union, they argue, is trying to force Russia to bring its domestic tariffs closer to those of the world market. Official statements reflect such concerns, with President Putin warning in 2003 that "the EU will not succeed in twisting Russia's arm in its desire to achieve a sharp hike in fuel prices". Moscow has argued that it is politically unrealistic to increase the prices paid by poor consumers significantly, that energy resources are Russia's natural competitive advantage, and that raising prices would cause difficulties for Russian enterprises.²⁶

The EU and its Member States should realise that it would be just as difficult for Moscow to impose increased costs on Russian businesses and consumers (who are used to negligible energy costs) as it would be for Western governments to impose more efficient energy use or cuts in consumption on their own populations.

May 2003. <http://eng.globalaffairs.ru/numbers/3/476.html>.

²⁵ Interview with Julian Lee, Senior Energy Analyst, Centre for Global Energy Studies, August 2005. 'Pipeline Monopoly Suggests Russian OPEC', 23 March 2004. www.mosnews.com. It is also worth noting the differences in expectation of oil production capabilities, for example, 'Russia won't be able to increase oil production – Economic Minister', 17 June 2004. www.mosnews.com, and 'Russia to increase oil production – Russian Finance Minister', 24 May 2004. www.mosnews.com. There seem to be ongoing differences between the Ministries for Natural Resources, Finance and Economics about legislation and planning.

²⁶ Putin cited in Paramonov & Stokov, p.7; J.Robinson West has noted that many Russian industries remain highly inefficient and rely on cheap energy to subsidise their operations. p.125.



Finally, while many experts predict that EU demand for gas will grow, there are concerns in Russia that the Union's demand for oil will not rise significantly and that the market is restricted.

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 (Table 1). 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 1. Russian oil and natural gas in European markets, 2000-2020.

	2000	2020	Increase
<i>Oil</i>			
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
<i>Natural gas</i>			
EU-30 net imports (bln m3)	200	500	300
Imports from Russia (bln m3)	134	165	30
Russia's share, per cent	63	33	10

Over the last 25 years, Europe has rapidly shifted from consuming traditional fuels, primarily coal and oil, to natural gas



and, to a lesser degree, nuclear energy. Between 1973 and 2000, oil's share of Europe's energy consumption dropped from 60% to 40% and oil demand growth in the EU-27 (including Bulgaria and Romania) is likely to have fallen by 12.5% from 2000 levels by 2015. The development of the Baltic pipeline system is therefore of limited strategic importance for Russia, since its function is to supply a stagnating European market²⁷. Even though Russia is an important European oil supplier, European 'dependence' on Russian oil is questionable. Even analysts who argue that the EU is vulnerable to Russian political manoeuvres acknowledge that while the Union imported 16% of its oil from Russia in 1999, this had dropped to around 14-15% by 2004²⁸. Moreover, while the EU's share of Russian exports has doubled since 1991, its share of total Russian oil exports has fallen. This again suggests that Russia is more dependent on EU demand than the Union is on Russian supply.

The situation is similar in relation to Europe's 'dependence' on Russian gas. Given that the EU imports a high percentage of the gas it needs from Russia, the Russian gas industry is effectively being maintained by revenues from its exports to Europe. Although exports to the Newly Independent States will become more profitable, one expert has argued that only if Russian earnings from European gas imports drop considerably will it be time to question whether Russia "can afford to jeopardise security of gas supplies to Europe"²⁹.

Another drawback of the 'producer vs. consumer' prism is that it underestimates the importance of the third party – the transit states – which have a significant impact on both producers and consumers. Three examples of key importance for the EU's energy security will suffice. The first concerns Ukraine,

²⁷Grigoriev & Chaplygina; V.Milov Russian Energy Policy Challenges, Presentation, Moscow, February 2005.

²⁸ I.Gorst 'Russian Pipeline Strategies: Business vs. Politics', The Energy Dimension in Russian Global Strategy, J.A.Baker III Institute for Public Policy of Rice University, October 2004. p.3. J.Leijonhielm & R. Larsson, Russia's Strategic Commodities: Energy and Metals as Security Levers. Oslo: Swedish Defence Research Agency, FOI, 2004. pp.47, 50-1.

