

ISSN 1883-1656



Центр Российских Исследований
RRC Working Paper Series No. 5

Russian Economic and Integration Prospects

Peter Havlik

April 2008

**RUSSIAN RESEARCH CENTER
THE INSTITUTE OF ECONOMIC RESEARCH
HITOTSUBASHI UNIVERSITY
Kunitachi, Tokyo, JAPAN**

Russian Economic and Integration Prospects[†]

Peter Havlik

The Vienna Institute for International Economic Studies (wiiw)

Abstract

This paper provides an overview of Russian economic developments during the period 2000-2007 and analyses key patterns and drivers of the recent economic growth. The growth sustainability is addressed as well, in particular with respect to the role played by energy prices and the growing involvement of the state in the economy, including attempts to implement tools of industrial policy and the public-private project financing schemes. Next, the resurgence of Russia as a regional power in the Commonwealth of Independent States (CIS) and the complicated relations with the European Union (EU) after recent EU enlargements with countries from Central and Eastern Europe are addressed. The paper discusses also prospects for and challenges of the future Russian integration in the European economy and outlines alternative scenarios for a medium-term economic outlook. Finally, the likely policies of the new Russian President Dmitry Medvedev are briefly discussed as well.

Keywords: Russia, economic growth, energy, European integration, economic forecast.

JEL classification: F15, F5, L52, N1, O11, O5, Q4

[†] This paper was presented for the Tokyo conference on “Economic Development and Future Perspectives of Russia” sponsored by the Russian Research Center on March 15, 2008.

Russian Economic and Integration Prospects

By Peter Havlik[†]

The Vienna Institute for International Economic Studies (wiiw)

April 2008

Introduction

This paper gives an overview of the recent economic developments in Russia, focusing mainly on the period of “Putin’s reign” during the years 2000-2007. It analyses the patterns and drivers of economic growth. The sustainability of growth is addressed as well, in particular given the fact that growth has been largely based on surging energy prices and the strengthened role of the state in the economy. Next, it looks at the resurgence of Russia as a regional power in the Commonwealth of Independent States (CIS), discusses Russian relations with the European Union (EU) after recent EU enlargements with countries from Central and Eastern Europe and outlines prospects for and challenges of the future Russian integration in the European economy. Finally, alternative scenarios for a medium-term economic outlook and the likely policies of the new Russian President Dmitry Medvedev are briefly discussed as well.

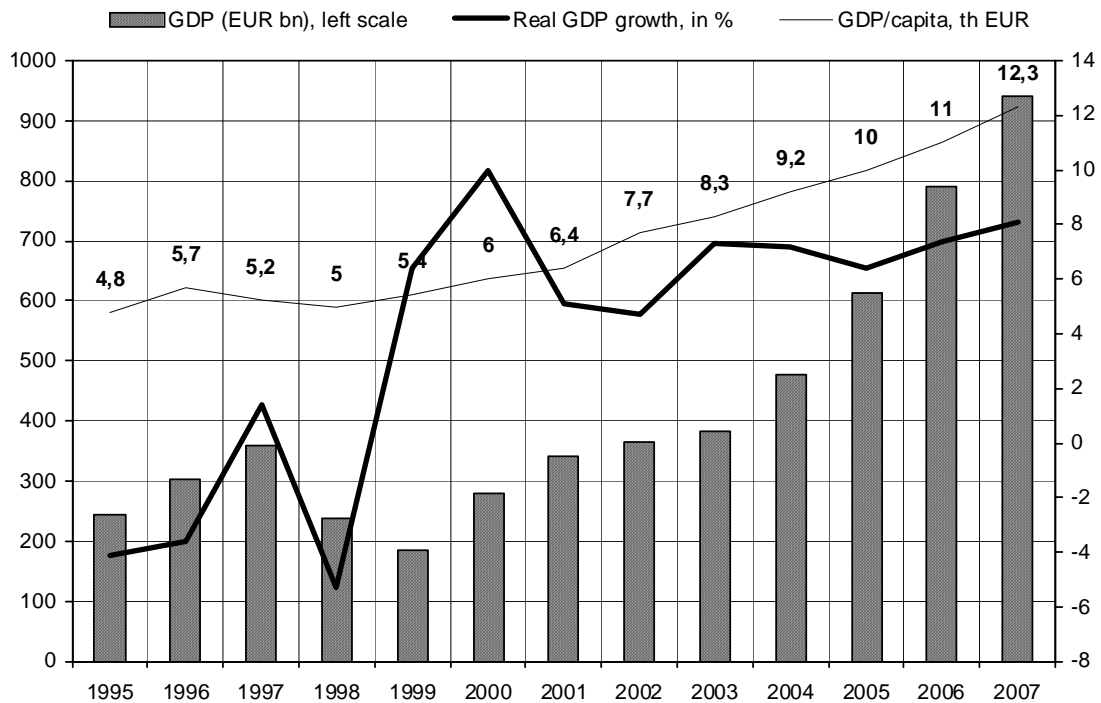
GDP growth and the ambivalent role of energy

The Russian economy has been booming in the past couple of years and most analysts – including the present author – have been busy repeatedly revising GDP growth forecasts upwards, largely owing to surging energy prices. Russian GDP growth exceeded 8% in 2007 according to the preliminary official data, driven by a double-digit expansion of household consumption and even faster growth of investments (Table 1). During the past five years, Russian real GDP increased by more than 40% and even more so in nominal euro terms (Figure 1). At purchasing power parity (PPP), Russian GDP amounted to EUR 1750 bn in 2007 – about 20% more than the aggregate GDP of the new EU member states from Central and Eastern Europe (NMS). In per capita terms, Russian GDP exceeded EUR 12,000 in 2007 – reaching about 50% of the EU average – and the speed of catching up to the average per capita GDP level in the EU has been impressive: about 15 percentage points since the year 2000 (this was more than the NMS achieved during the same period – see Havlik, P. and Holzner, M. (2008), Annex Table I.

[†] The author thanks to Tsuneaki Sato of the Yokohama City University, Riichi Tabata of the Graduate School of Economics, Osaka City University and Vasily Astrov, wiiw for valuable comments provided on earlier draft.

There have been a lot of other economic achievements of Putin's era which help to explain his extraordinary domestic popularity: rising incomes, wages and decreasing poverty levels, rising employment (and declining unemployment), a nearly full repayment of government's external debt, ballooning foreign exchange reserves, etc. Figure 2 provides some graphical illustration of the relevant indicators in the years 2000 and 2007. At the same time, Russian population has been declining due to a combination of high mortality rates and declining birth rates. Indeed, the adverse demographic developments and latent labour shortages are among the major challenges which Russia will be facing in the near future. And whereas the number of Russians with incomes below the official poverty threshold nearly halved between 2000 and 2006 (to 21.6 mn, that is 15.3% of the population in 2006), the income differentiation substantially increased.

