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**Research Report**

## European Energy Security in View of Russian Economic and Integration Prospects

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# Research Reports | 362 |

May  
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*Peter Havlik*

## **European Energy Security in View of Russian Economic and Integration Prospects**



**R**



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This paper was prepared within the framework of the project 'European Energy Security', financed from the Jubilee Fund of Oesterreichische Nationalbank (Project No. 115).

*Peter Havlik*

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## Summary

*The Russian economy had been booming in the past couple of years. The period of rising energy prices coincided roughly with the era of Vladimir Putin's presidency (2000-2008) that had been very successful economically. The speed of Russia's catching-up was then even faster than that of the new EU member states from Central and Eastern Europe. Russian economic growth had been fuelled mainly by surging energy export revenues which gave a boost to both private consumption and, later on, also to investment. The Russian rouble appreciated considerably in real terms, inflation remained in double digits and the cost competitiveness deteriorated as wages were rising much faster than labour productivity. Thanks to windfall gains from energy export revenues the government's external debts were paid back, foreign exchange reserves reached USD 600 billion as of mid-2008, and both the current account and the state budget were in a large surplus. However, the excessive dependence on energy has represented – together with adverse demographic developments and various institutional bottlenecks – a major challenge for the sustainability of Russian growth even in the medium and long run.*

*Russian policy makers have been aware of these vulnerabilities and launched an ambitious economic modernization programme already in 2007. The programme aimed at the diversification of the economy and at fostering innovation with the help of Industrial Policy tools and public-private partnership financing schemes. There were serious doubts that these efforts would lead to the desired results, inter alia due to the high risk of abuse, inefficiency and other institutional bottlenecks prevailing in Russia. Nevertheless, before the outbreak of the global crisis in mid-2008, the medium-term growth outlook was generally positive, although a growth slowdown appeared inevitable already at that time.*

*After September 2008, the global crisis hit Russia particularly hard; the main transmission channels were collapsing oil prices and sharply tightened credit conditions. The government responded quite early to the crisis with huge economic stimulation packages, supporting banks, large companies and also consumption. The government budget turned from a surplus into a large deficit. In spite of the anti-crisis measures, the GDP contracted by nearly 8% in 2009, largely a consequence of sharply reduced investment. However, recovery started already in late 2009 and may be rather robust – not least thanks to recovering energy prices. Apart from the collapse of oil prices and spillover effects from the global financial turbulence during 2008-2009, other challenges facing Russia relate to the country's integration in the world economy, especially regarding accession to the WTO, and Russia's relations with the EU and with former allies in Central Europe and the former Soviet Union. Relations with the latter – after having deteriorated owing to Russia's growing assertiveness which went together with the economic recovery, the enlargement of NATO and of the EU – have shown signs of improvement in early 2010. Despite large economic asymmetries between Russia and the EU (most evident in foreign trade,*



*investments and economic size) and sometimes conflicting interests (in particular regarding the contest for influence on the post-Soviet space), the paper argues that mutual interdependence requires cooperative approaches that would serve best the interests of Russia, the EU and the countries in between.*

*Russia is a major producer and exporter of energy, especially regarding natural gas. The EU is the biggest market for Russian energy exports – the EU-Russia energy dependency is thus mutual. The current mutual dependency notwithstanding, both the EU and Russia undertake serious efforts at diversifying energy supply sources (towards Azerbaijan, Kazakhstan, Iran, Turkmenistan, etc.), building new transit gas pipeline routes (Nord Stream, South Stream, Nabucco, etc.) and tapping alternative markets (China and Japan). Russia seems to be in a stronger position in the geopolitical game for controlling energy resources in the post-Soviet region, especially in the Caspian Basin and Central Asia: it has a common energy policy and strategy (in contrast to the EU) and possesses better knowledge and contacts to other energy producers in the region. In this way, and by exerting more control over the extraction and transit of energy from the region, Russia may also compensate for the exhaustion of domestic energy resources and can possibly counterbalance the declining indigenous energy production. Moreover, maintaining its energy export potential – which will remain crucial for Russian export revenues in the foreseeable future despite various diversification and modernization efforts – can also be facilitated by the mobilization of the still huge domestic energy efficiency potential. European energy imports from (or via) Russia can thus be maintained and probably even increased.*

*The relationship between the enlarged EU and the CIS requires a more intensive search for constructive approaches to the interaction within the triangle of Russia – EU – CIS countries. Turning the space of the common ‘near abroad’ of both Russia and the EU into a conflict area would be deplorable. Both Russia and the EU should therefore develop coordinated ‘neighbourhood’ policies – Common European (or Pan-European) Economic Space, recognizing the futility of ‘competing integrations’. Obviously, energy is one of the key areas for mutual policy coordination, but other steps should follow. A ‘reset’ of EU-Russian relations, away from the confrontation and towards more cooperation, is therefore highly desirable and the recent signs in this direction are encouraging.*

**Keywords:** *Russia, economic growth, energy, European Union, economic integration*

**JEL classification:** *E0, F15, F59, L9, Q4*

*Peter Havlik\**

## **European energy security in view of Russian economic and integration prospects**

### **Introduction**

Russian economic growth during the past decade has been largely based on surging energy prices and the strengthened role of the state in the economy. The attempted resurgence of Russia as a regional power in the Commonwealth of Independent States (CIS), deteriorating relations with the European Union (EU) as well as the challenges of future Russian integration in the European economy have also been associated with developments in the energy sector. The global crisis hit Russia particularly hard after September 2008: the excessive dependence on energy export revenues clearly exposed the weaknesses of the Russian economic development model. This paper analyses the role of energy in Russian economic growth, then turns to energy-related problems of Russian integration in the European and global economy, taking into account other major CIS energy producers (Azerbaijan, Kazakhstan and Turkmenistan) and transit countries (Belarus, Georgia and Ukraine).

The paper argues that Russia – one of the world's leading energy producers – will continue to rely on energy exports in the foreseeable future as its chances for a successful diversification of exports are quite meagre. Energy will thus remain the key source of Russian export revenues. Domestic extraction bottlenecks, another concern affecting the security of European energy supplies, can be compensated by tapping resources in other CIS energy producers as well as by exploiting huge efficiency reserves in domestic energy consumption. We find that the main challenge for European energy security is thus not only Russia's ability to supply, but also the ability and willingness to deliver energy to EU markets. The issue of energy transport and transit routes, especially regarding natural gas, is thus of crucial importance. The paper also argues that EU-Russia economic and energy dependence is mutual and the problems of European energy security need to be addressed by cooperation and dialogue rather than by a confrontation between Russia and the EU, taking into account the transit countries' interests (in particular Belarus and Ukraine) as well. The economic aspects of EU-Russian cooperation in the energy sector are discussed on the background of existing literature from both Russia and the EU. The recent research results related to energy issues in the region (e.g. European Economy, 2008; Papava et al, 2009; The World Bank, 2010) are updated and critically evaluated. The latest developments related to the effects of the global financial and economic crisis,

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fluctuating energy prices as well as Russian oil and gas output bottlenecks are briefly addressed as well.

### **Russian economic growth and the ambivalent role of energy**

We start with an overview of recent macroeconomic developments in Russia. The economy was booming in the past couple of years (economic growth resumed soon after the August 1998 financial crisis and the subsequent rouble devaluation) and most analysts – including the present author – were busy repeatedly revising GDP growth forecasts upwards, largely owing to surging energy prices.<sup>1</sup> Indeed, Russian GDP growth still exceeded 8% in 2007 according to official statistics, driven by a double-digit expansion of household consumption and even faster growth of investment (Table 1). During the period 2003-2007, Russian real GDP grew by more than 7% per year and even more so in nominal euro terms (Figure 1). At purchasing power parity (PPP), Russia's GDP amounted to EUR 1860 billion in 2008 – about 26% more than the aggregate GDP of the new EU member states of Central and Eastern Europe (NMS). In per capita terms, the Russian GDP exceeded EUR 13,000 in 2008 (at PPP) – reaching about 53% of the EU average – and the speed of catching-up to the average per capita GDP level in the EU had been impressive: about 18 percentage points between the years 2000 and 2008 (this was more than the NMS achieved during the same period – see Gligorov et al., 2010, Annex Table I).

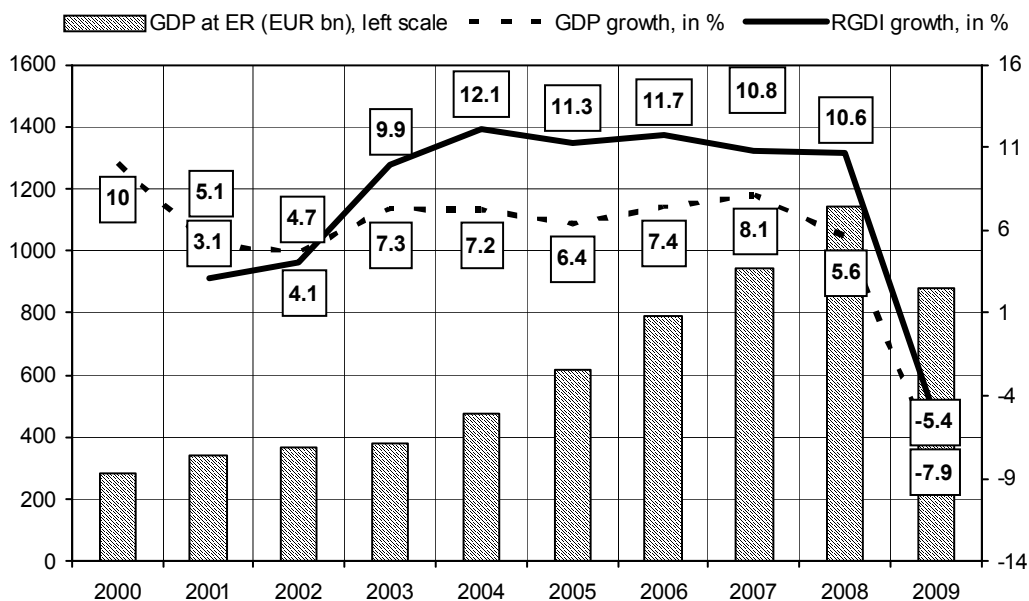
The global crisis hit Russia particularly hard and the vulnerability of the economic development model based on excessive dependence on energy became obvious. GDP growth virtually collapsed in the fourth quarter of 2008 and the economy plunged into a deep recession for almost one year. The stabilization and even (fragile) recovery in the autumn of 2009 notwithstanding, GDP contracted by nearly 8% in 2009 – mainly due to the collapse of investment (-20%). Foreign trade, with falling exports and sharply reduced imports (in both nominal and real terms), mitigated the overall economic decline: the real contribution of foreign trade to GDP growth was positive in 2009 after several 'negative' years. While manufacturing output and construction fell at double-digit rates, agriculture, trade and other services served as supply-side growth stabilizers. Preliminary figures indicate a 40% decline in FDI inflows and a reduction of the current account surplus (to about 3.8% of GDP). At the same time, CPI inflation slowed down (the GDP deflator even fell by nearly 3%) and the unemployment rate increased by about 2 percentage points. After the managed and costly depreciation at the turn of 2008-2009, the rouble has again been strengthening since mid-2009 as oil prices, export revenues and foreign exchange reserves started to recover.

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<sup>1</sup> The economic revival after the August 1998 financial crisis was initiated by the huge devaluation of the rouble which helped to boost import-substituting domestic industry. This effect has expired in 2007 at the latest (see below).

Figure 1

### Russian economic growth: GDP and RGDI\*



\*) RGDI is Real Gross Domestic Income – see Box 1 for details.

Source: ROSSTAT, Central Bank of Russia, own estimates.

The crisis threw the majority of the ambitious investment plans into the trashbin and the budget planning had to be thoroughly revised. Similar to the USA, the EU and China, the Russian government adopted various rescue and stimulus packages already in the fall of 2008. The aim was to improve the liquidity of the banking sector and restore confidence, to support the exchange rate and domestic consumption. The revised federal budget for 2009 entailed a huge fiscal stimulus as it reckoned with a nominal rise of expenditure by 7% despite falling revenues. As a result, the budget shifted from a surplus (5% of GDP in 2008) to a deficit of 5% of GDP. In sum, the costs of various anti-crisis measures may add up to 10% of GDP but their effects are hard to measure – judging by the sharp fall in consumption and investments they had been rather disappointing. Critics point to the usual dangers of misappropriation and corruption; they also argue that mainly the large (or well-connected) banks and companies stand to gain disproportionately. It is wondered – so far with some justification – whether the money had really reached the companies facing the liquidity squeeze. Indeed, the sharp fall of investments during 2009 (by at least 20%) indicated not only tightened credit, but a deterioration of business confidence, falling demand and the correction of previous housing bubble (construction output dropped by 16%). The share of investment (gross capital formation) fell to 20% of GDP in 2009 – a rather low figure compared to other transition countries and definitely insufficient for the urgently needed development of infrastructure and modernization of capital stocks.