²⁹ J.Stern Gazprom. p.144.



a central actor for both Russia and the EU. Ukraine is a key transit state for Russian exports, which flow through the Druzhba pipeline. Austria, France, Germany, Hungary, Poland and Slovakia were all affected by shortages during the latest Russian-Ukrainian gas crisis, when Gazprom turned off supplies to Ukraine. This captured the headlines around the world, with Russia and Gazprom shouldering much of the blame.

However, it now appears that the reason why gas supplies to EU Member States fell was that Ukraine was taking gas destined for Europe to make up for its own shortfalls³⁰. In addition, Ukraine's decision to amend the Russian-Ukrainian supply and transit contract in Spring 2005 – demanding that market prices be paid for the transit of Russian gas – could be considered a unilateral breach of contract under international law, thus invalidating the contract. However, Russia clearly lacked the public diplomacy skills to explain its position effectively.

This crisis also had more far-reaching consequences. It undermined Russia's reliability and reputation as a prominent energy supplier, reducing consumer confidence, and highlighted the risks of relying on foreign sources and transit. This in turn triggered EU concern and underlined that energy security is a generic issue beyond considerations of Russian foreign policy. Some EU Member States are extremely vulnerable to changes in Russian energy supplies. Among the Visegrad states, Slovakia is the most dependant on imported Russian oil, gas and nuclear supplies (97% dependent for gas and 98% for oil). However, Slovakia is also Russia's major transit route, creating an interdependence that will tilt against Slovakia as Gazprom seeks to diversify its transit routes, and their interests will become increasingly at odds. As a result, complex diversification – suppliers, routes, energy mix – is a national priority for

³⁰ J.Stern The Russian-Ukraine Gas Crisis.



Slovakia, regardless of what Russia does. A larger central Europe energy security approach is overdue.

The other two examples highlight the importance of the Caucasus as an alternative transit route. Georgia is crucial for exports from the Caspian Sea, particularly as part of an alternative route to avoid Russian-dominated transit networks (the Baku-Tbilisi-Ceyhan [BTC] pipeline). However, Georgia has an unsettled relationship with Russia, as well as many unresolved domestic problems, including the growth of separatist movements. Although Georgia may seek to be a reliable transit state, there are factors beyond the government's control which undermine its reliability.

The final example is Turkey, a key transit state as oil is transported through the Bosphorus Straits and the Blue Stream pipeline. Although the Bosphorus Straits are international waters, Turkey has, in the past, restricted the movement of long and large capacity tankers through the straits at night. Since this is the most cost-effective method of transport for charterers and cargo-owners, these restrictions create a more expensive chokepoint, increasing both producer and consumer costs.

As this affects exports from the port of Novorossiisk, it has a significant impact on Russian exports. Moscow claims that by increasing restrictions on access to the Bosphorus Straits, Turkey could be violating the 1936 Montreux Treaty, which prohibited Turkey from taking unilateral action to interfere with the 'innocent' passage of vessels³¹.

However, the right of innocent passage is not without restrictions, especially in relation to the transport of dangerous goods such as oil, and the Bosphorus is already a heavily congested route. It is important for the EU to diversify its energy transit routes so that one actor or state (e.g. Russia) does not

³¹ J.Helmer 'Putin's Hands on the Oil Pumps', Asia Times Online.
www.atimes.com/atimes/Central_Asia/FH26Ag01.html.



completely control or dominate them, and all of the current transit routes pose problems for EU energy security.

There is also the issue of Russian control over central Asian energy in Kazakhstan, Turkmenistan and Uzbekistan. As Russia has the potential to unlock those resources, particularly if it goes ahead with the planned construction of energy supply infrastructure, central Asia needs to be an integral part of the EU strategy.