Figure 1: Russian GDP: nominal, real growth (%) and per capita at PPP (EUR)

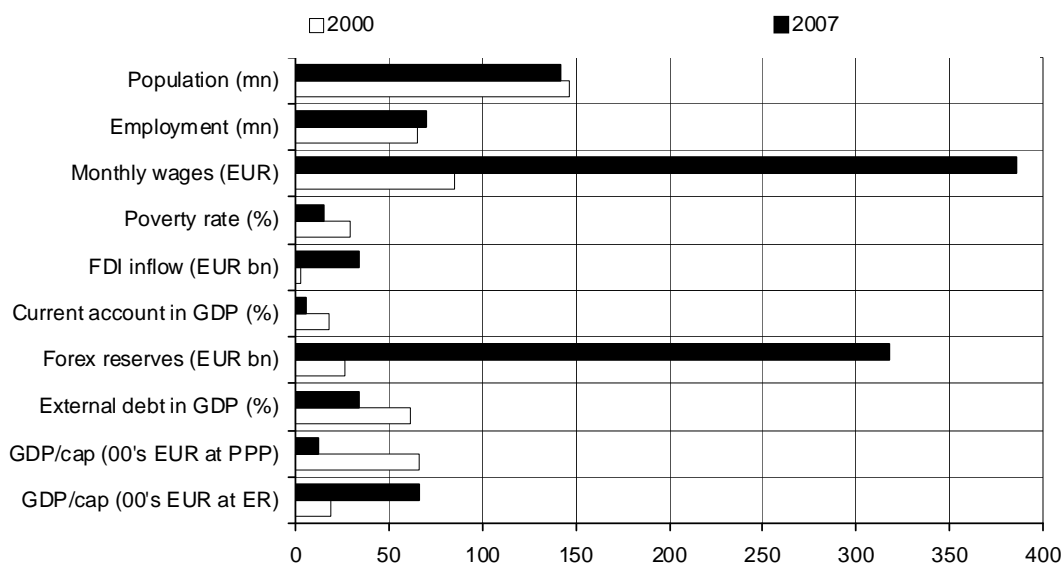


Source: Goskomstat, CBR, own calculations.

The recent economic boom can be explained to a large degree by surging world market commodity prices, in particular those of energy. Figure 3 shows how the development of Russian exports is 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 bn per year (around 40% of total export revenues), compared to more than EUR 150 bn (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

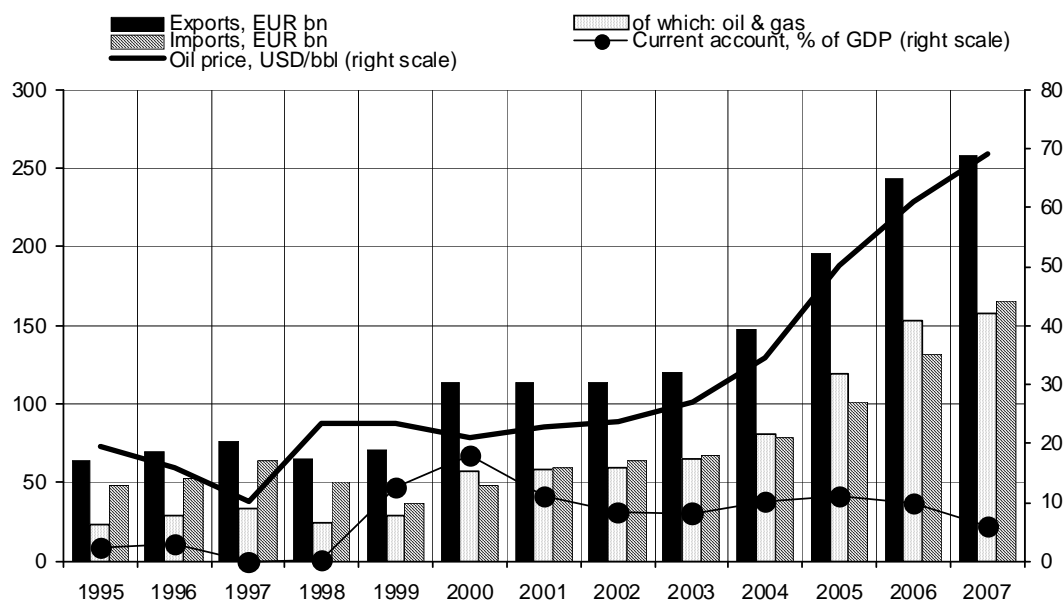
about 25%. As a result, the trade and current account surpluses diminished and the contribution of real net exports to GDP growth has been negative already since 2004 (see Figure 4). Higher oil prices helped to increase energy export revenues, yet proceeds from other exports – in particular metals – expanded even faster in 2007. The share of energy in total export revenues thus dropped by about 2 percentage points in 2007 compared to 2006 (to 61%) but it is too early to say whether this signals a reversal of the earlier trend.

Figure 2: Selected economic achievements of Putin's era



Source: Goskomstat, CBR, own calculations.

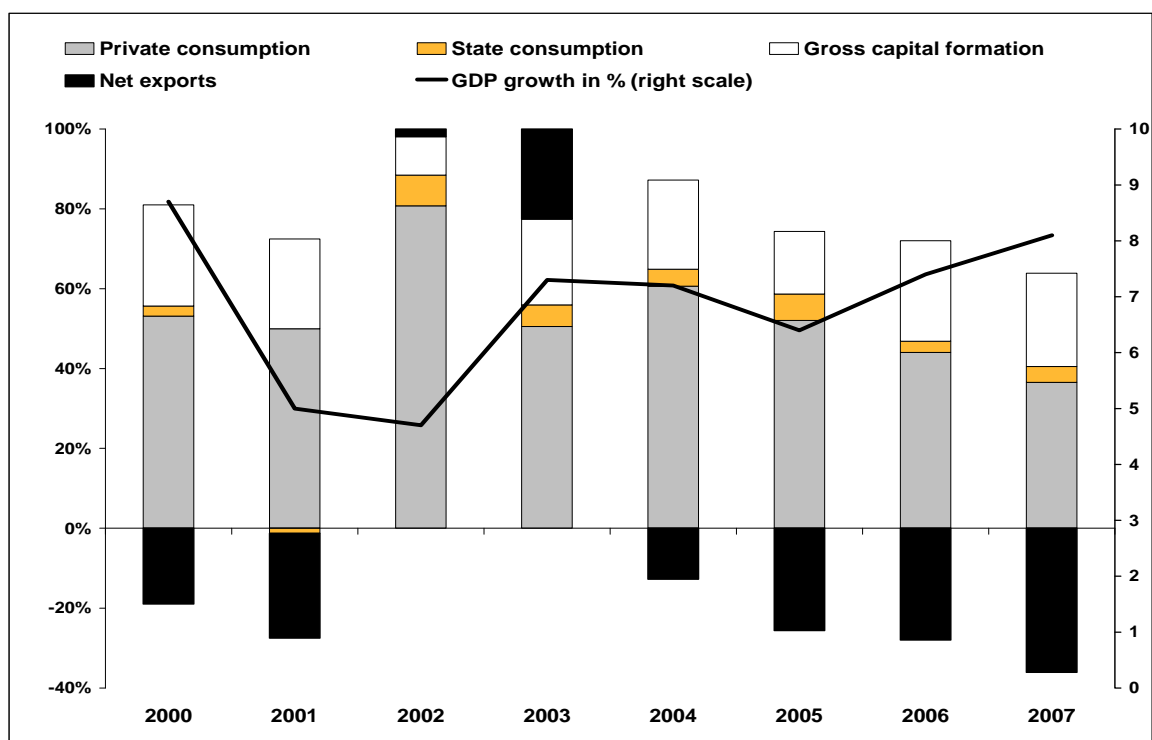
Figure 3: Russian external sector and oil prices