Table 1

## Russia: Selected economic indicators

	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010	2011	2012
	Forecast								
Population, th pers., average <sup>2)</sup>	143821	143114	142487	142115	141956	141000	140000	139500	139000
Gross domestic product, RUB bn, nom.	17048.1	21625.4	26903.5	33111.4	41256.0	39016.1	42500	47000	51000
Annual change in % (real)	7.2	6.4	7.7	8.1	5.6	-7.9	3.4	4	4.3
GDP/capita (EUR at exchange rate)	3300	4300	5500	6700	8000	6300	.	.	.
GDP/capita (EUR at PPP - wiiw)	9200	10000	11100	12400	13200	12400	.	.	.
Consumption of households, RUB bn, nom.	8405.6	10590.0	12887.9	15900.9	19752.8	20979.5	.	.	.
Annual change in % (real)	12.1	11.8	11.4	13.7	10.7	-8.1	4	5	4
Gross fixed capital form., RUB bn, nom.	3130.5	3836.9	4980.6	6982.5	9200.3	7863.2	.	.	.
Annual change in % (real)	12.6	10.6	18.0	21.1	10.6	-18.2	5	7	10
Gross industrial production									
Annual change in % (real)	8.0	5.1	6.3	6.3	2.1	-10.8	5	5	5
Gross agricultural production									
Annual change in % (real)	3.0	2.3	3.6	3.4	10.8	1.2	.	.	.
Construction industry									
Annual change in % (real)	10.1	10.5	18.1	18.2	12.8	-16.0	.	.	.
Employed persons - LFS, th, average	67274.8	68169.0	68855.0	70570.5	70965.0	69400	69000	69000	68700
Annual change in %	.	1.3	1.0	2.5	0.6	-2.2	-0.6	0	-0.4
Unemployed persons - LFS, th, average	5674.8	5262.8	5312.0	4589.0	4791.0	6420	6400	6000	6000
Unemployment rate - LFS, in %, average	7.8	7.2	7.2	6.1	6.3	8.5	8.5	8	8
Reg. unemployment rate, in %, end of period	2.6	2.5	2.3	2.0	2.0	2.9	.	.	.
Average gross monthly wages, RUB	6739.5	8554.9	10633.9	13593.4	17226.3	18785.0	.	.	.
Annual change in % (real, gross)	10.6	12.6	13.3	17.0	10.3	-2.8	.	.	.
Consumer prices, % p.a.	11.0	12.5	9.8	9.1	14.1	11.8	6	7.5	8
Producer prices in industry, % p.a. <sup>3)</sup>	24.0	20.7	12.4	14.1	21.4	-7.2	5	7	10
General governm.budget, nat.def., % GDP									
Revenues	31.9	39.7	39.5	40.4	38.8	35.5	.	.	.
Expenditures	27.4	31.5	31.1	34.4	33.9	40.9	.	.	.
Deficit (-) / surplus (+), % GDP	4.5	8.1	8.4	6.0	4.9	-5.4	-5	-3	0
Public debt, nat.def., in % of GDP <sup>4)</sup>	21.6	14.9	8.6	7.2	5.7	8.1	10	10	10
Base rate of NB % p.a., end of per.	13	12	11	10	13	9	.	.	.
Current account, EUR mn <sup>5)</sup>	47867	67858	75474	56266	69871	34200	40000	35000	32000
Current account in % of GDP	10.1	11.1	9.6	5.9	6.2	3.9	4.2	3.4	2.9
Exports of goods, BOP, EUR mn <sup>5)</sup>	147358	195545	241960	258930	321792	218000	260000	275000	300000
Annual growth rate in %	22.5	32.7	23.7	7.0	24.3	-32	19	6	9
Imports of goods, BOP, EUR mn <sup>5)</sup>	78327	100608	130948	163282	199148	139000	170000	200000	225000
Annual growth rate in %	16.4	28.4	30.2	24.7	22.0	-30	22	18	13
Exports of services, BOP, EUR mn <sup>5)</sup>	16564	20028	24791	28798	35008	30000	35000	38000	42000
Annual growth rate in %	15.4	20.9	23.8	16.2	21.6	-14	17	9	11
Imports of services, BOP, EUR mn <sup>5)</sup>	26774	31077	35643	43151	52101	45000	55000	60000	70000
Annual growth rate in %	11.6	16.1	14.7	21.1	20.7	-14	22	9	17
FDI inflow, EUR mn <sup>5)</sup>	12422	10336	23675	40237	49732	30000	35000	45000	50000
FDI outflow, EUR mn <sup>5)</sup>	11085	10240	18454	33547	35911	25000	35000	40000	45000
Gross reserves of NB, excl. gold, EUR mn	88663	148094	224306	318840	292483	290431	.	.	.
Gross external debt, EUR mn	156687	216553	237687	321743	340234	327409	.	.	.
Gross external debt in % of GDP	34.8	34.2	30.7	34.9	34.2	36.4	.	.	.
Average exchange rate RUB/EUR	35.81	35.26	34.11	35.01	36.43	44.14	45	46	46
Purchasing power parity RUB/EUR, wiiw <sup>6)</sup>	12.92	15.06	16.99	18.80	22.09	22.35	.	.	.

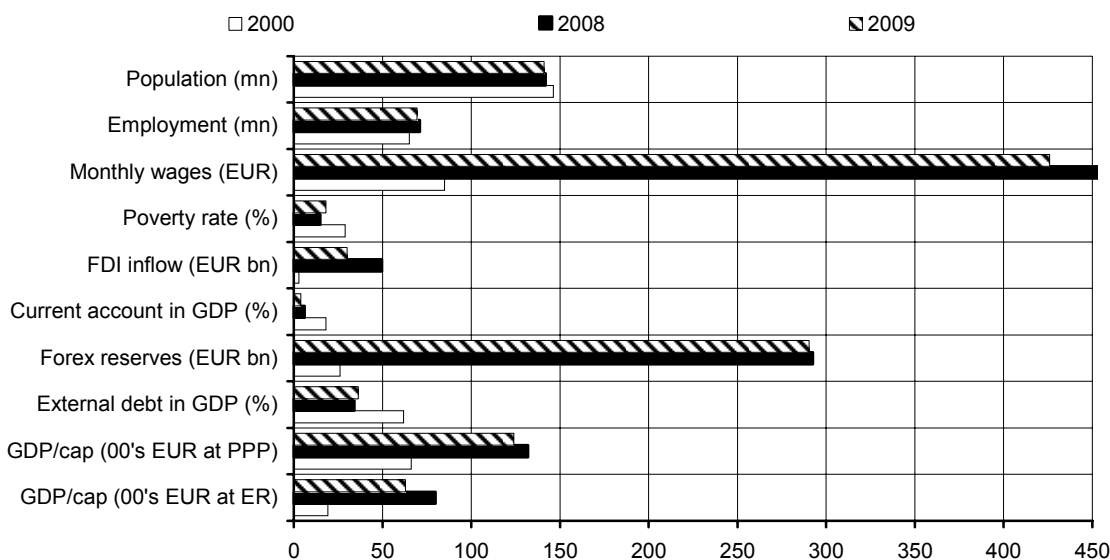
1) Preliminary and wiiw estimates. - 2) Resident population. - 3) Domestic output prices. - 4) wiiw estimate. - 5) Converted from USD with the average exchange rate. - 6) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: ROSSTAT, CBR, wiiw estimates; forecasts: wiiw (as of May 2010).

The Moscow stock market dropped by more than 70% between May 2008 (peak) and January 2009 – one of the largest declines among the emerging markets. A number of Russian blue chip companies (such as Gazprom, Rosneft, Lukoil, Sberbank, Norilsk Nickel) were initially hit particularly hard, reflecting partly investors’ overreaction, although fundamental factors played a role as well (decline in world prices for oil and metals and high exposure to short-term foreign debts). The adverse external shocks that triggered these events may have been compounded by domestic political factors, such as the Mechel and TNK-BP affairs of early summer 2008, the August 2008 war in Georgia and the gas conflict with Ukraine at the beginning of 2009. However, the shallow depth and relative immaturity of the domestic stock market should keep repercussions on the real economy in check. Indeed, the stock market developments reflected more a temporary overreaction on the part of the market participants rather than a lasting deterioration of the domestic investment climate (the stock market increased by more than 30% between January 2009 and end-January 2010).<sup>2</sup>

Figure 2

**Selected economic achievements of Putin’s era**



Source: ROSSTAT, CBR, own calculations.

During the past decade, accelerated economic growth contributed to rising incomes and wages and decreasing poverty levels, to rising employment (and declining unemployment), nearly full repayment of the government’s external debt, ballooning foreign exchange reserves, etc. Figure 2 provides a graphical illustration of selected relevant indicators in the years 2000 and 2008. Thanks to large windfall gains from rising world market energy prices and the related terms of trade improvement, the Russian government was able not

<sup>2</sup> See *The Economist*, 6 February 2010, p. 90.

only to repay nearly all outstanding public external debts, but also to accumulate close to USD 600 billion of foreign exchange reserves as of mid-2008. Apart from the Stabilization Fund (recently renamed Reserve Fund), another part of windfall proceeds from oil and gas exports is being accumulated in the newly established National Welfare Fund (more on that, see below). Moreover, several national development projects – targeting infrastructure, housing, the health sector, education, and agriculture – were launched during 2008 and salaries in the public sector and pensions were raised as well. By mid-2008 at the latest, the economy displayed clear signs of overheating, with inflation returning to double-digit figures and the rouble markedly appreciating (Figures 4 and 5).

As can be seen from Box 1, the terms of trade gains were large and positive from 2003 onwards and the real gross domestic income (RGDI, which takes into account the latter effect) was growing even faster than GDP. RGDI in 2008 was one fifth higher than the corresponding GDP. During 2004-2008, the cumulated terms of trade gains exceeded EUR 100 billion and real economic growth (measured by RGDI) exceeded 10% per year – matching closely the Chinese results. In contrast, and taking into account the recent oil price developments,<sup>3</sup> it can be expected that a substantial terms of trade loss was realized in 2009. Both GDP and RGDI growth was negative (estimated decline by about 8%), the associated terms of trade loss amounted to some EUR 13 billion.

The economic boom of the past decade can be explained to a large degree by surging world market commodity prices, in particular those of energy and metals. Figure 3 shows how the development of Russian exports has been closely linked to rising oil prices. Indeed, the surging revenues from energy exports have accounted for a major (and growing) share of total export revenues. During 1995-1998, energy export revenues fluctuated around EUR 25 billion per year (around 40% of total export revenues), compared to more than EUR 150 billion (and 60% of export revenues) recently. Yet after the surge of export revenues during 2004-2006, the export volume grew only slowly in 2007 while imports (in both real and nominal terms) soared by about 25%. As a result, the trade and current account surpluses diminished and the contribution of real net exports to GDP growth has been negative already since 2004 (see Figure 4). Higher oil prices helped to increase energy export revenues, yet proceeds from other exports – in particular metals – expanded even faster in 2007. The share of energy in total export revenues thus dropped by about 2 percentage points in 2007 (to 61%) compared to 2006. The sharp jump of oil prices in the first half of 2008 resulted in an increase of the share of energy in total export revenues to 67%. The opposite happened in the second half of 2008 and early 2009: the oil price dropped by half and with it also export revenues declined by nearly the same proportion.

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<sup>3</sup> During 2009, the average export price of Russian crude oil (USD 60.7 per bbl) dropped by 35% in USD terms as compared to 2008. According to preliminary balance of payments data from the Central Bank of Russia (CBR), export revenues decreased by 35% in nominal USD terms in 2009 (largely owing to declining energy exports).

### Effects of energy prices on Russian economic growth

Russian GDP growth has been driven since 2004 by booming private consumption and investment. At the same time, the growth effect of real net exports (exports minus imports, both at constant prices) has been negative because the volume of exports is growing at a slower pace than that of imports (Figure 3 below). Per definition, the methodology used for the measurement of real GDP excludes price effects – not only of the domestic inflation, but the effects of export and import prices as well (the effect of the so-called terms of trade). The latter effect, highly relevant in the current Russian context, is captured by another indicator: the real gross domestic income (RGDI). RGDI is defined as:<sup>4</sup>

$$\text{RGDI} = \text{GDP} + \text{ToT} \quad (1)$$

where:

$$\text{ToT} = (\text{X}-\text{M})/\text{P} - (\text{X}/\text{Px} - \text{M}/\text{Pm}) \quad (2)$$

ToT are terms of trade and X(M) are nominal exports (imports), Px (Pm) are deflators of exports (imports), and P is the average deflator of exports and imports. A positive (improving) terms of trade effect thus results in gross domestic income being higher than GDP.

#### Russian GDP and estimated Real Gross Domestic Income (RGDI), 2004-2009

Year	2004	2005	2006	2007	2008	2009
GDP (RUB bn, 2003 prices)	14197	15105	16223	17537	18515	17000
real GDP growth (%)	7.2	6.4	7.4	8.1	5.6	-7.9
ToT (2003 = 100)	116.0	133.8	149.1	155.2	178.0	173.0
ToT (RUB bn, 2003 prices)	652.8	1423.5	2243.9	2916.8	4107.6	3660
RGDI (RUB bn, 2003 prices)	14849.5	16528.8	18467.0	20454.0	22622.6	20700
RGDI growth (%)	12.1	11.3	11.7	10.8	10.6	-8.4
ToT effect, pp	4.9	4.9	4.3	2.7	5.0	-0.5
ToT effect (EUR bn)	18.8	22.2	23.6	19.4	34.3	-13

\*) Projection assuming that ToT deteriorated by 10% in 2009.

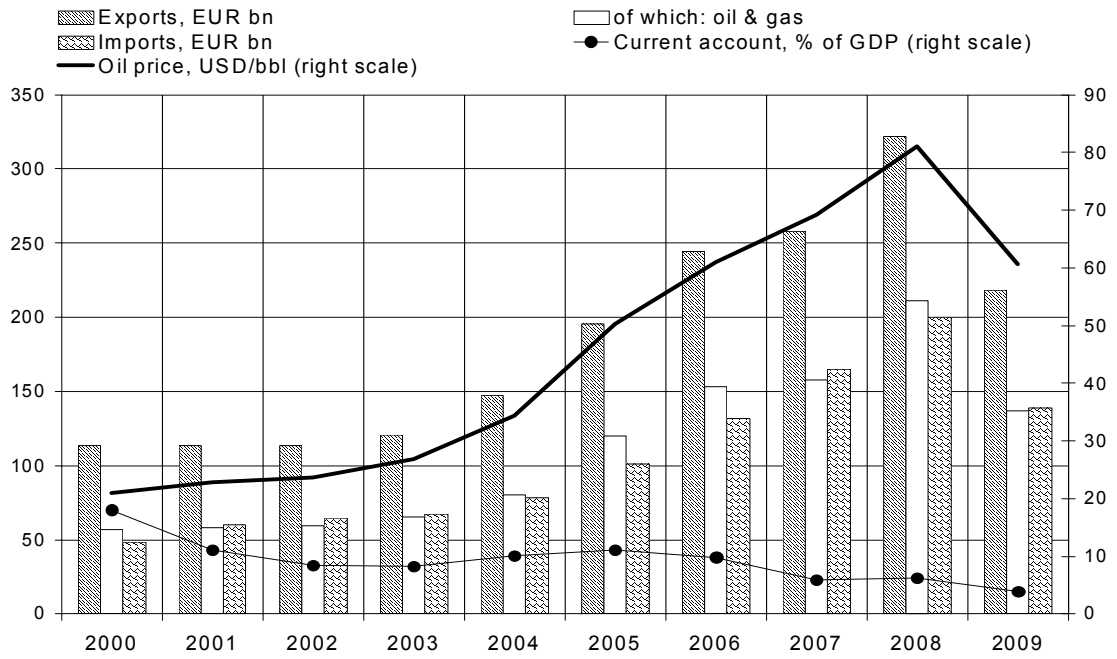
Source: OECD (2006); own estimates and forecast based on ROSSTAT and Central Bank of Russia (CBR).