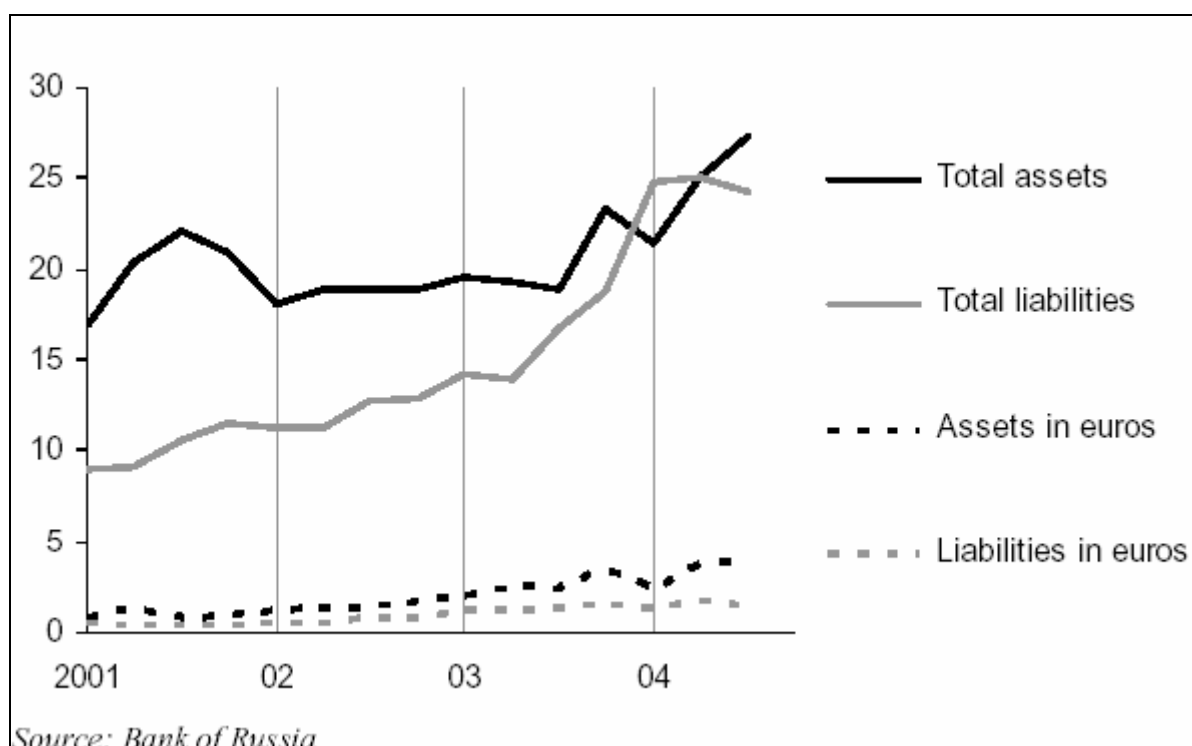
To sum up, energy security depends on a number of elements: diversity of sources and transit routes, energy type and energy efficiency. The EU is already beginning to address these issues. However, energy security is also about perceptions and confidence, underlining the need to build up an effective producer-consumer relationship.

4.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), 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.³²



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

³² 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.