Source: Goskomstat, CBR, own calculations.

Russia is awash in money: both foreign exchange reserves and capital inflows are at record levels (the inflow of FDI in 2007 amounted to some EUR 38 billion; FOREX reserves reached nearly EUR 320 bn as of end-2007), the government budget runs a large surplus (more than 6% of GDP in 2007) and public foreign debt has largely been paid back. The shadow side of the current economic boom is – apart from growing assertiveness, nationalism and a revival of some ugly remnants of Soviet stereotypes – the return of double-digit inflation and strong rouble appreciation in real terms.

Figure 4: Drivers of Russian GDP growth (contributions of main components)



Source: Goskomstat, own calculations.

Return of double-digit inflation

The appreciation pressure remains strong given the huge inflows of foreign exchange, despite some relief provided by the Reserve and National Welfare Funds which accumulate 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. The rapid growth of money supply makes meeting the CBR inflation target extremely difficult. Besides, consumer price inflation is fuelled by rising prices for food, energy and housing as well as by administered tariff adjustments.

Figure 5: Russian consumer price inflation and money supply (M2)

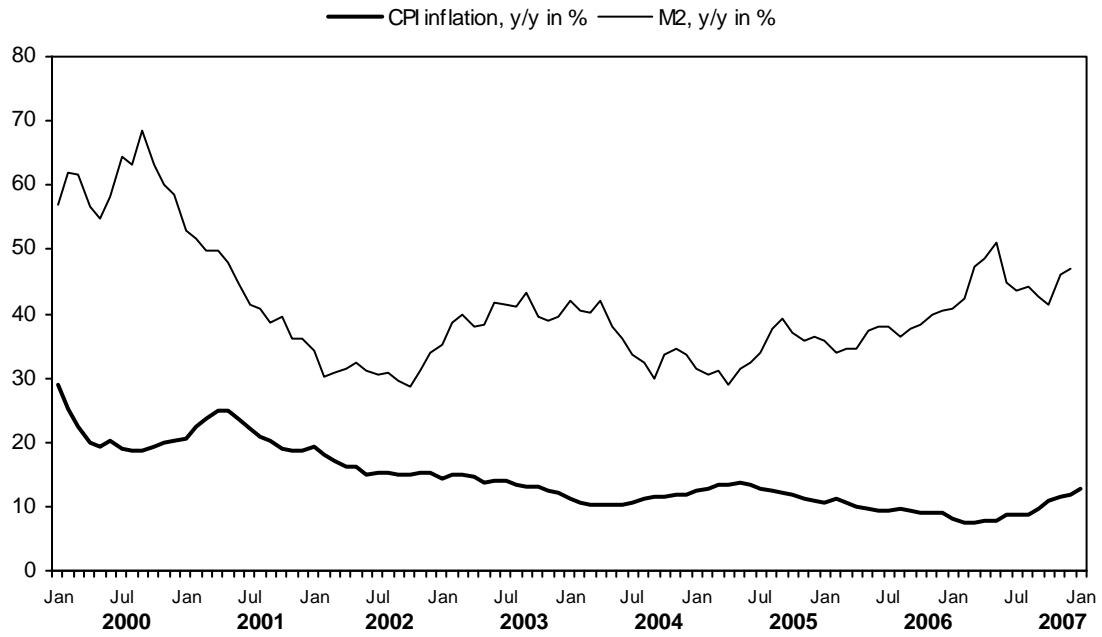
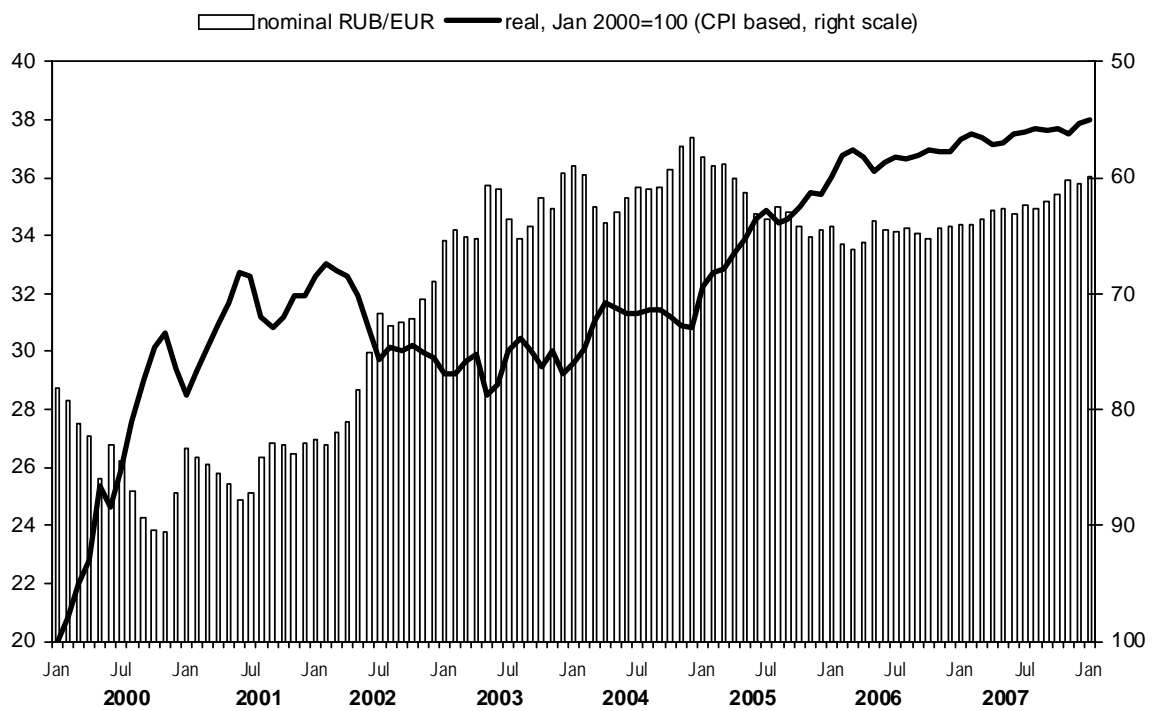