<sup>4</sup> The term 'real' does not refer here to constant prices, but the product that the country has at its disposal. It is sometimes referred to as 'command' GDP, reflecting the real purchasing power of domestic residents – see Kohli (2004). The relation between RGDI and GDP was analysed by Vintrova (2005) and Mora (2006) for Central and East European countries. For Russia, the relation was analysed in OECD (2006) and by Kuboniwa (2007), who calculated various price deflators. The table in Box 1 provides estimates of RGDI for the years 2004-2009 using the above expression (2) and implicit price deflators of exports and imports, based on the latest (January 2010) official Russian data from ROSSTAT.



Figure 3

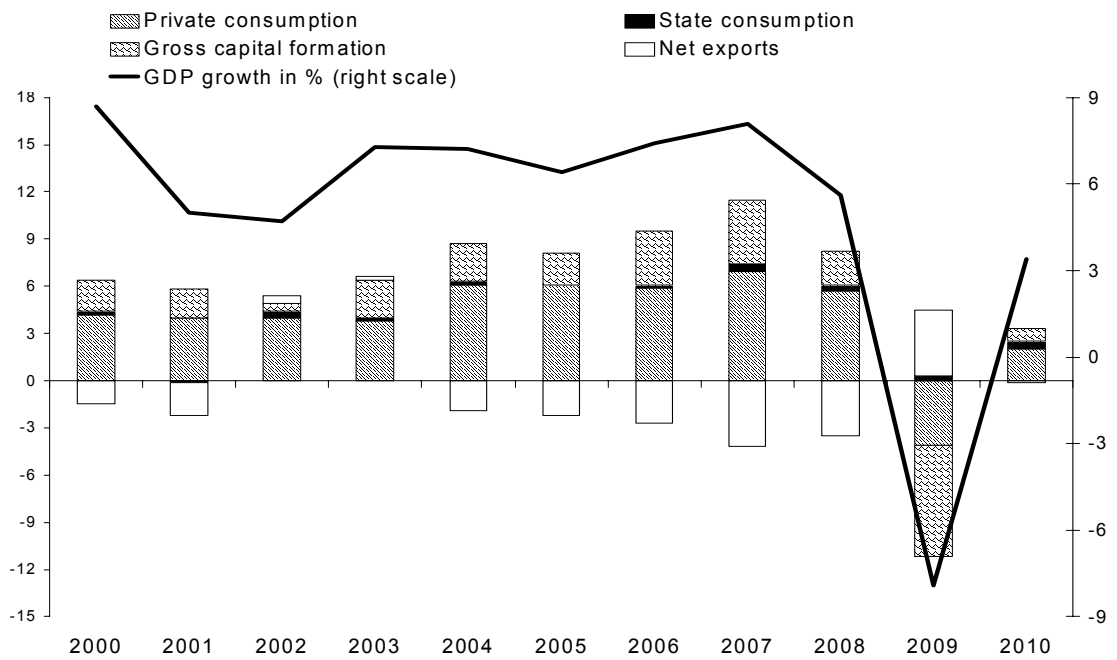
### Russian external sector and oil prices



Source: ROSSTAT, CBR, own calculations.

Figure 4

### Drivers of Russian GDP growth (contributions of main components in pp)



Source: ROSSTAT, own calculations.

## Persisting double-digit inflation

Russia was awash in money until very recently: both foreign exchange reserves and capital inflows were at record levels (the inflow of FDI in 2008 amounted to some EUR 50 billion; Foreign exchange reserves reached nearly EUR 300 billion as of end-2008), the government budget ran large surpluses (more than 6% of GDP in 2007 and still nearly 5% of GDP in 2008). The external public debt has largely been paid back (Table 1). The shadow side of that economic boom has been – apart from growing assertiveness, nationalism and a revival of some ugly remnants of past Soviet stereotypes – the return of double-digit inflation and strong rouble appreciation in real terms. The appreciation pressures resulted from the huge inflows of foreign exchange, despite some relief provided by the Reserve and National Welfare Funds which accumulate and sterilize part of energy-related export revenues. The managed peg exchange rate regime (the rouble is pegged to a basket of US dollar and euro, with the share of the latter gradually increasing) and the full liberalization of capital account transactions (since June 2006) require massive currency interventions in order to avoid an even more pronounced appreciation. The rapid growth of money supply in the past has made meeting the CBR inflation target extremely difficult, neither modest upward interest rate adjustments nor higher reserve requirements could bring much relief. Besides, consumer price inflation has been fuelled by rising prices for food, energy and housing as well as by administered tariff adjustments – at least until late 2008.

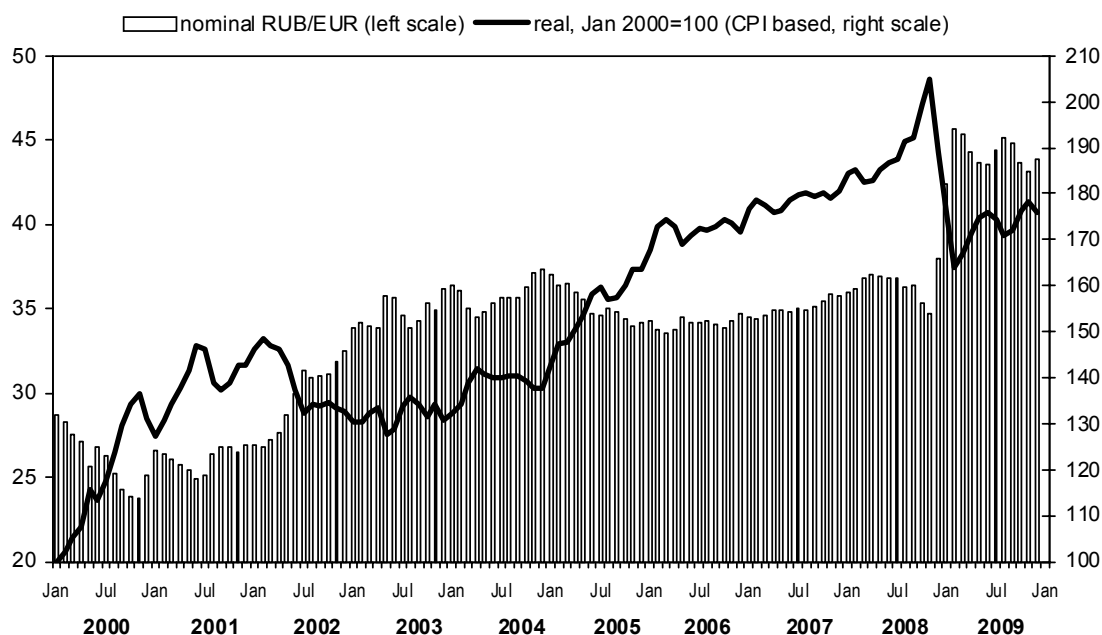
Figure 5



Source: wiiw Monthly Database, ROSSTAT, CBR, own calculations.

Figure 6

### Nominal and real exchange rates (rouble per euro)



*Note:* Increasing line indicates real appreciation.

*Source:* wiw Monthly Database, ROSSTAT, CBR, own calculations.

These factors translated into stubbornly high double-digit annual inflation – even in 2009 (Figure 5) – and a sizeable real appreciation of the rouble against the euro. Since the beginning of 2000, the rouble has appreciated by almost 50% against the euro (the nominal devaluation in late 2008/early 2009 was swiftly corrected after March 2009 – see Figure 6). The official inflation target of single-digit inflation aimed at in the past couple of years has never been reached; double-digit annual inflation persisted in 2009 as well – although producer prices have declined recently – despite a marked deceleration of money supply growth (Figure 5) and a new round of rouble appreciation (Figure 6). A gradual disinflation is forecast for the coming years (Table 1).

The three-year budget plan for the period 2008-2010, adopted in May 2007, reflected some important changes in economic policies. First, budget revenues were to depend less on energy proceeds (apart from the Stabilization Fund, which has been renamed Reserve Fund and should be maintained at 10% of GDP; another part of windfall proceeds from oil and gas exports were to be accumulated in the newly established National Welfare Fund – see Astrov, 2007). As a result, the share of budget revenues in GDP was envisaged to decline by about 5 percentage points between 2007 and 2010. Second, government expenditures were to increase (even as a share of GDP) with state-sponsored priority programmes to benefit most. In this way, the previous budget surpluses should be eliminated almost completely – well before any global crisis was in sight.

The global crisis exposed the vulnerability of the economic development model based on the excessive dependence on energy ('Dutch Disease'). GDP growth virtually collapsed in the fourth quarter of 2008 and the economy plunged into a deep recession for almost one year. The stabilization and even (fragile) recovery in the autumn of 2009 notwithstanding, GDP contracted by nearly 8% in 2009 – mainly due to the collapse of investment (-20%). Foreign trade, with falling exports and sharply reduced imports (in both nominal and real terms), mitigated the overall economic decline: the real contribution of foreign trade to GDP growth was positive in 2009 after several 'negative' years.

Among the anti-crisis measures figured also the support of the exchange rate. The Central Bank released more than USD 200 billion out of its reserves in order to provide additional liquidity and to support the rouble exchange rate in the final months of 2008. New loans to the banking sector with a maturity of up to six months were provided via the state-owned Vneshekonombank (VEB) with no collateral required. In addition, the VEB provided credit for refinancing short-term foreign loans, while acquiring shares in those companies as collateral. The bank guarantee on private deposits was raised to RUB 700,000 (about EUR 20,000 at the time). Altogether, more than USD 200 billion of state assistance in various forms was earmarked in an endeavour to ease the liquidity in the financial sector. Apart from the increased role of the state in the economy (this phenomenon occurred worldwide in the aftermath of the crisis), critics in Russia point to the usual dangers of misappropriation and corruption; they also expect that in the main the large (or well-connected) banks and companies stand to gain disproportionately. They wonder in fact – so far with some justification – whether the money will reach the companies facing the liquidity squeeze.<sup>5</sup> It is to be expected that a number of small and medium-sized banks will eventually collapse, the banking sector will be streamlined and the state will exert greater influence on companies seeking and obtaining financial help.

The revised federal budget for 2009 entailed a huge fiscal stimulus as it reckons with a rise of expenditure (+7 percentage points of GDP) despite falling revenues. As a result, the budget shifted from a surplus (5% of GDP in 2008) to a deficit of 5.5% of GDP in 2009. Previously accumulated resources in the Reserve Fund and the issuance of domestic debt will be used to support government expenditures on various investment and social programmes. In sum, the above anti-crisis measures may have cost about 10% of Russian GDP but their effects are hard to measure. Judging by the huge fall of GDP and investment one has the impression that the additional spending was largely squandered.<sup>6</sup>

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<sup>5</sup> In a recent study (the publication of which may perhaps signal a new attack on the oligarchs), two Russian researchers illustrate various ways of how those exploit the current crisis and disproportionately profit from government assistance and use various off-shore schemes for avoiding taxation – see Krichevskiy (2009).

<sup>6</sup> See Krichevskiy (2009). For a more detailed description of various anti-crisis measures adopted by the Russian government as of early 2009 and an assessment of their likely impacts see, for instance, Ericson (2009), Simachev et al. (2009).

The Russian authorities, as well as the IMF, OECD, The World Bank and others (including wiiw) have been busily revising GDP forecasts for 2009 downwards in the course of the past year. In mid-2009 the range of GDP growth forecasts for the year 2009 fluctuated between -2% and -10%, largely depending on assumptions regarding the level of oil prices. The preliminary official estimate of GDP decline in 2009 (-7.9%) turned out even lower than the revised wiiw forecast from autumn 2009 (which reckoned with GDP contracting by about 6-7%, largely as a consequence of sharply falling exports and reduced stocks in particular).

Nevertheless, fragile signs of recovery became visible already since late summer 2009. These included a modest increase in output, rising export revenues (thanks to higher oil prices), improving consumers' confidence and a stabilization of inflation. Indeed, GDP growth resumed in the fourth quarter of 2009, not least thanks to statistical base effects, with modest (up to 4% per year) growth acceleration possible in 2010-2012. After the huge contraction of foreign trade in 2009, both exports and imports have resumed growth again. This recovery notwithstanding, a GDP growth slowdown appears inevitable in the medium term, before any (highly uncertain) modernization and diversification efforts start to bear fruit.

### **Diversification with Industrial Policy tools**

The long-discussed controversial idea of Industrial Policy (IP) gained official blessing by early 2008. The government-sponsored IP should offer targeted support to various public-private partnership (PPP) projects in the automotive, aviation, shipbuilding and selected high-tech industries (such as nano, nuclear and space technologies). Some of these initiatives were mentioned as the key priorities in the economic programme of the new Russian President Dmitry Medvedev already after his election in 2008, yet the feasibility and efficiency of their implementation have been raising serious doubts – because of lack of resources in the aftermath of the crisis and not least also due to the widespread corruption and other institutional bottlenecks.

In the recent (September 2009) major policy declaration titled 'Russia, Forward' – which is sometimes being compared with Gorbachev's launch of 'perestroika' in the mid-1980s – President Dmitry Medvedev enumerated five *priority modernization areas* for overcoming Russia's 'historic' ills (the latter are represented by economic backwardness, widespread corruption and paternalist feelings in the society):

1. Leadership in the efficiency of the production, transportation and the use of energy.
2. New developments in the field of nuclear technology.
3. Development of information technologies.

4. Earth- and space-based infrastructure for broad information services.
5. Development of medical equipment, diagnostic and pharmaceuticals for the treatment of viral, cardiovascular, cancer and neurological diseases.<sup>7</sup>

Indeed, the main challenge for the Russian economy in the medium and long run is whether it will succeed in replacing energy exports as the key growth driver by the development of other sectors (diversification towards manufacturing, high-tech branches, services, etc.), and how it will cope with the acute demographic crisis (the population is projected to decline by nearly 10 million in the coming decade). The latest (August 2008) officially endorsed long-term development programme until 2020, prepared by the Ministry of Economic Development and Trade, envisaged in its 'innovation scenario' an ambitious economic diversification away from the current heavy reliance on energy and a gradual switch to innovation-based development supported by the above-mentioned IP instruments, as well as the completion of reforms aiming at an improved climate for investment and entrepreneurship. Growing investment in transport infrastructure, education, health and R&D should help to generate and maintain an average annual GDP growth rate above 6% over the next decade. In this scenario, the Russian economy will restructure, become more efficient, modern and competitive in the medium and long run. Alternative scenarios, based on continued heavy reliance on energy resources, lower oil prices and less investment would result in lower GDP growth rates – see Dashkeyev (2008).