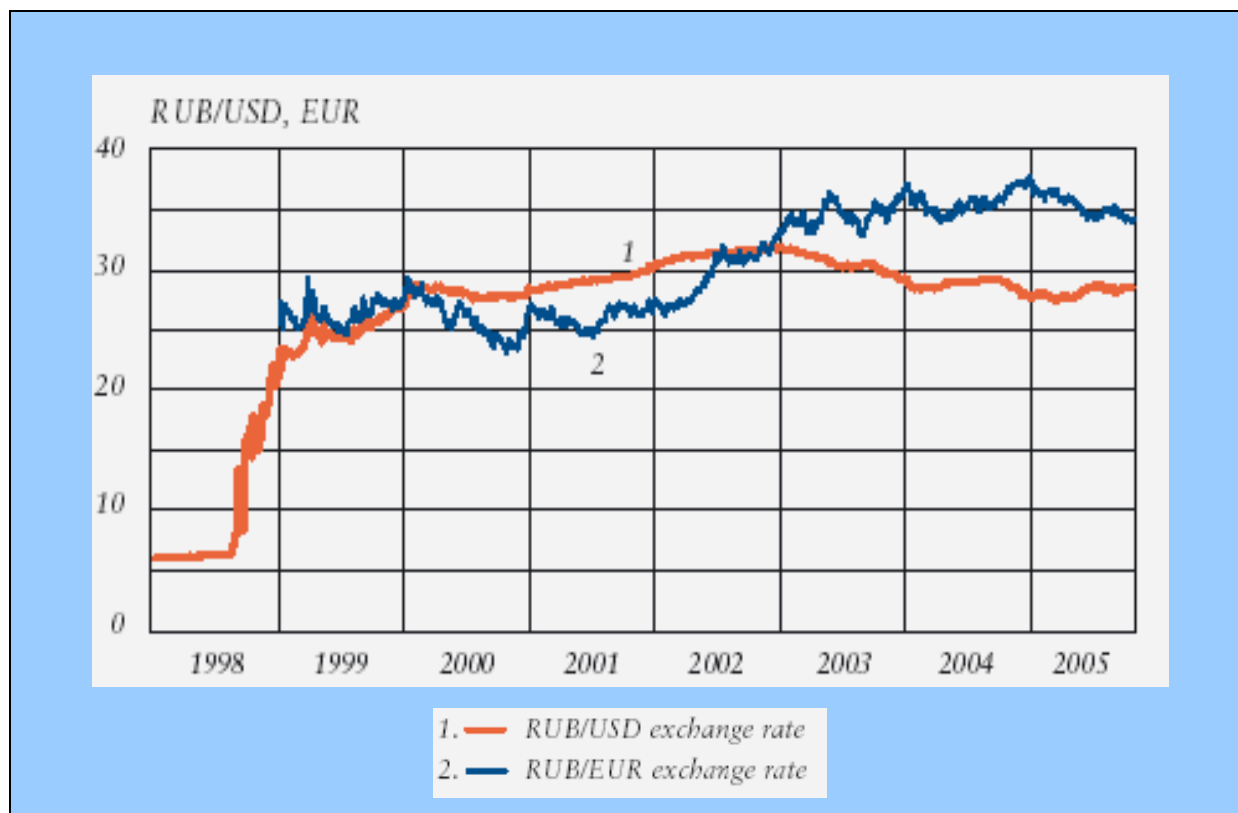


a somewhat problematic combination, especially given recent and foreseeable fluctuations in the euro-dollar exchange rate.

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.

The Russian current account has been very strong, with the surplus ranging from 10% to 15% of GDP. The surplus in 2005 is likely to stay at 14%. These are exceptionally high ratios by international standards. Russian economic policy in recent years deserves excellent marks, unlike in the early part of the 1990s, in particular. The temptation to use export receipts for immediate improvements in living standards or for large-scale public investments has been apparent, but this sort of policy would have easily led to an inflationary spiral and inefficiencies. Political consensus aimed at balanced economic policy has also lasted flawlessly, constituting – together with a robust improvement in the terms of trade – one of the pillars of growth. In this respect, Russia contrasts sharply with a number of Latin American countries, for example. The large current account surplus poses a challenge to monetary policy, especially when the Russian small financial market scarcely provides scope for sterilising the inflow of foreign currency.

In practice, the Russian central bank has kept the nominal value of the rouble fairly stable in relation to a basket composed of the US dollar and the euro .



The euro's weight in the basket has gradually been increased up to 35%. The broadly stable nominal exchange rate means a rapid appreciation of the rouble in real terms, being, on a trade-weighted basis, clearly more than 10% in the current year. According to recent statements, the monetary policy focus would be shifted towards deceleration in inflation. Fiscal policy has been supportive of balanced developments in maintaining considerable surpluses and transferring large income into reserves. Economic policy has accomplished a number of objectives. While inflation continues to be fairly high, presumably 10–11% this year, it does not appear to act as a constraint on financial market development. With anticipated price increases, the ongoing banking reform – combined with strongly rising stock prices – underpins both bank saving and a growth in the lending stock. From the supervisory authorities' point of view, the