Figure 6: Nominal and real exchange rates (Rouble per EUR)



Source: *wiiw Monthly Database, Goskomstat, CBR, own calculations.*

These factors translated into double-digit annual inflation in 2007 again (Figure 5) and to a sizeable appreciation of the Rouble against EUR in real terms. Since the beginning of 2000, the Rouble appreciated by almost 50% against EUR (Figure 6; appreciation against USD was even more pronounced). The official inflation target of 6-7% for 2008 is out of reach again; double digit inflation will persist in 2008 as well and the producer price inflation will be even higher.

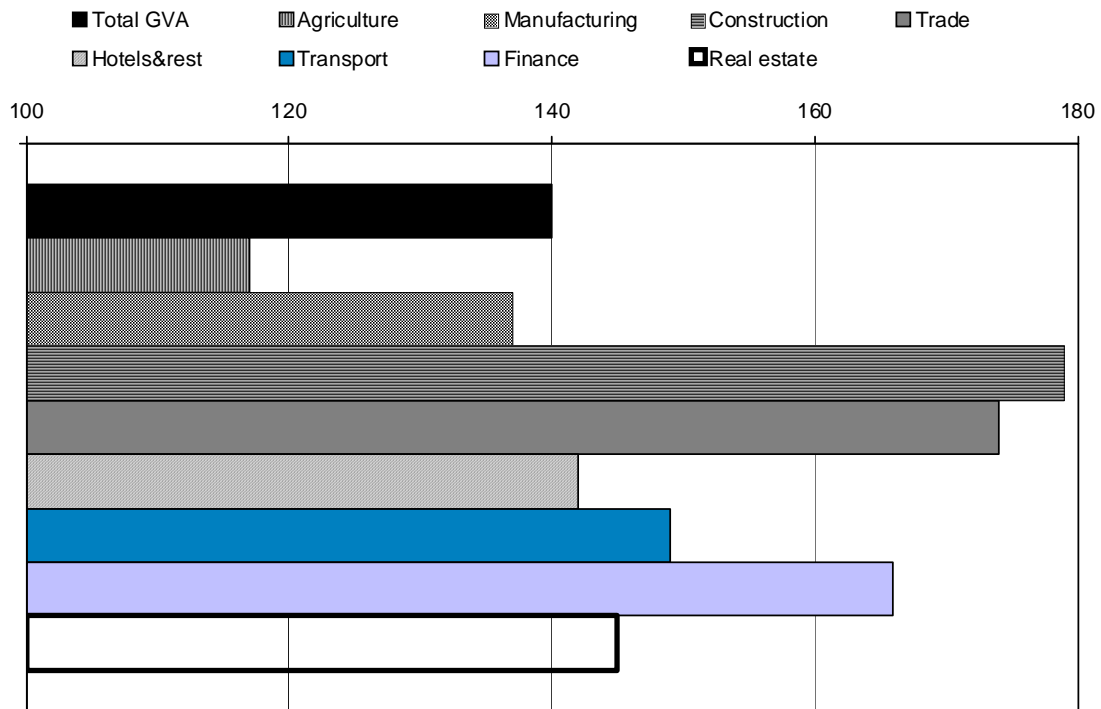
Thanks to large windfall gains from high world market energy prices, the Russian government was able not only to repay nearly all outstanding public external debts (although private debt increased) but to raise salaries in the public sector and pensions as well. Besides, several national development projects (targeting infrastructure, housing, health sector, education and agriculture) were initiated. The recently (May 2007) adopted three-year budget plan for the period 2008-2010 reflects some important changes in economic policies. First, future budget revenues will depend less on energy proceeds (apart from the Stabilization Fund, which has been renamed Reserve Fund and will be maintained at 10% of GDP; another part of windfall proceeds from oil and gas exports will be accumulated in the newly established National Welfare Fund – see Astrov (2007)). As a result, the share of budget revenues in GDP will decline by about 5 percentage points between 2007 and 2010. Second, government expenditures will increase (even as a share of GDP) with state-sponsored priority programmes to benefit most. In this way, the current government budget surpluses will be eliminated almost completely. The long-discussed controversial idea of Industrial Policy (IP) has apparently gained official blessing. The government-sponsored IP will offer targeted support to various public-private partnership 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 newly elected Russian President Dmitry Medvedev, yet the efficiency of their implementation raises serious doubts – not least due to widespread corruption and other institutional bottlenecks.

Diversification with Industrial Policy tools

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 officially endorsed long-term development programme, prepared by the Ministry of Economic Development and Trade, envisages 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 investments and entrepreneurship. Growing investments in transport infrastructure, education, health and R&D should help to generate 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 investments would generate GDP growth rates around 4-5% whereas the Urals oil price at last year's level (USD 70 per bbl) would help to keep GDP growth at 7% in 2008 – see Dashkeyev (2008).

Figure 7: Economic growth by sectors, year 2007 (2002= 100)



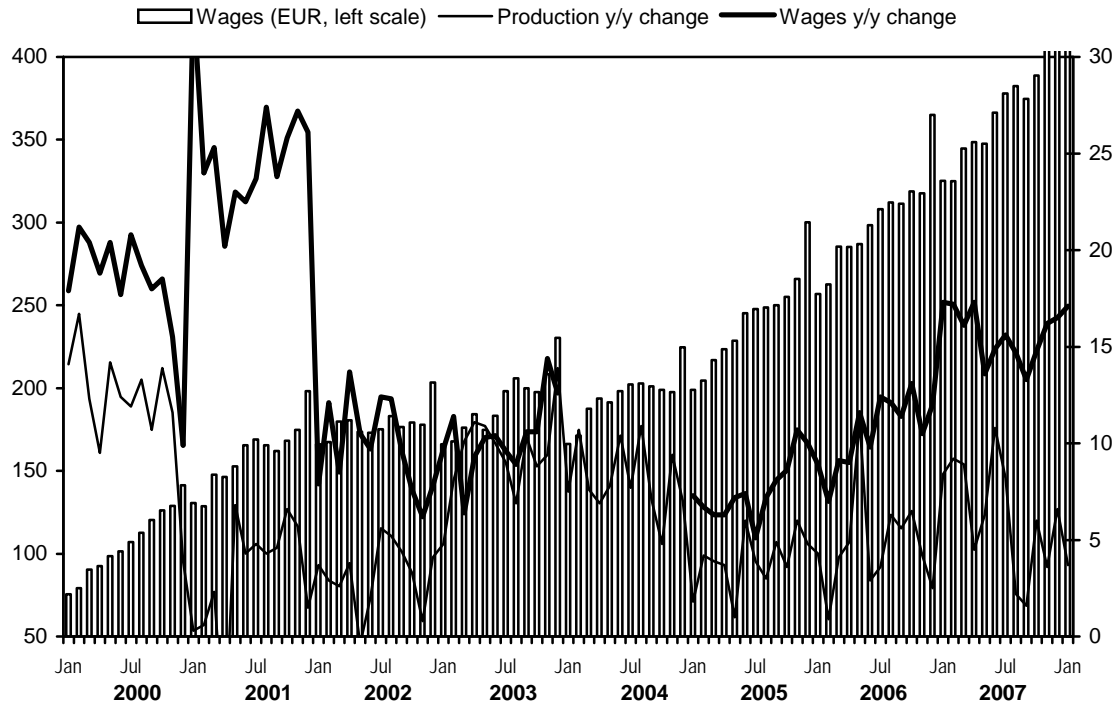
Source: Goskomstat, own calculations.