The chances for a success of the 'innovation development' scenario had never been particularly high. They have definitely diminished in the aftermath of the war with Georgia in August 2008. The collapse of the oil price and the effects of the global crisis had radically curtailed – previously abundant – financial resources (at the same time, the limits of the resource-based growth scenario became even more obvious). Yet the main concern is that the recent sharp deterioration of Russian relations with (and not only with) the West will lead not only to serious repercussions for the future path of Russian economic reforms, but also to an inward-looking, autarkic development strategy which is doomed to fail.<sup>8</sup> The repeatedly delayed WTO accession represents an important setback for Russian economic reforms.<sup>9</sup> Russia has never been too enthusiastic about joining WTO. In fact, more recently the envisaged IP tools could well be in conflict with WTO rules. In this respect, the delayed Russian WTO accession initiated by the West (e.g. in the aftermath of

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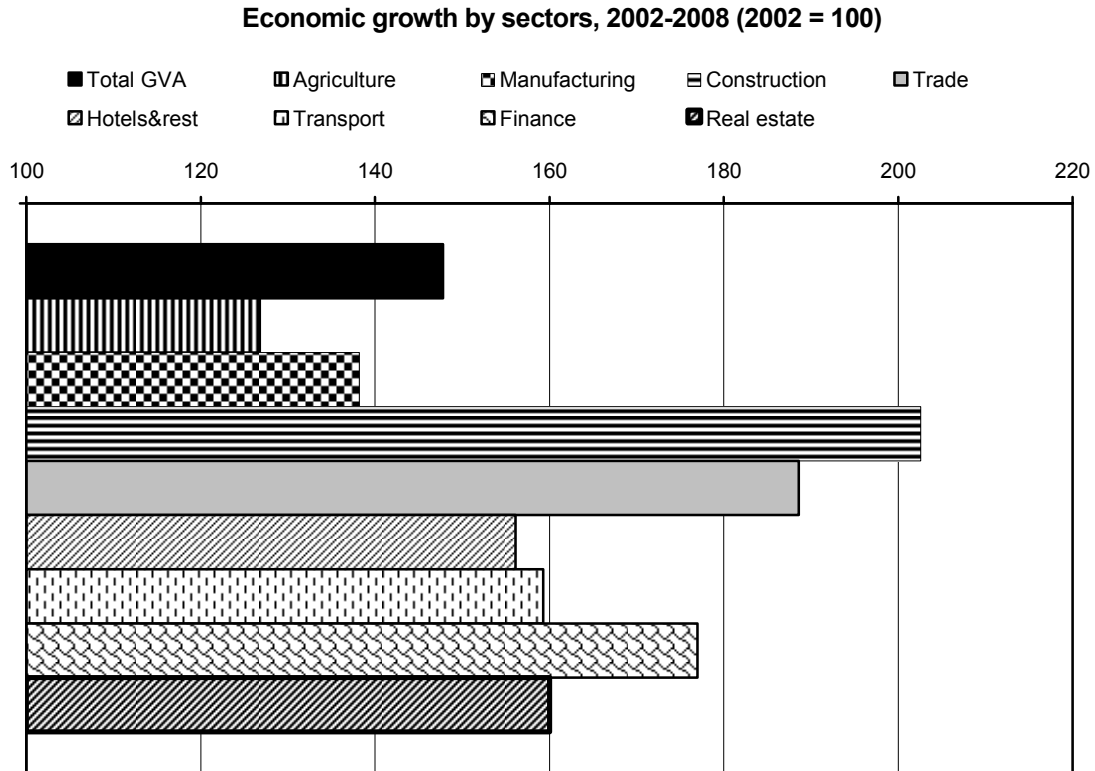
<sup>7</sup> Besides, in this policy declaration, President Medvedev once more reiterated his urgent appeal to modernize and diversify the Russian economy – see *Izvestiya*, 11 September 2009, pp. 2-3.

<sup>8</sup> In external relations, Russia has become increasingly assertive. Dangers of escalating external conflicts (e.g. a confrontation with Ukraine over the Crimea) are being recognized – see, for example, *International Herald Tribune*, 21 August 2009, p. 6.

<sup>9</sup> WTO accession represents one of the few available institutional anchors for economic reforms in the transition economies which lack the EU accession perspective – see Grinberg, Havlik and Havrylyshyn (2008).

the war in Georgia in August 2008) played to the hands of more protectionist Russian policy makers and sectoral lobbies. The accession to WTO was postponed once more in June 2009, this time after the agreement on forming a Customs Union with Belarus and Kazakhstan (starting from January 2010) had been finalized (see below).

Figure 7



Source: ROSSTAT, own calculations.

As far as Russia's ambitions regarding the above-mentioned 'innovation development' scenario is concerned, the prospects for its realization outside the WTO are also definitely bleaker. Another possible repercussion of the Russian-Georgian conflict is represented by the postponement of negotiations of a new EU-Russia Partnership Agreement (to replace the existing Partnership and Cooperation Agreement, which expired at the end of 2007 and has been automatically prolonged year by year).<sup>10</sup> Paradoxically, both types of Western 'sanctions' (delaying WTO and OECD accession, suspending talks about the new Partnership Agreement) not only further weaken the position of liberal reformers in Russia, but also diminish the success chances for an 'innovation-based' development strategy. The recent attempts by the new US administration to 'reset' relations with Russia represent a welcome step in the right direction which should be followed by similar initiatives by the EU (see below).

<sup>10</sup> For the conclusions of the EU extraordinary summit on 1 September 2008 see: [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ec/102545.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/102545.pdf)

### **Growth slowdown inevitable in the medium run**

As shown in Figure 4 above, Russia's GDP growth had been driven mainly by booming private consumption from 2004 and, increasingly, also by expanding investments. The contributions of real net exports to GDP growth became negative as the volume of exports was growing only at a modest pace (less than 10% per year) whereas import volumes were surging by more than 20% per year. On the supply side, the major part of the overall GDP growth resulted from booming retail and wholesale trade, financial services, telecoms and construction activities whereas manufacturing industry and agriculture expanded less than the overall gross value added (Figure 7).

As mentioned above, most forecasters have been busily revising GDP forecasts for 2009 downwards in the first half of that year (on this see, for example, Balling, 2009 and the contributions therein). Later on, after signs of a fragile recovery had become apparent from mid-2009 onwards, less gloomy assessments of the depth of the recession appeared. Nevertheless, with export revenues down by more than 30% as a result of lower energy prices, as well as due to rapidly falling investments, GDP dropped by nearly 8% in 2009 – more than initially expected, especially given the extent of the government's anti-crisis measures. Forecasts from the spring of 2010 reckon with a relatively robust V-shaped GDP recovery in Russia – not least thanks to a rebound in energy prices (GDP may increase by around 4% in 2010).<sup>11</sup>

Nevertheless, a GDP growth slowdown appears inevitable in the medium term, before any (uncertain) modernization and diversification efforts start to bear fruit. Our forecast for 2010 is based on a modest recovery of oil prices (Urals costing around USD 70 per barrel) and a limited lasting impact of the current financial market turmoil. Both private consumption and investment are expected to grow faster than GDP; real exports will continue to be sluggish at best since the volumes of exported oil and gas will hardly increase, while imports will grow at a faster rate – roughly in line with private consumption and investment. This implies an ongoing negative (albeit diminishing) contribution of real net exports to GDP and, in nominal terms, a gradual reduction of the trade and current account surpluses. In fact, the current account surplus, which leapt to EUR 70 billion in 2008 (more than 6% of GDP), has been gradually diminishing. Inflation will remain stubbornly close to 10% both in 2010 and thereafter (see Table 1 above).

Apart from the inward-looking and protectionist economic policies which began to emerge in the aftermath of the August 2008 Russian-Georgian conflict at the latest, another, and potentially even more serious, barrier to future sustainable economic growth and a successful diversification of the Russian economy is related to the danger of Dutch Disease and the gradual erosion of cost competitiveness. This results from a combination

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<sup>11</sup> See Gligorov et al. (2010), The World Bank (2010).



of factors such as the ongoing real appreciation of the rouble, rapid growth of wages and only sluggish improvements in labour productivity. During the past decade, unit labour costs in Russia were rising by close to 20% per year. By 2008, the level of Russian unit labour costs reached those in some Central European new EU member states (e.g. Bulgaria and Slovakia – see Gligorov et al., 2010 for a detailed comparison).<sup>12</sup> Given the competition from Central and Eastern Europe (including Ukraine) and from China in particular, Russia has already become a location too expensive (and thus non-competitive) for export-oriented manufacturing. Rising local production costs may distract even such investments, in particular FDI, that are oriented at the (until recently rapidly expanding) domestic market since the respective imports are cheaper (unless high tariffs or other protectionist measures are in place). In fact, the ongoing deterioration of competitiveness is probably one of the reasons why Russia has been so reluctant to join the WTO.

As mentioned above, the sharp deterioration of Russian relations with the West in the aftermath of the war in Georgia has also led to serious repercussions for the future path of Russian economic reforms (the outbreak of the global crisis in September 2008 was an additional factor). The accession to WTO (previously thought possible already in 2008) was delayed. Negotiations of a new EU-Russia Partnership Agreement were suspended immediately after the war; later on they were officially resumed but de facto put on ice. This stalemate harms both the EU and Russia: it further weakens the position of liberal reformers in Russia and strengthens the domestic protectionist and interventionist lobbies. Nevertheless, Russia's medium-term economic outlook remains broadly positive with both consumption and investment (including FDI) expected to expand further.

The economy is going to resume its growth in 2010 – albeit at much lower rates than expected previously (before the crisis). After the huge contraction of foreign trade in 2009, both exports and imports are expected to. Our forecast for 2010-2012 is based on the assumption of modestly recovering oil prices (Urals costing around USD 70-80 per barrel) and no abrupt policy changes or new external shocks. Both private consumption and investment are expected to grow faster than GDP; real exports will continue to be sluggish at best since the volumes of exported oil and gas will hardly increase, while imports will grow at a faster rate – roughly in line with private consumption and investment. This implies a small negative contribution of real net exports to GDP growth and, in nominal terms, a gradual reduction of the trade and current account surpluses. In fact, the current account surplus will gradually diminish (below 3% of GDP). GDP growth will not exceed 4-5% per year and inflation will remain stubbornly close to 10% in both 2010 and thereafter. Unemployment has been on the rise during 2009, though not dramatically. Apart from a few 'monocities' which depend on the fate of a single big plant (such as the

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<sup>12</sup> The growth of (domestic) unit labour costs continued during the crisis of 2009 since wages fell less than productivity. In EUR (and USD) terms, Russian (international) unit labour costs declined owing to rouble depreciation.

troubled Togliatti car factory Avtovaz), the employment effects of the crisis have so far been rather modest. They are being mitigated by demography as the domestic labour supply is diminishing. In fact, labour shortages are likely to reappear soon and will definitely put a brake on economic growth already in the medium run. Needless to say, another wave of crisis cannot be ruled out either.

The previous risks of overheating, especially in housing and credit markets, appear manageable whereas the above-mentioned concerns regarding the erosion of competitiveness may represent a more serious potential threat in the medium and long run. With a stronger economy, more financial resources and power consolidation at home, Russia's self-confidence (as well as its outward investments) will grow further – and this may lead to more conflicts with both the EU and USA, although the present tensions may calm down provided a further escalation (e.g. over Ukraine) is avoided. However, there is little doubt that both Mr. Medvedev and Mr. Putin will defend Russian interests – whether these are real or perceived – and these need not be necessarily identical with those of either the EU or the USA and will likely lead to additional tensions.<sup>13</sup> Some of these challenges, in particular those related to energy, relations with the EU and Russian integration policies and prospects, will be discussed in the rest of the paper below.

### **EU-Russia relations, European integration and energy security**

Several key problem areas affect the evolution of future EU-Russia relations in the context of energy security and a broader European economic integration. In this paper, we will briefly address only two aspects: EU-Russian trade (focusing on energy and the security of energy supplies) and the 'contest' between the EU and Russia for influence on the post-Soviet space.<sup>14</sup> In short, after showing the *mutual* EU-Russia dependency (and focusing on energy security only), we will argue that it is not only the physical availability of energy (production, transport infrastructure and exports) which affects the security of European energy supplies, but also prices, the existence of alternative markets and the willingness of suppliers and buyers to deal with each other. In this context, a diversification of energy supply sources, development of alternative transport and transit routes, as well as of markets, play an important role for both Russia and the EU by fostering competition. On the other hand, the construction of alternative transport routes requires huge amount of investment which may be difficult to finance in the current fragile financial situation.<sup>15</sup>

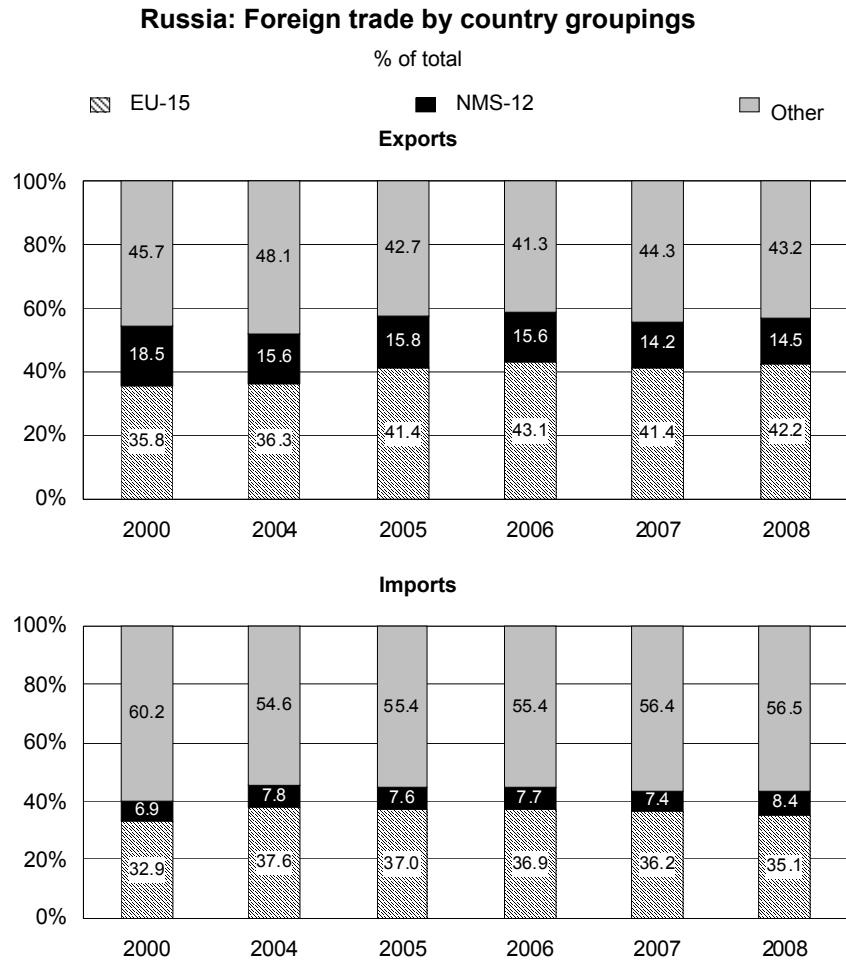
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<sup>13</sup> For an overview of Russian foreign policy after the year 2000 and an insightful analysis of the reasons underlying the worsened relations with the West see Sakwa (2008).