stock of lending may even grow too fast. Borrowers have hardly any credit history, and the capability of monetary financial institutions of assessing risks is inevitably insufficient. The possibility of problem credits exists, but it must be recalled that the rapid growth in the stock of lending departed from a very low level. The Russian banking system continues to be very small. Bank deposits only account for 12% of GDP. Nevertheless, the share of longterm deposits has grown. Overall, the amount of money in circulation in the economy (M2) has grown rapidly, by several tens of per cent per annum. At the same time, the dollar's recent depreciation has led to a shift in roubles as the savings currency. In the first quarter of 2005, all bank deposits registered 30% growth, whereas foreign-currency deposits grew only by 20%. This is a highly welcome phenomenon. In a largely dollarised country, economic agents are quick to respond to exchange rate movements. As the rouble, like the currencies of other emerging economies, can be expected to appreciate further still, the shift into rouble holdings will continue. Meanwhile, the position of the euro will also strengthen, as economic agents diversify their asset allocation.

The rapid rouble appreciation in real terms could be expected to jeopardise output other than that of energy and commodities and lead to the traditional Dutch disease. This typically refers to a situation where a strong current account surplus, resulting from a recent discovery of natural resources or a sharp surge in the prices of natural resources, pushes up the value of the domestic currency so high that it becomes unsustainable. As a consequence, profitability elsewhere in the open sector collapses and the structure of the economy becomes more one-sided (as occurred in the Netherlands after the discovery of North Sea oil). This gives rise to large cyclical fluctuations, widening standard-of-living gaps and protectionist maintenance of jobs. Much as the Dutch disease may have been discussed in Russia, it poses no de facto problem. The rouble continues to be undervalued. This is a feature typical of emerging economies, and in the case of Russia the difference between current



exchange rates and the estimated purchasing power parity is also considerable, about threefold. Admittedly, the structure of Russian exports has become more one-sided, but it would appear that the problem is the real lack of competitiveness as a legacy from the Soviet times rather than an overvalued currency. The real exchange rate has edged up to the pre- 1998 crisis level, which many consider too strong; meanwhile, however, the productivity of the open sector has been enhanced so that unit labour costs in most sectors have not gone up in the post-crisis period. Improved productivity has largely rested on the higher utilisation rate of the existing production capacity, but many Russian companies have – in contrast to what is generally believed – intensified their production in other respects, too, and introduced various innovations. As the inherited efficiency is weak, it can also be expected to continue improving without unreasonably high costs. This offsets the eroding impact exerted by the strengthening real exchange rate on price competitiveness.

Both political decision-makers and experts fully understand the urgent need to diversify the production structure. Russia can never live solely by exporting energy and raw materials. At the present, the energy sector, contributing one quarter to GDP, employs only 1% of the labour force.

5 CONCLUSION

These results do point out several important conclusions. First, 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 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 farreaching consequences.



Second, as Hamilton (2002) emphasises, like all economically small nations, Russia must minimise the impact of geopolitics on trade relations. Small nations cannot afford to make economic decisions on political grounds. Russia must defend its interests, while recognising the facts of life. Russia's European strategy must be planned and implemented taking into account that the net benefits of further integration will not be distributed evenly.

Third, energy is a crucial element of the EU-Russia relationship. Here there are other significant problems. One is the lack of a coherent, coordinated energy strategy both in Russia and in the Union. Although this relationship has often been sluggish, the UK's successful prioritisation of the EU-Russia energy dialogue in 2005 reinvigorated this process and broadened the range of those with a vested interest. The proliferation of competing interests on both sides means that it is not clear what is being negotiated. In a market which requires considerable strategic planning and long-term financial outlay, this lack of clarity undermines the practical possibilities of the relationship.

The EU will also have to monitor the situation carefully in important non-member transit states, particularly Georgia, Turkey and Ukraine, as third-party relationships have already had an impact on the EU's supplies. This is all the more important because Russia's relations with its neighbours, particularly Georgia and Ukraine, are likely to remain difficult in the short-to-medium term. Most importantly, Russia's ability to meet demand may be considerably lower than anticipated, particularly in relation to gas production, and especially without significant investment. Finally, there will be increasing domestic and international competition for these limited Russian resources.

On another level, 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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