Growth slowdown appears inevitable, current account surplus disappearing

The range of GDP growth forecasts for the year 2008 fluctuates between 6-8% - largely depending on assumptions regarding the level of energy prices. As shown in Figure 4 above, since 2004 the Russian GDP growth was driven mainly by booming private consumption and, increasingly, also by expanding investments. The contributions of real net exports to GDP growth became negative as the volume of exports has been growing only at a modest pace (less than 10% per year) whereas import volumes have been surging by more than 20% per year. On the supply side, the major part of the overall GDP growth resulted from booming trade, financial services, telecoms and construction activities whereas manufacturing industry and agriculture expanded less than the overall gross value added (Figure 7).

The wiiw forecast of Russian GDP growth for the coming years is closer to the official 'intermediate' scenario which reckons with ongoing reliance on the (modernized) energy sector, possibly with a few high-tech niches, and average annual GDP growth of around 5-6%. The expected growth slowdown appears inevitable, at least until the end of the decade

Figure 8: Industrial production and wages



Source: wiiw Monthly Database, Goskomstat, own calculations.

before any (uncertain) modernization efforts start to bear fruit. Our forecast is based on relatively stable oil prices (Urals costing not more than USD 80/bbl) and limited effects of any (potential) impact of current financial markets turmoil. Both private consumption and investments are expected to grow faster than GDP, real exports will continue to be sluggish while imports will expand roughly in line with private consumption (see Table 1 for details). This implies an ongoing negative (albeit diminishing) contribution of real net exports to GDP and – in nominal terms – a gradual reduction of trade and current account surpluses (in fact, the current account surplus may disappear already in 2009-2010). Inflation will remain above 10% in 2008 and stubbornly close to 10% afterwards. Assuming a fairly constant nominal rouble exchange rate against EUR, this implies continued real appreciation. The latter represents – apart from the less likely risk of an oil price collapse – the major challenge for Russian growth, restructuring and competitiveness owing to its adverse effect on unit labour costs. Another potential risk is related to the danger of overheating in consumer and credit markets where especially consumer credits were growing particularly fast (by about 40% per year during 2006-2007, albeit from a low level).

The danger of contagion from the current subprime crisis cannot be ignored either, particularly if the possible recession in the United States this year leads to a slump in global oil prices. However, the accumulated foreign exchange reserves (including the two Oil Funds) should help to avoid any major financial crisis.

A potentially even more serious barrier to the future sustainable economic growth and a successful diversification of the Russian economy is related to the danger of a Dutch Disease and the gradual erosion of costs competitiveness. The latter results from a combination of factors such as the ongoing real appreciation of the Rouble (Figure 6), rapid growth of wages and only sluggish improvements in labour productivity (Figure 8). Average gross wages exceeded EUR 370 per month in 2007 which represents a nominal increase by almost 25% year on year. During 2000-2007, unit labour costs in Russia were rising by more than 20% per year and their level is now already higher than in some Central European new EU member states (e.g. Bulgaria and Slovakia – see Havlik, P. and Holzner, M. et al., (2008) for a detailed comparison). Given the competition from Central and Eastern Europe (including Ukraine) and especially from China, Russia could soon become a too expensive (and thus non-competitive) location for export-oriented manufacturing. Rising local production costs may distract even such investments (in particular FDI) which are oriented at the (rapidly expanding) domestic market since the respective imports are cheaper. The expected accession to WTO (possibly already in 2008) and the related reduction of import tariffs may even aggravate these problems. It is also not clear whether the above mentioned envisaged IP tools will not be conflicting with the accession to WTO.

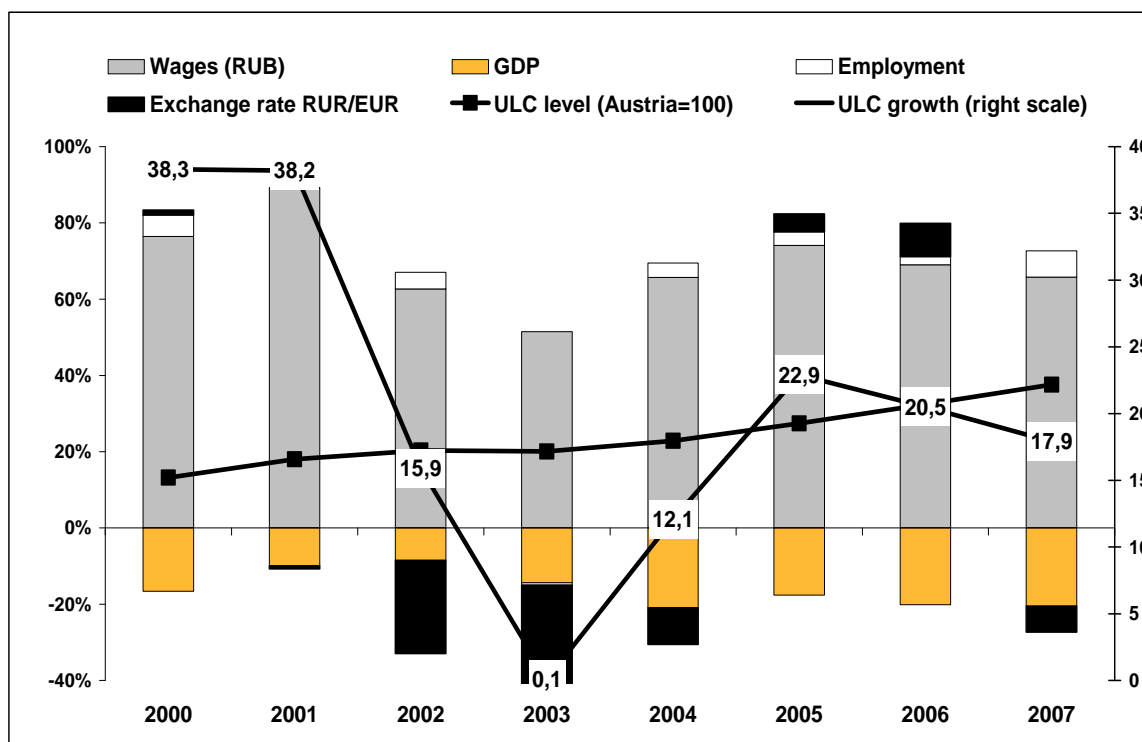
Russia's greatest untapped potential lies in efficiency-seeking FDI. With its technological capabilities and human skills, Russia could become a major international engineering hub. But the success may prove inadequate under a scenario of intense global competition for FDI projects, in which case the country would also need to upgrade its investment promotion efforts, including the liberalization of FDI and the provision of targeted incentives. If that happens, Russia could multiply its inward FDI stock within a relatively short period of time and the last year's record FDI inflow is certainly encouraging in this respect.[‡] One of important caveats is that before this happens, Russia could become a too expensive location for export-oriented FDI projects. Besides, the size of Russian economy, national security concerns and the abundance of natural resources will doubtlessly shape FDI flows differently from patterns observed in the NMS. Furthermore, the role, patterns and effects of outward Russian FDI – especially in the CIS countries - is becoming an increasingly hot topic which requires additional research.[§] The above aspects have again important