<sup>14</sup> Other areas of EU concern such as migration, the fight against organized crime, the environment, human rights and 'common values' etc. – all likely to be dealt with in the new EU–Russia partnership or strategic agreement – are beyond the scope of the present paper.

<sup>15</sup> More details on alternative transport routes see Mangott (2010).

Figure 8



Source: ROSSTAT, own calculations.

Starting with an overview of EU-Russian trade, it is useful to point out several asymmetries that characterize the present (and most likely also the future) trade flows between Russia and the EU. First, while more than half of Russian exports are destined for the EU (56% in 2008 – see Figure 8), Russia is still a relatively minor trading partner for the latter: only 4.2% of overall EU imports came from Russia in 2008 (and only 2.6% of EU exports went to Russia, less than EU exports to Switzerland – see Figure 10). From this point of view, one could argue that Russia is much more dependent on the EU than vice versa.<sup>16</sup>

Second, the EU has a large trade deficit with Russia (EUR 68.2 billion in 2008) and is therefore interested in getting a more free access to the Russian market, not only for goods but also for services (in particular banking and insurance). Most of the trade-related issues had been preliminarily agreed in the framework of the bilateral EU-Russia WTO accession deal which was finalized already in 2004. However, Russia's WTO accession has been dragging on for years and it is by no means certain that Russia will become a WTO

<sup>16</sup> For a more detailed analysis of trade between the EU and Russia see Havlik and Stöllinger (2009).

member any time soon – not only because of the aftermath of the war with Georgia,<sup>17</sup> but mainly because Russia is becoming more protectionist and the above-mentioned Industrial Policy may be in conflict with WTO rules. Apparently, the IP tools now enjoy higher priority than WTO accession. Indeed, Russia (Prime Minister Putin and Deputy Prime Minister Shuvalov) announced already in August 2008 the intention to critically review and, if perceived as disadvantageous, to suspend the implementation of agreed commitments prior to WTO accession (e.g. the reduction of quotas on poultry and pork meat imports). In June 2009, Russia announced that it intends to join WTO in a group with Belarus and Kazakhstan since all three countries have agreed to form a Customs Union starting in January 2010 (the latter two countries are much less advanced than Russia in their WTO negotiations).<sup>18</sup> All these dragging steps may be interpreted as a victory of Russian domestic protectionist and anti-reform lobbies. The standard position of the EU is that any negotiations about a future free trade agreement may start only after Russia has become a member of WTO.<sup>19</sup> Therefore, such negotiations are very unlikely to start any time soon, especially after the EU's postponing the talks on a new Partnership Agreement with Russia at the extraordinary Summit on 1<sup>st</sup> September 2008 following the conflict in Georgia and Russia's official recognition of independence of Abkhazia and South Ossetia. The subsequent worsening of EU-Russia relations resulted in stalled negotiations, despite the fact that EU-Russia talks were resumed later on.

Two thirds of Russia's overall exports consist of mineral fuels (Figure 9). Figure 10 shows the commodity composition of EU-Russia trade which is rather similar. EU imports from Russia concentrate on oil and gas, refined fuels and metals. These three commodity groups accounted for more than 70% of EU imports from Russia in both 2008 and 2009. In that year, EU's trade with Russia sharply declined (by close to 40% owing to the collapse of commodity prices) yet the share of energy in EU imports even increased since Russia did not manage to compensate adverse price developments – another illustration of the urgency of Russian economic diversification.

The EU is highly dependent on energy imports: the EU's import dependency exceeds 80% in the case of oil and 60% for natural gas.<sup>20</sup> More than one third of EU oil imports and 42% of EU gas imports (in physical units) originate in Russia.<sup>21</sup> This is the backbone of the

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<sup>17</sup> Georgia (WTO member since 2000) has threatened to block Russian WTO membership even before the recent escalation of the conflict over South Ossetia after Russia imposed trade sanctions on imports of Georgian wine and mineral water in 2006.

<sup>18</sup> According to Russian Deputy Prime Minister Igor Shuvalov, Russia may accede WTO in June 2010 and WTO accession still remains a priority – see [www.rb.ru](http://www.rb.ru) from 17 July 2009.

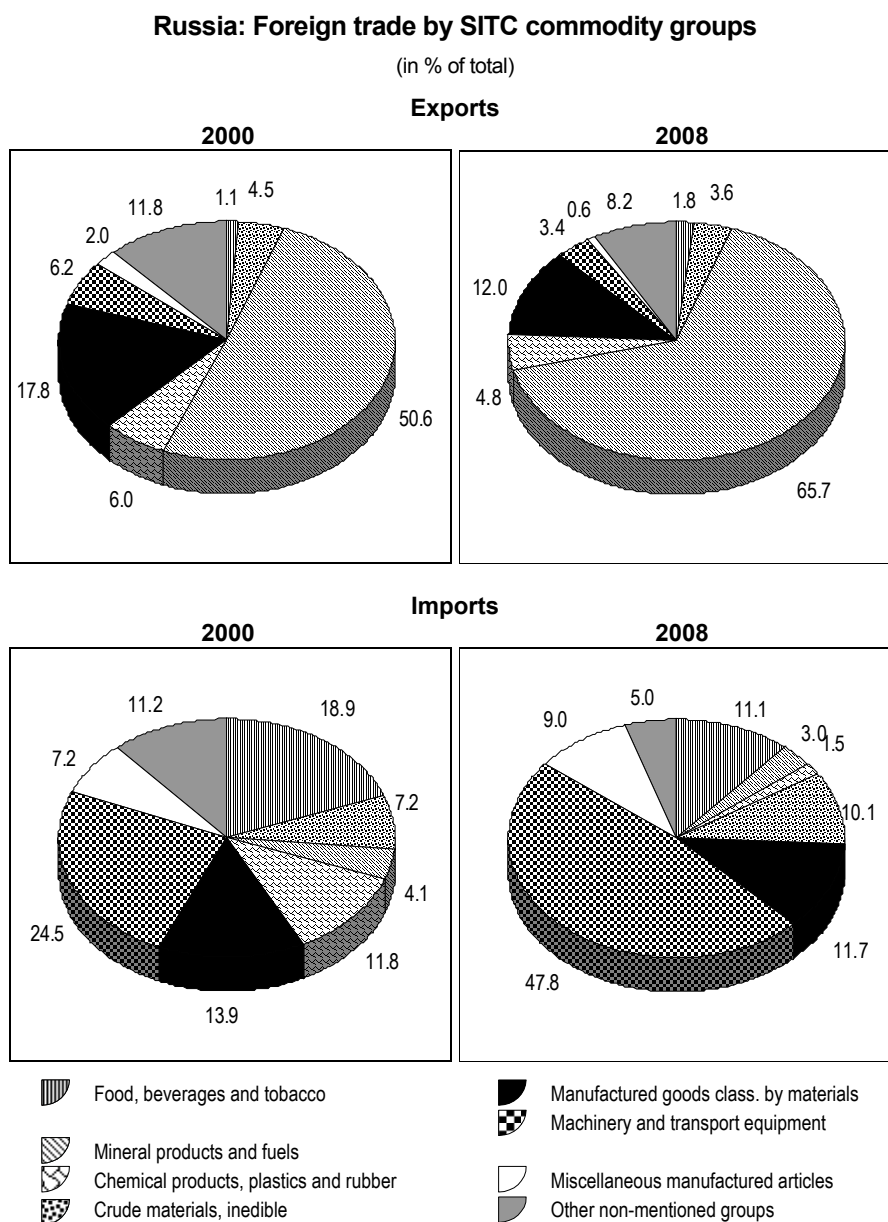
<sup>19</sup> This is similar to the case of Ukraine: negotiations about a free trade agreement with the EU started only in February 2008 after Ukraine had signed an accession agreement with the WTO.

<sup>20</sup> See European Commission (2008), Table 2.2.3. At the time of writing, the latest available data were for the year 2006.

<sup>21</sup> The EU's second most important energy source is Norway (16% of oil and 24% of gas imports) – see European Commission (2008), Table 2.2.4.

above-mentioned mutual EU-Russia dependency on which we elaborate in more detail below.

Figure 9



Source: ROSSTAT, own calculations.

Indeed, it is energy (and natural gas in particular) which dominates EU-Russia economic relations. Russia has been by far the largest energy supplier of the EU, although exact data are difficult to come by (the latest available volume figures from Eurostat refer to the year 2006). As shown in Figure 11 (which is based on the Eurostat COMEXT Database), in 2008 only 20% of the value of total EU energy imports originated from Russia; the new EU member states of Central and Eastern Europe (NMS-10, but among them especially Poland, Lithuania, Hungary and Slovakia) are highly dependent on Russian energy

deliveries.<sup>22</sup> And whereas the NMS have somewhat diversified their sources of energy imports recently (although more than half of their energy imports still comes from Russia), the West European (EU-15) energy dependence on Russia has even increased after 2000 (to 14.2% of their total energy imports in 2008). Russia refuses to ratify the European Energy Charter Treaty because of political and other (mostly economic) concerns, but has provisionally applied it in selected areas since 1998.<sup>23</sup> The Energy Charter would permit, for instance, the access of European companies to Russian energy distribution networks which is currently restricted. At the same time, Russia attempts to enter the downstream energy markets in the EU via several bilateral deals with Austrian, German, French, Italian, Bulgarian, Hungarian and Slovak companies. The Russian state-controlled giant Gazprom is particularly active in this area. Since energy is being considered a strategic sector, the Russian state has substantially increased its grip not only on domestic natural gas (where Gazprom has always played a dominant role), but also on independent crude oil producers by reversing, or at least revising, the earlier privatization deals or production sharing agreements, basically arguing that these deals were unfair having been made in the period of Russian weakness during the 1990s.<sup>24</sup>

There are several new Russian initiatives regarding energy issues: the proposal by President Medvedev of a 'conceptual approach to the new legal framework for energy cooperation' from 21 April 2009 which should replace the Energy Charter (see [www.kremlin.ru](http://www.kremlin.ru)) and the government's efforts to attract foreign companies in order to develop the Yamal gas field jointly with Gazprom and Novatek, probably due to the lack of own financial resources.<sup>25</sup>

While the EU depends to a considerable degree on Russian energy deliveries, Russia is even more dependent on the EU market for its (heavily energy-loaded) exports. With more than 56% of overall Russian exports going to the EU and two thirds of overall export revenues originating from exports of energy carriers, one could even argue that Russia is more dependent on the EU than vice versa (see also Figures 8 and 9 above). This situation of mutual interdependence is likely to persist in the foreseeable future because alternative supply routes and supplier countries for the EU are virtually non-existent – just as there are

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<sup>22</sup> 30% of the EU's petroleum and products imports (SITC 33) and only 16% of natural gas (SITC 34) imports originated from Russia according to Eurostat. However, Eurostat's trade statistics are confusing and some data are confidential. In some EU countries (e.g. Bulgaria and Austria), the energy imports from Russia officially reported by Eurostat are suspiciously low (Figure 11). The Austrian Statistical Office reports, for example, that more than 60% of Austrian natural gas imports came from Russia in 2006 (Astrov, 2009).

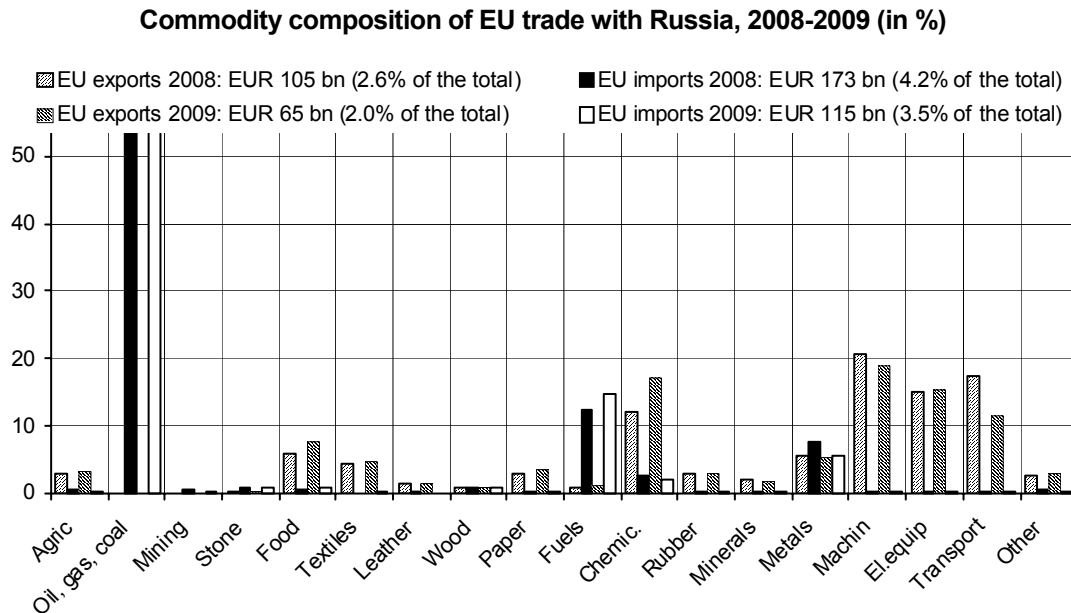
<sup>23</sup> This is similar to the PCA agreement which expired in 2007 but has been automatically prolonged. Among the Russian concerns regarding the Energy Charter the most important is the issue of a lacking Transit Protocol – see [www.konoplyanik.ru](http://www.konoplyanik.ru).