[‡] FDI inflow doubled in 2007, amounting to nearly USD 28 bn according to Goskomstat and more than USD 47 bn according to the CBR balance of payments statistics (an increase by 57% compared to 2006).

[§] See Libman, A. M. and Kheyfets, B. A. (2006) on Russian investments in the CIS and Kuznetsov (2007) on Russian FDI in the EU. Besides, INDEUNIS, an international research project financed by the EU under its 6th framework programme and coordinated by this author, was one of the first research projects which analysed this issue in more detail (see <http://indeunis.wiwi.ac.at>).

implications for the potential relocation of production to Russia, the attempted economic diversification, adequate business strategies of foreign companies and for EU-Russia economic relations.

Figure 9: Unit Labour Costs (ULC): Growth and contributions of key components, annual averages in %, 2000-2007



Source: Goskomstat, CBR, Eurostat and own calculations.

Duo Medvedev-Putin potentially dissonant

The recent economic developments have been overshadowed by politics, in particular by the issue of Vladimir Putin's successor after March 2nd, 2008 presidential elections. Putin's last-minute support of the United Russia party helped to secure it a comfortable majority in the Duma last year's elections; his endorsement of Deputy Prime Minister (and Gazprom Chairman) Dmitry Medvedev as the preferred candidate while agreeing to serve as Prime Minister in the new government secured Mr Medvedev's easy victory (70% of the vote). The elections were not entirely fair since Putin's preferred candidate had been disproportionally endorsed by the state-controlled media, yet there is little doubt that both Mr Putin and Mr Medvedev (the latter seen as a guarantee for the continuity of Putin's successful policies) enjoy an overwhelming support in the Russian electorate. Owing to his popularity and age, Mr Putin is likely to dominate Russian politics in years to come - he may even return to the Kremlin after some time. Despite more than 17 years working together and having a good personal relationship, the suggested constellation (President

Medvedev and the Prime Minister Putin) may lead to tensions, at least between their respective apparatuses.^{‡‡} Some hints regarding the future political stability in Russia will begin to appear already in April-June 2008, after the new government is formed and the reshuffle (if any) in the presidential administration will be completed.

Nevertheless, the Russian economic outlook remains broadly positive with both consumption and investment (including FDI) expected to expand further. The risks of overheating, especially in housing and credit markets, appear manageable whereas the above mentioned concerns regarding the erosion 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 her 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 the new President Medvedev will keep his credentials as a liberal politician who supports the rule of law and fight against corruption. However, there is little doubt that either Mr Medvedev or Mr Putin will both 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 may lead to additional tensions. Some of these challenges, related to relations with the EU and Russian integration policies and prospects, will be discussed in the rest of the paper below.

Challenges for EU-Russian relations

Several key problem areas will affect the evolution of future EU-Russian relations in the context of a broader European economic integration. In this paper, we will briefly address only two aspects: EU-Russian trade (including energy and the security of energy supplies) and the contest between the EU and Russia for the influence on the post-Soviet space.^{§§} Starting with foreign trade, it is useful to point out several asymmetries which characterize the present trade flows between Russia and the EU. First, whereas more than half of Russian exports go to the EU, Russia is still a minor trading partner for the latter since only 3.7% of overall EU imports come from Russia (and less than 2% of EU exports go to Russia – see Figure 10). Second, the EU has a large trade deficit with Russia (EUR 80 bn in 2006) and is therefore interested in getting a more free access to the Russian market, not only for goods but also services (especially banking and insurance). Most of the trade-related issues had been preliminarily agreed in the framework of the bilateral EU-Russian WTO accession agreement which was finalised already in 2004. However, the Russian WTO accession has been dragging on for years and it is by no means certain that Russia will become WTO member even in 2008 as the above mentioned IP may conflict with

^{‡‡} Formally, Russian constitution gives much more power to the President which may, inter alia, appoint (or dismiss) the Prime Minister.

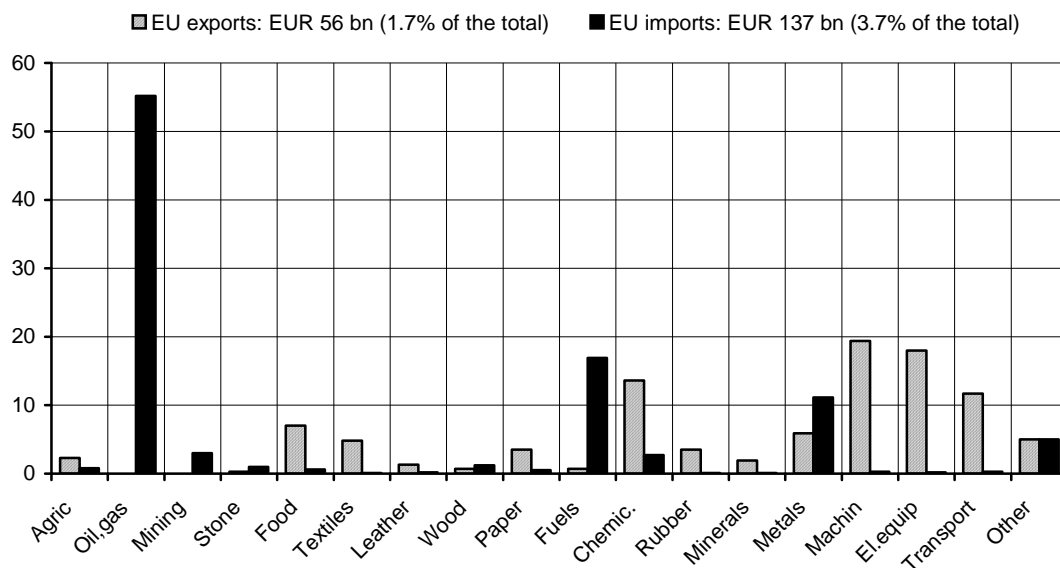
^{§§} Other areas of EU concern like migration, fight against organised crime, environment, human rights and “common values”, etc. – all likely to be dealt with in the future EU-Russian partnership or strategic agreement - are beyond the scope of the present paper.

WTO rules and may get a higher priority. The position of the EU is that any negotiations about a future free trade agreement may start only after Russia has become WTO member.^{***} Third, Figure 10 also shows the commodity composition of EU-Russia trade with EU imports concentrating on oil and gas, refined fuels and metals. These three commodity groups accounted for more than 80% of EU imports from Russia in 2006 and once more illustrate the urgency of Russian economic diversification.

Figure 10: Commodity composition of EU trade with Russia, year 2006 (in %)

Source: Eurostat and own calculations.

Indeed, it is the energy (and especially natural gas) which is dominating EU-Russia economic relations. As shown in Figure 11, nearly 20% of total EU energy imports originate



from Russia, and the new EU member states from Central and Eastern Europe (NMS 10, but especially Poland, Lithuania, Hungary and Slovakia) are relying much more on Russian energy deliveries. And whereas the NMS have somewhat diversified their sources of energy imports recently (although 60% of their energy imports still comes from Russia), the West European (EU15) energy dependence on Russia has even increased after 2000 (to 14.7% of total energy imports in 2006). Russia refuses to sign the European Energy Charter which would permit an access of European companies to her energy distribution networks while at the same time attempts to enter the downstream energy markets in the EU via several bilateral deals with German, French, Italian, Bulgarian, Hungarian and Slovak companies. The Russian state-controlled giant Gazprom is especially active in this area. Since energy is being considered as the strategic sector, the Russian state has

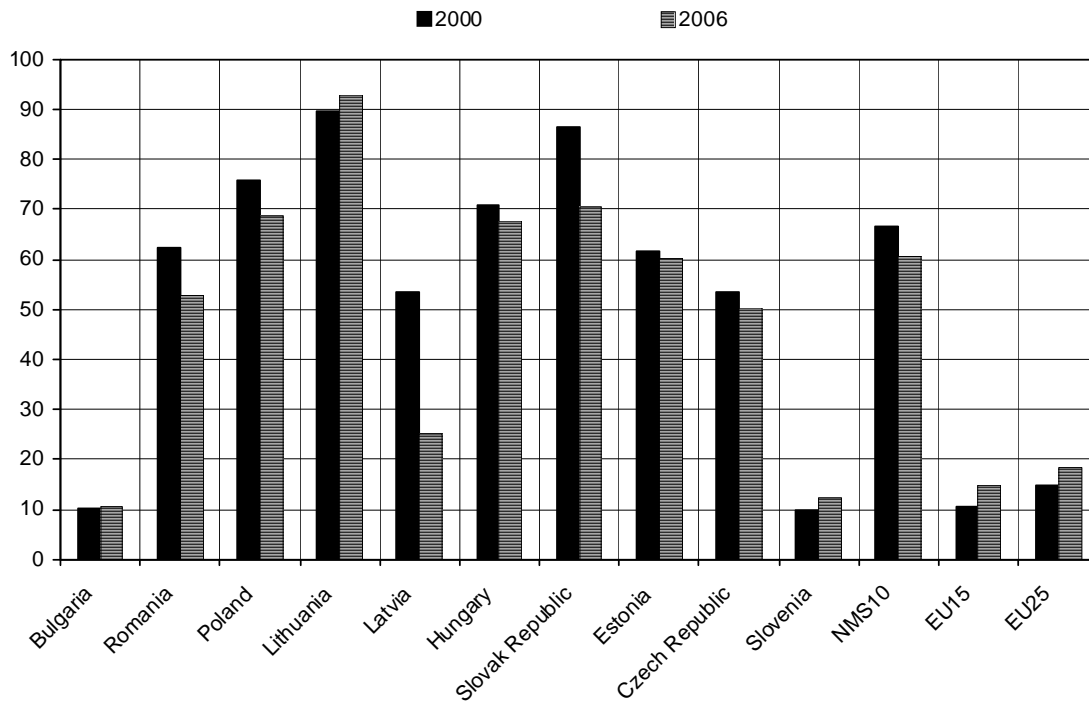
^{***} This is similar to Ukraine: negotiations about a free trade agreement with the EU have started only in February 2008 after Ukraine signed accession agreement with WTO (the membership is still pending owing to the ratification by Ukrainian parliament).

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 privatisation deals or production sharing agreements, basically arguing that these deals were unfair while made in the period of Russian weakness during 1990s.^{§§§}

Figure 11: Shares of Russia in total EU energy imports (SITC 3)

Source: Eurostat COEMEXT Database and own calculations.

A separate (though partly related) issue represents the struggle for alternative gas pipelines routes linking Russia and EU markets such as the Russian-German pipeline North Stream bypassing the Baltics and Poland, the Blue Stream and South Stream pipeline projects which intend to deliver Russian and Caspian gas to Europe via Black Sea and compete with the planned Austrian-led Nabucco pipeline project. In all these initiatives



a complex mix of commercial and political interests is involved: the EU's declared aim at the diversification of energy supplies on the one hand (that is to reduce its dependence on Russia). On the other hand, the Russian intention is to secure (and perhaps even to increase) its role as the key energy supplier, as well as to bypass (some say to blackmail) the present transit countries such as Belarus, Ukraine and the Baltics, and to increase its position at European energy supply and distribution markets. Besides, Russia is also

^{§§§} A de facto re-nationalisation of the biggest private oil company Yukos (and putting its boss Mr Khodorkovsky in jail), as well as disputes surrounding the Sachalin production sharing agreements are the best known examples in this respect.

looking for alternative markets in the east (especially China and Japan), or energy supplies (e.g. Turkmenistan and Libya). In all these projects not only huge investments but also considerable risks are involved – for more detailed discussion see Cheng (2008) and Goldthau (2008).