<sup>24</sup> The de facto re-nationalization of Yukos, the biggest private oil company (and putting in jail its boss M. Khodorkovsky) as well as the disputes surrounding the Sachalin production sharing agreements are the best-known examples in this respect.

<sup>25</sup> The development of the Yamal deposit may cost up to USD 100 billion – see *Vedomosti*, 22 September 2009.

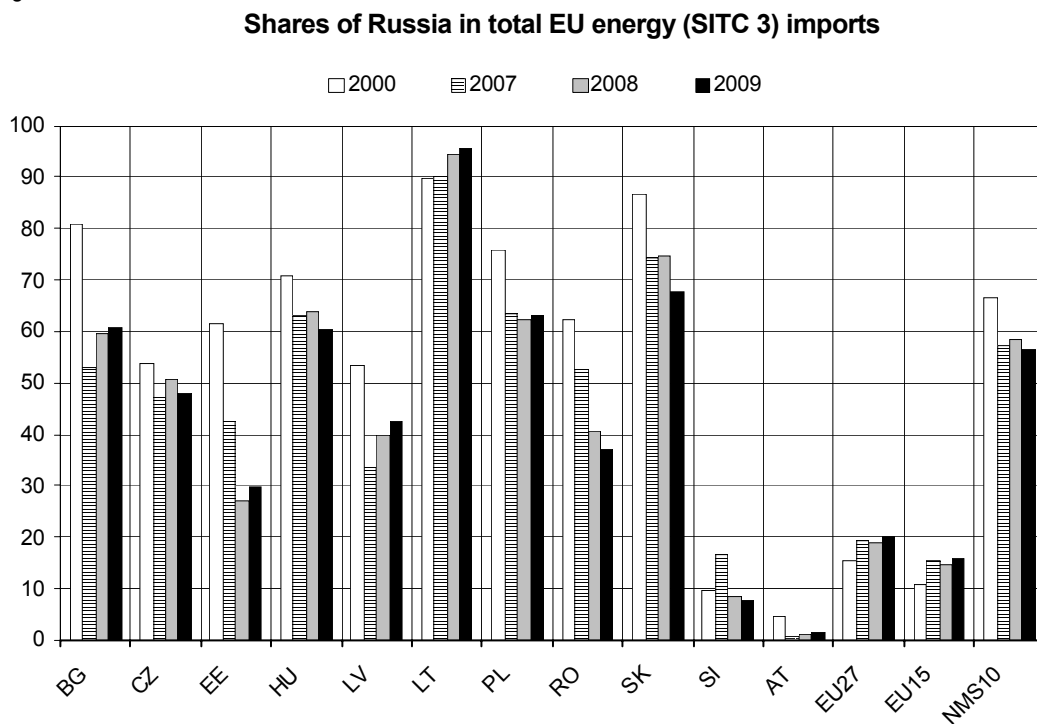
hardly any alternative markets for Russia. The question of European energy security in relation to Russia is therefore not primarily whether Russia is willing to deliver (it has hardly any alternatives in the foreseeable future), but it will be able to satisfy the growing share of EU energy demand given domestic production and other (e.g. transit) constraints.

Figure 10



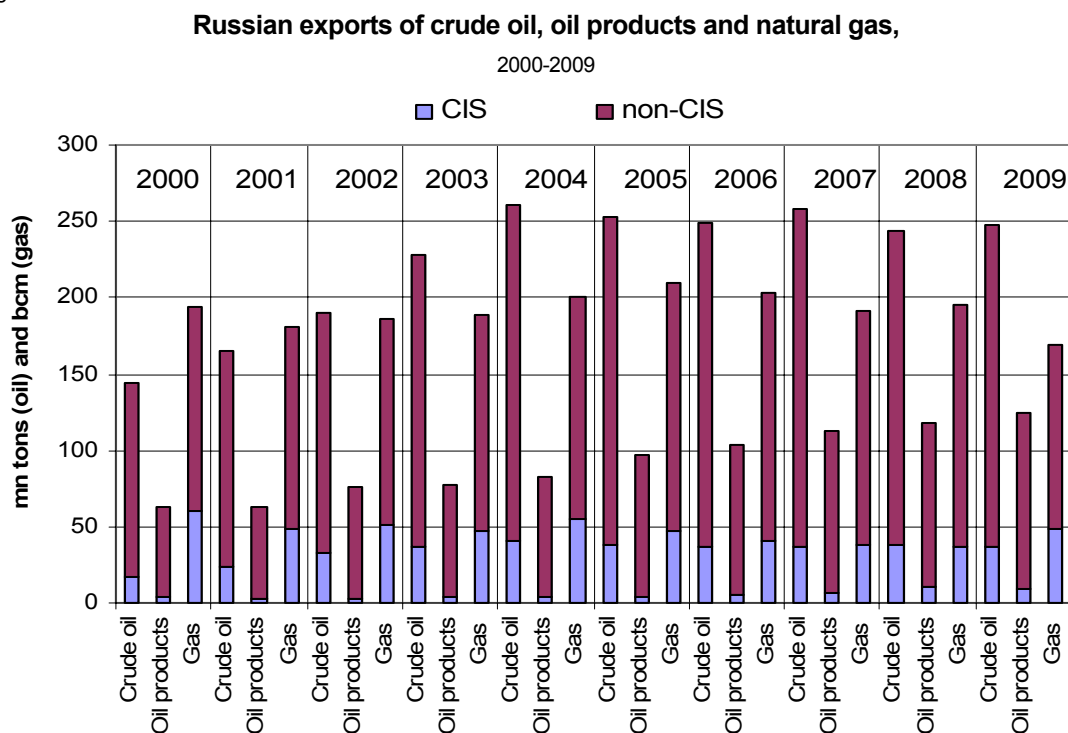
Source: Eurostat COMEXT and own calculations.

Figure 11



Source: Eurostat COMEXT Database and own calculations.

Figure 12



Source: ROSSTAT, CBR, own calculations.

The overwhelming share of Russian energy exports is currently shipped outside the CIS, largely to the EU (Figure 12).<sup>26</sup> Notwithstanding the recent (2009) drop in Russian energy supplies (especially of demand-constrained natural gas), in the longer run the available export resources (production minus domestic consumption), and therefore also the European energy security, should not be constrained by the shortage of Russian energy supplies either (see also Christie, 2010).

Box 2

**Recent developments in the CIS energy sector**

In 2009, the CIS countries produced 625 million tons of crude oil (including gas condensate), about the same amount as in 2007. This represented some 16% of the world's output. The bulk of the CIS oil output is being produced by Russia (494 mn tons, 78% of CIS output), other major CIS oil producers are Kazakhstan (76.4 mn tons), Azerbaijan (50.4 mn tons) and Turkmenistan (estimated about 9 mn tons). Smaller (and declining) amounts of oil are being extracted in Ukraine and Uzbekistan. CIS oil extraction has been stagnating in the last couple of years (except Azerbaijan where new fields resulted in doubling the oil output after 2005). During 2009, the Russian oil output stagnated but increased in Kazakhstan (+8%) and Azerbaijan (+13%). More than 61% of CIS oil output (383.4 mn tons in 2008) is being exported.

<sup>26</sup> The re-orientation of Russian trade, away from the CIS markets, occurred to a large degree already during the 1990s (see Havrylyshyn et al, 2008).



CIS countries are major producers of natural gas (about 28% of the world's gas output). The CIS countries extracted 861 bcm of natural gas in 2008, the main producers being Russia (663 bcm, 77% of the CIS), Turkmenistan (65 bcm), Uzbekistan (62 bcm), Kazakhstan (33.4 bcm) and Azerbaijan (16.3 bcm). CIS gas output grew by 3% in 2008 compared 2007, mainly thanks to an increase in Kazakhstan (+13%) and Azerbaijan (+48%). However, in the first five months of 2009 the CIS gas extraction dropped by 15%, mainly due to a drop by 19% in Russia (Azerbaijan's gas output grew by 18% in the same period). About 25% of CIS gas extraction is being exported (213 bcm in 2008), the main exporters being Russia (195.4 bcm) and Kazakhstan (17.4 bcm). In 2009, Russian gas production dropped by 12% and exports shrank by 14% compared to the previous year. It is expected, that for the year as a whole Russian gas extraction will decline by more than 10% and gas exports by nearly 20%.

Besides oil and gas, the CIS countries are also major producers of coal (517 mn tons, that is 8% of the world output, in 2008) and electricity (1465 bn KWh, 7.3% of the world's generation). The largest CIS coal producers are again Russia (326 mn tons), Kazakhstan (110 mn tons) and Ukraine (78 mn tons). In the first five months of 2009, the CIS coal extraction dropped by some 14% compared to the previous year. 71% of the CIS electricity in 2008 was generated in Russia (1037 bn KWh), another 13% (193 bn KWh) in Ukraine. In the year 2009, CIS electricity generation declined by about 6% compared to 2008.

*Source:* CIS Statistical Bulletin, No. 13, 2009, No. 2, 2010, Moscow.

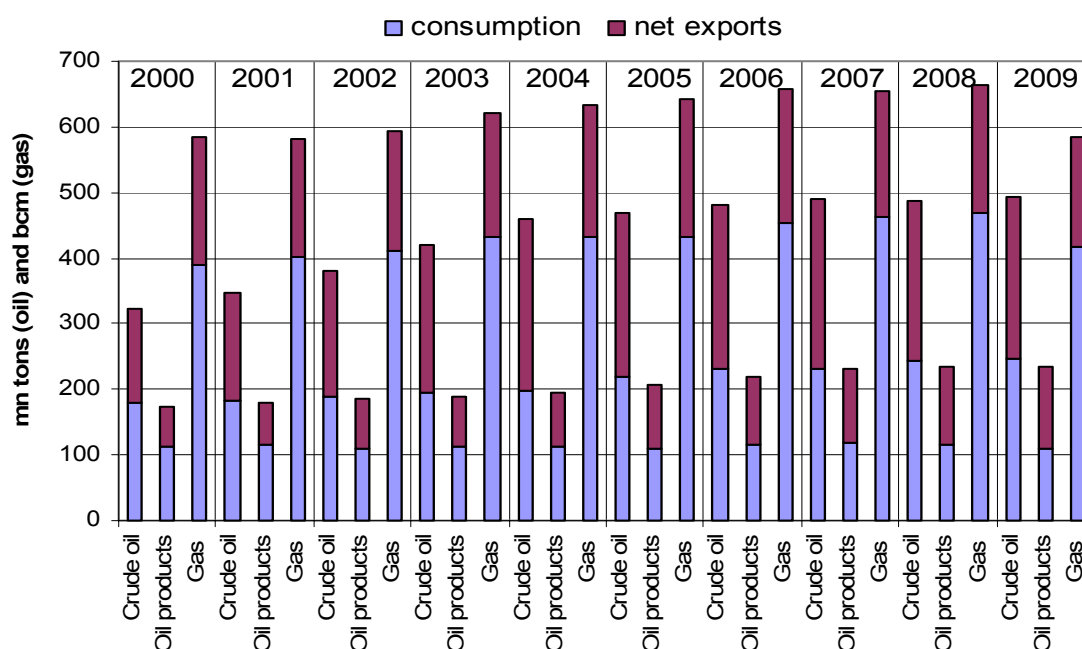
The trends in Russia's (and other CIS countries') energy production and energy trade patterns were analysed in detail in several recent papers (see, for example, European Economy, 2008; Papava et al., 2009; The World Bank, 2010) and will not be replicated here. Instead, we will highlight the main trends and briefly discuss the most recent developments – see Box 2. Russia, the largest CIS and (natural gas) world producer, has been exporting about half of domestically produced crude oil and only one third of its natural gas extraction. During the past decade, Russian energy production and export volumes have been gradually increasing (Figure 13). In the period 2004-2009, crude oil exports fluctuated at around 250 million tons per year, natural gas exports at around 200 bcm per year, and oil product exports increased from 82 mn tons in 2004 to more than 124 mn tons in 2009. Natural gas exports in 2009 dropped by 14% in volume as gas shipments outside the CIS were cut by 24% (Figure 12). The apparent domestic energy consumption (crudely estimated as the difference between production and exports) increased rather modestly – by 37% in the case of oil and 20% for natural gas between the years 2000 and 2008 – much less than the GDP growth in the same period (Figure 13; for energy export revenues see Figure 3 above). According to BP statistics,<sup>27</sup> Russia's total primary energy consumption (in mtoe) increased by only 9.5% between 2000 and 2008 whereas real GDP nearly doubled in the same period.

<sup>27</sup> See [www.bp.com/statisticalreview](http://www.bp.com/statisticalreview).

Figure 13

### Russian crude oil, oil products and natural gas; domestic consumption and net exports

2000-2009



Source: ROSSTAT, CBR, own calculations.

In 2009, the production, exports and consumption of natural gas in Russia dropped by some 15% owing to the global crisis. Indeed, developments in the energy sector have been quite turbulent recently. Besides huge price fluctuations during 2008-2009, the global crisis affected the demand for energy and new developments in the gas sector have led to a reassessment of likely future demand and supply trends. European gas demand (EU-27 plus Turkey and Switzerland) dropped by 4% in 2009 but is expected to recover in 2010. Total gas imports dropped marginally in 2009 (by less than 2%) and will rebound strongly. It is expected that the share of Russia in total European gas imports will rise from 40% in 2009 to more than 43% in 2010.<sup>28</sup> New discoveries of shale gas and other non-conventional energy resources in the USA and Canada (and possibly in Poland and elsewhere in the world) may change the structure of energy supplies in the medium and long run.<sup>29</sup> The development of new gas fields (e.g. Stokhman in the Arctic), pipeline construction feasibility plans (e.g. Nabucco) and even Gazprom's pricing schemes may be affected.<sup>30</sup>

<sup>28</sup> MGA Energy Special Report, 25 February 2010, p. 2.

<sup>29</sup> The Economist, 13 March 2010, pp. 67-69.

<sup>30</sup> Financial Times, 26 February 2010, p. 15 and 26 March 2010, p. 9. See also Financial Times Special Report, 29 March 2010.

## Efficiency reserves compensating declining extraction?

Russia is not only a large energy producer and exporter, but also the world's third biggest energy consumer (after the USA and China).<sup>31</sup> A recent study conducted by the Russian Centre for Efficient Energy Use (CENEF) on behalf of The World Bank and the International Finance Corporation has found that the energy intensity of Russia's GDP declined by 24% in the period 2000-2006. However, it is still much higher than in the EU and the potential for improvements is thus huge: the authors estimate the potential savings of primary energy consumption at 45% (down from 654 mtoe in 2005 to 360 mtoe – see CENEF, 2008).<sup>32</sup> Improvements in the efficiency of Russia's domestic energy use would, apart from environmental benefits, potentially release more energy resources for exports and compensate the likely fall in extraction (this applies particularly to gas, oil and oil products – see Figure 13). In OECD countries, the estimated effect of energy efficiency improvements on energy use during 1973-1997 amounted to 50% of actual energy use (The World Bank, 2010, p. 49). The experience of other countries, in particular the NMS, also suggests that economic restructuring, the introduction of new energy-saving technologies as well as price adjustments may result in spectacular energy efficiency improvements (see The World Bank, 2010 for details and estimates for gas by Christie, 2010). The above-quoted CENEF study estimates investments required to meet the Russian efficiency saving goals at USD 320 billion – much less than the investments needed to increase energy production. The measures necessary for energy efficiency improvements include the planned implementation (for the year 2010) of electricity and gas tariff adjustments, adjustments in the norms and legal regulations related to energy consumption and easier access to long-term financing resources. The largest efficiency reserves are in the residential sector (heating), energy production (e.g. gas flaring) and within industry. The above-quoted World Bank study estimates potential energy savings in Russia in 2030 at 45% of residential energy consumption and 41% of industrial energy use (The World Bank, 2010, p. 53). The study also quotes a number of examples how to achieve energy savings.

## Energy transit issues in brief

A separate (though partly related) issue of energy security is represented by the struggle for future alternative energy transport routes, linking Russia (and Caspian energy producers) with EU markets, such as the Russian-German pipeline Nord Stream, bypassing the Baltics, Belarus and Poland, and the Blue Stream and South Stream pipeline projects which bypass Ukraine and intend to deliver Russian and Caspian gas to

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<sup>31</sup> *BP Statistical Review of World Energy*, June 2009 – see <http://www.bp.com/statisticalreview>.

<sup>32</sup> More specifically, Russia could save 240 bcm of natural gas and 43 mn tons of crude oil per year. See also <http://www.vedomosti.ru/newspaper/article.shtml?2009/08/27/211661>. For comparison, the amount of inefficiently used energy equals the annual primary energy consumption in France (ibid).

Europe via the Black Sea and thus compete with the planned Austrian-led Nabucco pipeline project. In all these initiatives a complex mix of commercial and (geo)political interests is involved: on the one hand, the EU's declared aim to diversify energy supplies (in order to reduce its dependence on Russia). On the other hand, the Russian intention is to secure, and possibly even to increase, its role as the key energy supplier, as well as to bypass (some say to blackmail or destabilize) the present transit countries such as Belarus, Georgia, Ukraine and the Baltics, and to increase its position at European energy supply and distribution markets. Besides, Russia is also looking for alternative markets in the Far East (especially in China and Japan),<sup>33</sup> or energy supplies (e.g. Azerbaijan, Kazakhstan, Turkmenistan and Libya). In all these projects not only huge investments but also considerable risks are involved (for a more detailed discussion see Cheng, 2008; Goldthau, 2008; Astrov, 2010). The recent experience and the analysis of issues related to transit pipelines (including the lack and/or fragmentation of legislation) suggest that transit pipelines are prone to conflicts (for a concise analysis and suggested solutions of transit pipelines problems see Stevens, 2009).

There are several reasons to believe that Russia may eventually prevail in this geopolitical energy game.<sup>34</sup> First of all it is the lack of a common EU energy policy, as different member states pursue individual national interests (e.g. Germany, Italy, Hungary, France and Slovakia, who are more inclined to cooperate with Russia, while the Baltic States and Poland show more reservation in this respect). The disunity of the EU regarding energy issues was demonstrated anew in August 2009 when D. Grybauskaite, a former EU commissioner and recently elected Lithuanian president, displayed hostility towards the Nord Stream gas pipeline projects. At the same briefing, J. Buzek, the newly elected president of the European Parliament, reiterated that Nord Stream is not a priority project for the EU.<sup>35</sup> However, both Grybauskaite and Buzek were rebuked soon afterwards by EU Energy Commissioner A. Piebalgs, who made it plain that Nord Stream is a project of European interest.<sup>36</sup> In April 2010, the new EU Energy Commissioner G. Öttinger even went to Moscow (his first official visit outside the EU) marking the start of the construction of the Nord Stream pipeline, stating on this occasion that 'Russia is a strategic partner for Europe and the cooperation with the Russian government is one of my priorities.'<sup>37</sup> Other recent developments (the election of V. Yanukovich as President of Ukraine in March 2010, the tragic plane crash near Smolensk in April 2010 and its aftermath) also indicate a

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<sup>33</sup> In March 2010 the Russian state-owned company Transneft started the construction of the connecting part Purpe-Samotlor of the East Siberia – Pacific Ocean oil pipeline linking the Bankor oil deposits in Khanty-Mansyisk Autonomous Oblast'. The Far East part of the pipeline (Skovodino – Kozmino near Vladivostok) is already under construction – see *Izvestiya*, 12 March 2010, p. 5.

<sup>34</sup> For a similar reasoning and more detailed arguments see Filis (2009), SEESOX (2009) as well as Popescu and Wilson (2009) as well as Mangott (2010).

<sup>35</sup> See EurActiv.com, 27 August 2009.

<sup>36</sup> See EurActiv.com, 2 September 2009.

<sup>37</sup> See EurActiv.com, 8 April 2010.

rapprochement between Russia and Ukraine and, between Russia and Poland, respectively.

Controversies surround other pipeline projects, in particular South Stream and Nabucco.<sup>38</sup> The latter project seems to be particularly vulnerable owing to highly uncertain gas supplies as the involvement of Iran appears increasingly problematic. Russia is well aware of this situation and is ready to exploit European disunity (see Yurgens, 2009). Russia enjoys geopolitical advantages in the Black Sea transit and Caspian Basin energy-rich former Soviet republics (especially in Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan) where Russia's Gazprom has recently outmanoeuvred the EU in securing gas supply contracts of its own. Last but not least, Russia's consolidation of economic power (despite current setbacks – see above) and its role as both the leading trade and investment partner of the CIS underlines its influence in the region as well. Although the recent Russia-Georgia conflict was not primarily about energy transit, it illustrated the risks of alternative supply routes from the Caspian Basin; these risks tend to be perceived more seriously by (West) European market players. However, as emphasized by Stevens (2009), the international energy markets must live with this potential instability. 'The only way to mitigate this would be through diversification for both consumers and producers' (Stevens, 2009, p. 29).

### **Directions of future European integration**

Apart from energy issues, it is probably the EU's (and especially NATO's) Eastern enlargement as well as the EU's Eastern Neighbourhood Policy (ENP) vis-à-vis the CIS countries (in particular Ukraine, Georgia and Moldova) which are creating tensions between Russia and the EU.<sup>39</sup> The ENP has been perceived by Russia as an unwelcome foreign inroad into its traditional spheres of influence – the 'near abroad' in Russian terminology. The ENP aims to create a 'ring of friends' in the EU's neighbourhood by providing various incentives such as reform support, economic assistance, technical advice, trade concessions, etc. – without offering to these countries the potentially biggest incentive, namely EU membership. At the same time, Ukraine and Georgia aspire to full EU membership and other former Soviet republics (Moldova, potentially even Belarus) may voice similar aspirations in the future. However, the Western support of the 'colour' revolutions in several CIS countries is perceived by Russia as a deliberate attempt at regime change, ultimately aiming at the reduction of Russian influence in the CIS. From the Russian (even rather liberal) point of view, the 'EU's "neighbourhood" politics amounts in

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<sup>38</sup> See Mangott (2010) for more details.

<sup>39</sup> In May 2009, the EU launched a 'new phase' of ENP by establishing the Eastern Partnership with Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. The Eastern Partnership offers a 'new quality' in relations between eastern partners and the EU (Kentchadze, 2009). The explicit exclusion of Russia from this initiative raises many questions and opens room for potential conflicts.

essence to a strategy for creating an advantageously dependent periphery in the regions bordering the EU' (Yurgens, 2009, p. 11).<sup>40</sup>

Simultaneously, there is a number of integration projects on the post-Soviet space such as the Commonwealth of Independent States (CIS) involving all former Soviet republics except the three Baltic States (which became EU members in 2004),<sup>41</sup> the Common Economic Space (CES) involving Russia, Belarus, Ukraine and Kazakhstan with the aim to establish at least a Customs Union (the latter is opposed by Ukraine), the Central-Asian Cooperation, the Union State of Russia and Belarus, etc. – all involving Russia as the dominant partner.<sup>42</sup> So far these integration efforts have not been very effective.<sup>43</sup> However, Russia is considering its 'near neighbourhood' as its traditional sphere of influence; President Medvedev has declared relations with the CIS as top priority.

The geo-economic context for understanding the competition on the post-Soviet space is illustrated by Figure 14, comparing the relative economic strength of the key actors. It is interesting to see that the relative size of the Russian economy (real GDP, at purchasing power parity – PPP) in the CIS is practically equal to that of Western Europe ('old' EU-15 member states) in the broader Europe. One could argue that just as the EU-15 dominates the European economy ('European' includes the new EU member states, Russia and Ukraine), it is Russia which dominates the economy of the CIS. And similar picture would emerge by comparing trade and investment flows: owing to its economic strength, the EU-15 is by far the biggest trading partner of the NMS and Russia, whereas the latter are much less important for the former (see above). Russia's strategy to negotiate bilaterally with individual EU member states (e.g. in energy issues) is thus perfectly rational since it reduces the economic overweight which the 'unified' EU as a whole would otherwise enjoy in Europe.<sup>44</sup>

As mentioned above, intra-CIS trade declined dramatically during the 1990s, immediately after the dissolution of the USSR (see Havlik, 2007). Yet in contrast to the relatively small role of the CIS in Russia's foreign trade (in 2008 only 15% of Russian exports and imports were traded within the CIS), the share of the CIS (and of Russia in particular) remains still high in the foreign trade of smaller CIS republics, including both Ukraine (36% of exports and 39% of imports) and Belarus (44% of exports and 66% of imports) – especially as far

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<sup>40</sup> The policies of the EU and Russia towards Central Asia are analysed by Cameron (2009).

<sup>41</sup> Georgia quit the CIS after the August 2008 war with Russia.

<sup>42</sup> The only integration project on the post-Soviet space without Russia is GUAM, which comprises Georgia, Ukraine, Azerbaijan and Moldova. For more details on various integration projects on the post-Soviet space see, for example, Pankov (2007).

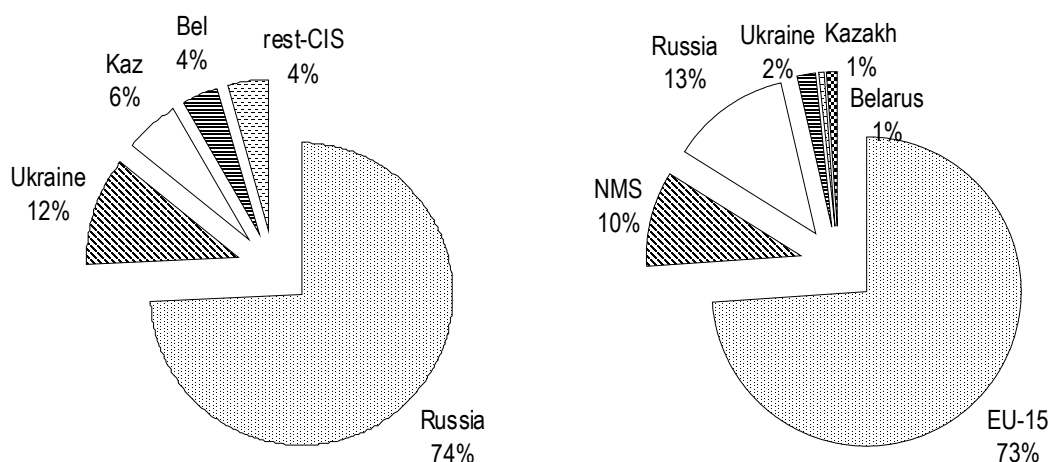
<sup>43</sup> The Customs Union of Belarus, Russia and Kazakhstan, officially launched in January 2010, is still far from being finalized and fully operational (as of May 2010).

<sup>44</sup> Yurgens et al. (2009), p. 14, recommend that 'Russia should pursue stronger bilateral relations with individual EU countries, primarily with those countries that are interested in positive relations with Russia'.

as imports of energy are concerned.<sup>45</sup> Belarus' and Ukraine's dependence on Russian energy deliveries is a well-known fact (reiterated by the recent oil and gas price disputes). However, not less important is the CIS (and here again Russia's in particular) for these countries as a market for their exports – particularly of manufactured products which otherwise would not be competitive elsewhere.<sup>46</sup>

Figure 14

**Comparing economic size: Russia in the CIS vs. EU-15 in Europe, year 2008**



Source: CISSTAT, EBRD, Eurostat and own estimates.

Owing to its rising economic strength, Russia is again becoming a more important trading partner for the CIS republics – and this tendency is being reinforced by increasing Russian investment flows, especially in the energy, metals and telecom sectors (see Libman and Kheyfets, 2006; Zashev, Vahtra and Liuhto, 2007 for details). Under 'normal' conditions, also economic theory (e.g. gravity models which use economic size, common border and language among the explaining variables for bilateral trade flows) provides some evidence that Russia would remain the key trading partner for neighbouring smaller CIS economies, albeit below the shares which existed previously under the autarkic Soviet system (see Vavilov and Viugin, 1993). In addition to trade (and other 'strictly' economic issues), there is a number of other ('soft') arguments which put Russia in a more favourable position in its Eastern Neighbourhood than the EU (see Popescu and Wilson, 2009 for more details).

European integration is still at a crossroads. After the recent EU enlargements by the former socialist countries of Central and Eastern Europe (May 2004: the Czech Republic,

<sup>45</sup> In 2008, 44% of Belarusian exports (and 66% of imports) were traded with the CIS. The corresponding figures for Ukraine were 36% (exports) and 39% (imports) – see *CIS Statistical Bulletin*, No. 5, CISSTAT, Moscow, 2009. For more details see Havlik (2007) and Pindyuk (2007). In 2009, the global crisis adversely affected intra-CIS trade as well.

<sup>46</sup> There is a wide dichotomy between the commodity composition of exports to the CIS and the EU, in particular regarding Belarus and Ukraine – see Astrov and Havlik (2007).

Hungary, Estonia, Poland, Latvia, Lithuania, the Slovak Republic and Slovenia; January 2007: Bulgaria and Romania – NMS), as well as owing to the stalemate following the rejection of a draft EU Constitutional Treaty by referenda in France and the Netherlands in 2005, the EU has been preoccupied with internal debates. Future EU enlargements (Turkey, Croatia, Macedonia are moving slowly forward, other Western Balkan states are all potential candidates) seem to be put on hold while the EU Neighbourhood Policy (ENP) is in disarray and remains largely toothless. The attitudes towards future enlargements (Turkey's EU membership in particular) became negative in several EU member states (in particular in Austria, France and Germany), the outstanding Stabilization and Association Agreements in the Western Balkans are hostage to the settlement of Kosovo's status while the design, scope and conduct of the ENP became more controversial as several NMS (especially Poland and the Baltic States) have been bringing in new accents.<sup>47</sup> The ENP's implementation has also been complicated by disappointments in the actual developments of the 'Orange' revolution in Ukraine, the crisis in EU relations with Belarus and – last but not least – by a marked deterioration of EU-Russia relations. The evolution of the EU-Russia Strategic Partnership is unclear after the Partnership and Cooperation Agreement (PCA) expired in 2007 (the PCA has been automatically prolonged year by year). For all these policy directions new initiatives and sustained efforts (a 'reset') of both the EU and Russia are badly needed. The EU – as the stronger partner – should take the initiative.<sup>48</sup>

The global financial turbulence and the subsequent economic crisis hit both the EU and the CIS hard (in particular the Baltic States, but Russia and Ukraine as well). Trade and especially investment flows contracted sharply in 2009. But signs of recovery appeared in the second half of that year and economic growth – although a modest one and probably lower than in the past even in the medium run – has returned to the region in 2010. Investment flows have been moving not only from the West to the East but, perhaps surprisingly and sometimes controversially, from East to West as well.<sup>49</sup> Meanwhile, the trade integration of the European economy continues to increase: not only is intra-EU trade of key importance especially for the NMS, but the EU (in particular after the recent enlargements) has become the leading trading partner for Russia (55% of Russian exports go to the EU), and for Ukraine (28%) and even for Belarus (45% of exports) as well.

European economic integration is progressing 'from the bottom', driven by both the accession process (in the NMS and, less clearly so, also in the Western Balkans) and by the growing business interests in rapidly expanding lucrative markets further East

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<sup>47</sup> For an assessment see, for example, Emerson (2007) and Barisch (2007). For bilateral EU–Russian disputes see Roth (2009).

<sup>48</sup> As mentioned above, there are signs of a rapprochement – e.g. between Russia and Ukraine, as well as between Russia and Poland.

<sup>49</sup> For a recent overview of Russian outward FDI see Kuznetsov (2010).



(especially in Russia). EU trade and investments in these dynamic markets grow despite the difficult and unclear contractual environment (PCA with Russia ending, the envisioned Deep Free Trade agreement with Ukraine may not meet the latter's expectations, disrupted relations with Belarus, etc.). Even the current crisis is only temporary and will not disrupt EU-Russia business contacts.

But the institutional framework for doing business in a wider Europe is in a clear mismatch with economic reality, challenging not only the future European integration but also its competitiveness in the global economy. The next integration steps are complicated not only by internal EU disputes, but also by Russia's growing assertiveness linked to its increasing economic strength and attempts to restore its influence on the post-Soviet space where it views EU inroads as an unwelcome intrusion in its traditional sphere of influence (see above). This, in turn, is viewed with suspicion by several NMS (especially by Poland and the Baltic States) where the distrust in Russian intentions is particularly strong. However, some recent Russian actions vis-à-vis its 'near abroad' (energy price disputes with Ukraine and Belarus leading to the interruption of supplies, trade sanctions against Georgia and Moldova, restrictions on migrant workers) have apparently been at least in part politically motivated, and are not instrumental to the promotion of economic cooperation within the region either.

Closer economic integration between the enlarged EU, the CIS and Russia in particular requires stronger political commitment of all parties involved as well as further mutual trade liberalization and the encouragement of cooperation in various fields such as industry, transport infrastructure and research. The EU – the stronger side – should be expected to lead the process.<sup>50</sup> A contrasting view, increasingly popular in Russia, is that Russia is different from both the NMS and other CIS countries: it is big and does not wish, or need, to integrate with the EU. Accordingly, Russia should develop its own integration space encompassing the bulk of the post-Soviet area (the Common Economic Space). Integration within that space should create an economy that would be multi-country and multi-sector but basically inward-oriented. However, before that were to happen, Russia would have to change its sturdy behaviour towards its potential integration partners, offering incentives for such an integration project instead of threats when the potential partners are hesitant.

Despite considerable differences among the individual EU member states regarding policy approaches towards Russia (which go beyond divisions between 'old' and 'new' member states – see, for example, Leonard and Popescu, 2008 and Roth, 2009) more engagement of the EU is definitely needed. Unfortunately, given the broad dichotomy of views on how to deal with Russia, no quick and easy solutions are to be expected. On the one hand,

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<sup>50</sup> This argument was emphasized already by Tsoukalis (2007) and recently also by Popescu and Wilson (2009). In a similar way, it is argued that the USA should lead the effort aiming at the 'reset' of US-Russian relations – see Legvold (2009), p. 83.

several former leading politicians from Central and Eastern Europe (including five former presidents, among them Vaclav Havel and Lech Walesa) wrote an open letter to US President Barack Obama in July 2009, voicing their concern about the impact the announced 'reset' of American-Russian relations may have for their countries (the new EU member states).<sup>51</sup> With respect to energy security they write:

*'The threat to energy supplies can exert an immediate influence on our nations' political sovereignty also as allies contributing to common decisions in NATO. That is why it must also become a transatlantic priority. Although most of the responsibility for energy security lies within the realm of the EU, the United States also has a role to play. Absent American support, the Baku-Tbilisi-Ceyhan pipeline would never have been built. Energy security must become an integral part of US-European strategic cooperation. Central and Eastern European countries should lobby harder (and with more unity) inside Europe for diversification of the energy mix, suppliers, and transit routes, as well as for tough legal scrutiny of Russia's abuse of its monopoly and cartel-like power inside the EU. But American political support on this will play a crucial role. Similarly, the United States can play an important role in solidifying further its support for the Nabucco pipeline, particularly in using its security relationship with the main transit country, Turkey, as well as the North-South interconnector of Central Europe and LNG terminals in our region.'*

Still, there is a broad agreement among economists and other observers that the relationship between the enlarged EU and the CIS requires a more intensive search for constructive approaches to the interaction within the triangle of Russia – EU – CIS countries. Turning the space of the common 'near abroad' of both Russia and the EU into a conflict area would be deplorable. Both Russia and the EU should develop coordinated 'neighbourhood' policies that should recognize the futility of 'competing integrations' in relation to the CIS with Russia trying hard to involve its major partners in the Customs Union of the 'Four' (Belarus, Russia, Kazakhstan and Ukraine) and the EU hindering this process while offering those countries no clear prospects of deeper EU economic integration.<sup>52</sup> The *Single Economic Space* integration should be an 'interface' project between the enlarged EU and the CIS, as part of the gradually evolving *Common European Economic Space*.<sup>53</sup> These (and many other) issues should be addressed in a new (Partnership or Strategic) Agreement between Russia and the EU. There is no doubt that in this future agreement energy will play a prominent role. In short, energy figures prominently among the 'flagship' cooperation projects between the EU, Russia and the CIS – as suggested earlier by Glinkina and Kulikova (2007) within the *Common European Economic Space*, and more recently also by Emerson et al. (2009) in the *Pan-European Space*.<sup>54</sup>

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<sup>51</sup> See, for example, <http://wyborcza.pl/2029020,75477,6825987.html> for the whole text.

<sup>52</sup> A similar argument has recently been put forth by R. Legvold regarding US–Russian relations. With respect to energy he writes: 'If the United States and Russia compete, rather than cooperate, over energy in Euroasia and add a military dimension to their disputed claims in the Arctic, as they have begun to do, the effects will be negative for far more than the prices of oil and gas' (Legvold, 2009, p. 79).

<sup>53</sup> See Glinkina, S., Kulikova, N. (2007); Astrov and Havlik (2005); Yurgens (2008).

<sup>54</sup> Other 'flagship' projects include trade (Free Trade Agreements or Deep Free Trade Agreements), transport, climate change and joint dealing with the global financial and economic crisis – see Emerson et al. (2009).

Regarding energy security, the arguments brought forth by Legvold with respect to Russia and the USA and his 'core question' can be transmitted to EU-Russia relations as well: 'Do the two countries intend for the relationship to be cooperative or competitive?' (Legvold, 2009, p. 92). Legvold proposes 'a three-way dialogue among the United States, Russia, and Europe' (presumably the EU). In a similar vein, Filis argues that the 'EU and Russia need to reach a strategic settlement on issues that unite rather than divide them ... , energy relations – instead of being approached in a zero sum mentality – may provide a context for this' (Filis, 2009, p. 38). There are certainly also some analysts who argue that 'it is neither desirable nor necessary to have an energy dialogue with the Russian Federation' and claim that under certain conditions (the EU meets the 20-20-20 targets, etc.) additional transport infrastructure projects such as Nord Stream and South Stream will prove to be totally unnecessary. In fact, they would reduce the energy security of the European Union and should therefore be cancelled' (Christie, 2009, p. 21). Needless to say, not only the present author but also most other analysts argue that such a strategy would be highly risky not only for the EU's energy security, but for future European integration as well (among others, Filis, 2009; Stevens, 2009; Legvold, 2009; and Liuhto, 2009b provide more detailed arguments).

### **Summary conclusions**

The Russian economy had been booming in the past couple of years. The period of rising energy prices coincided roughly with the era of Vladimir Putin's presidency (2000-2008) that had been very successful economically. The speed of Russia's catching-up was then even faster than that of the new EU member states from Central and Eastern Europe. Russian economic growth had been fuelled mainly by surging energy export revenues which gave a boost to both private consumption and, later on, also to investment. The Russian rouble appreciated considerably in real terms, inflation remained in double digits and the cost competitiveness deteriorated as wages were rising much faster than labour productivity. Thanks to windfall gains from energy export revenues the government's external debts were paid back, foreign exchange reserves reached USD 600 billion as of mid-2008, and both the current account and the state budget were in a large surplus. However, the excessive dependence on energy has represented – together with adverse demographic developments and various institutional bottlenecks – a major challenge for the sustainability of Russian growth even in the medium and long run.

Russian policy makers have been aware of these vulnerabilities and launched an ambitious economic modernization programme already in 2007. The programme aimed at the diversification of the economy and at fostering innovation with the help of Industrial Policy tools and public-private partnership financing schemes. There were serious doubts that these efforts would lead to the desired results, *inter alia* due to the high risk of abuse, inefficiency and other institutional bottlenecks prevailing in Russia. Nevertheless, before

the outbreak of the global crisis in mid-2008, the medium-term growth outlook was generally positive, although a growth slowdown appeared inevitable already at that time.

After September 2008, the global crisis hit Russia particularly hard; the main transmission channels were collapsing oil prices and sharply tightened credit conditions. The government responded quite early to the crisis with huge economic stimulation packages, supporting banks, large companies and also consumption. The government budget turned from a surplus into a large deficit. In spite of the anti-crisis measures, the GDP contracted by nearly 8% in 2009, largely a consequence of sharply reduced investment. However, recovery started already in late 2009 and may be rather robust – not least thanks to recovering energy prices. Apart from the collapse of oil prices and spillover effects from the global financial turbulence during 2008-2009, other challenges facing Russia relate to the country's integration in the world economy, especially regarding accession to the WTO, and Russia's relations with the EU and with former allies in Central Europe and the former Soviet Union. Relations with the latter – after having deteriorated owing to Russia's growing assertiveness which went together with the economic recovery, the enlargement of NATO and of the EU – have shown signs of improvement in early 2010. Despite large economic asymmetries between Russia and the EU (most evident in foreign trade, investments and economic size) and sometimes conflicting interests (in particular regarding the contest for influence on the post-Soviet space), the paper argues that mutual interdependence requires cooperative approaches that would serve best the interests of Russia, the EU and the countries in between.

Russia is a major producer and exporter of energy, especially regarding natural gas. The EU is the biggest market for Russian energy exports – the EU-Russia energy dependency is thus mutual. The current mutual dependency notwithstanding, both the EU and Russia undertake serious efforts at diversifying energy supply sources (towards Azerbaijan, Kazakhstan, Iran, Turkmenistan, etc.), building new transit gas pipeline routes (Nord Stream, South Stream, Nabucco, etc.) and tapping alternative markets (China and Japan). Russia seems to be in a stronger position in the geopolitical game for controlling energy resources in the post-Soviet region, especially in the Caspian Basin and Central Asia: it has a common energy policy and strategy (in contrast to the EU) and possesses better knowledge and contacts to other energy producers in the region. In this way, and by exerting more control over the extraction and transit of energy from the region, Russia may also compensate for the exhaustion of domestic energy resources and can possibly counterbalance the declining indigenous energy production. Moreover, maintaining its energy export potential – which will remain crucial for Russian export revenues in the foreseeable future despite various diversification and modernization efforts – can also be facilitated by the mobilization of the still huge domestic energy efficiency potential. European energy imports from (or via) Russia can thus be maintained and probably even increased.

The relationship between the enlarged EU and the CIS requires a more intensive search for constructive approaches to the interaction within the triangle of Russia – EU – CIS countries. Turning the space of the common ‘near abroad’ of both Russia and the EU into a conflict area would be deplorable. Both Russia and the EU should therefore develop coordinated ‘neighbourhood’ policies – Common European (or Pan-European) Economic Space, recognizing the futility of ‘competing integrations’. Obviously, energy is one of the key areas for mutual policy coordination, but other steps should follow. A ‘reset’ of EU-Russian relations, away from the confrontation and towards more cooperation, is therefore highly desirable and the recent signs in this direction are encouraging.

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