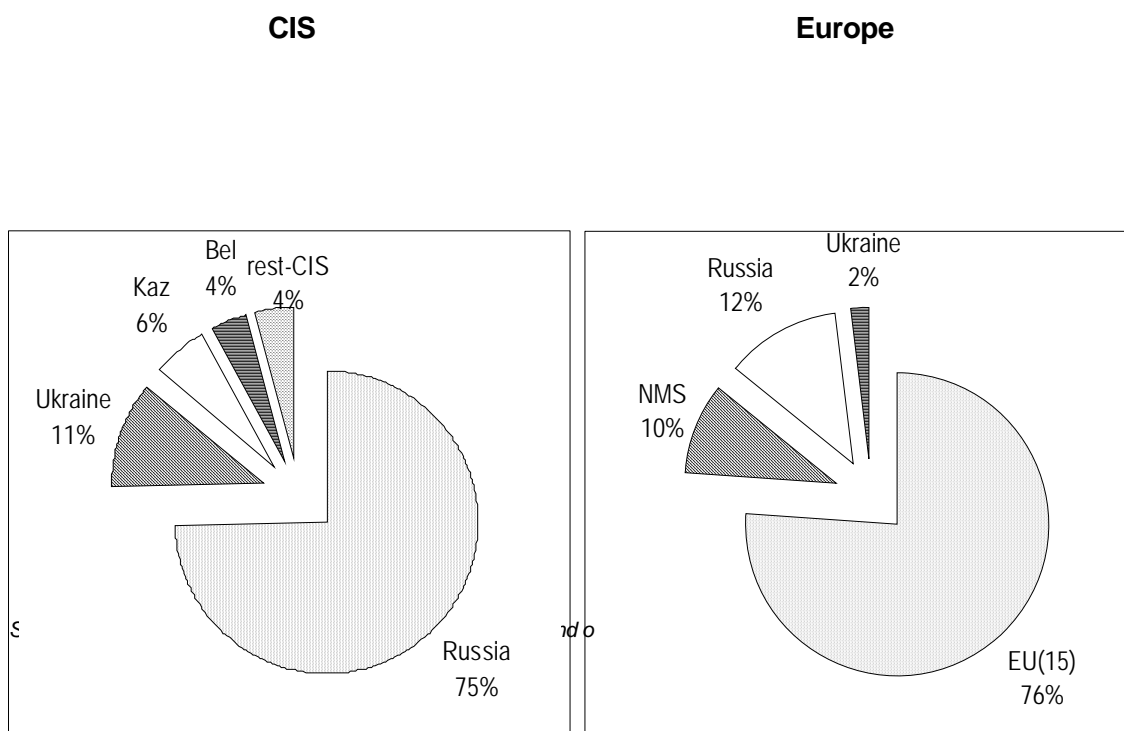
There are several reasons to believe that Russia may eventually prevail in this regional energy game: first of all the lack of a common EU energy policy as different member states pursue individual national interests (e.g. Germany, Italy, Hungary, France), Russia's geopolitical advantages in the Black Sea and Caspian Basin energy-rich former Soviet republics (especially in Kazakhstan, Turkmenistan and Uzbekistan) where the Russian Gazprom has recently outmanoeuvred the EU in securing gas supply contracts of its own. Last but not least, Russia's growing economic strength (see above) and its role as both the trading and investment partner of the CIS will raise her influence in the region as well.

Apart from energy issues, it is probably the EU (and NATO) eastern enlargement as well as the EU's Neighbourhood Policy (ENP) vis-à-vis the CIS countries (especially Ukraine and Georgia) which are creating tensions between Russia and the EU. The ENP is perceived by Russia as an unwelcome foreign inroad into her traditional spheres of influence – the “near abroad” in the Russian terminology. The ENP aims to create a “ring of friends” in EU's neighbourhood by providing various incentives such as the reform support, economic assistance, technical advice, trade concessions, etc. – without offering to these countries the potentially biggest incentive, namely the EU membership. At the same time, Ukraine and Georgia aspire at full EU membership and other former Soviet republics (Moldova, potentially even Belarus) may voice similar aspirations in the future. However, the Western support of “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.

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), 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 a dominant partner.**** So far these integration efforts have not been very effective. However, Russia is considering its “near neighbourhood” as her traditional sphere of influence; the new President-elect D. Medvedev has declared relations with the CIS as the top priority.

**** 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).

Figure 12: Real GDP in the CIS and in Europe, year 2007 (at PPPs)



The geo-economic context for understanding the competition on the post-Soviet space illustrates the Figure 12 by 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 a broader Europe. One could argue that just as the EU(15) dominates the European economy (including the new EU member states, Russia and Ukraine), it is Russia which dominates the economy of the CIS. As similar picture would emerge by comparing trade and investments 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 EU as a whole would otherwise enjoy.

The intra-CIS trade has declined dramatically during the 1990s after the dissolution of the USSR (Havlik, 2007). Yet in contrast to a relatively small role of the CIS in the foreign trade of Russia (in 2007 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 and Belarus – especially as far as imports of energy are concerned.^{††††} Belarus’ and Ukraine’s dependence on the Russian energy

^{††††} In 2007, 46% of Belarus exports (and 66% of imports) were traded with the CIS. The corresponding figures for Ukraine were 38% (exports) and 43% (imports) – see CIS in 2007, CISSTAT, Moscow, 2008, p. 146-147. For more details see Havlik (2007) and Pindyuk (2007).

deliveries is a well known fact (reiterated by the recent 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 – especially of manufactured products which otherwise would not be competitive elsewhere.^{§§§§}

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 investments flows, especially in energy, metals and telecom sectors (see Libman and Kheyfets, 2006; Zashev, Vahtra and Luihto, 2007 for details). Under “normal” conditions, also the economic theory (gravity models) 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, A., Viugin, O., 1993).

Directions of future European integration

European integration is at crossroads. After recent EU enlargements with the former socialist countries from Central and Eastern Europe (May 2004: the Czech Republic, Hungary, Estonia, Poland, Latvia, Lithuania, the Slovak Republic and Slovenia; January 2007: Bulgaria and Romania - NMS), as well as 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 Western Balkans are hostage to the settlement of Kosovo status while the design, scope and conduct of the ENP became more controversial as several NMS (especially Poland and the Baltic States) are bringing new accents.^{*****} The ENP's implementation has been complicated also 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-Russian relations. The evolution of EU-Russian Strategic Partnership is unclear after the Partnership and Cooperation Agreement (PCA) in expired November 2007 (PCA has been automatically prolonged). For all these policy directions new initiatives and sustained efforts of both the EU and Russia are badly needed.

^{§§§§} There is a wide dichotomy between the commodity composition of exports to the CIS and the EU, in particular regarding Belarus – see Havlik and Astrov (2007).

^{*****} For a recent assessment see, for example, Emerson, M. (2007) and Barisch, K. (2007).

The EU enlargement has been a clear economic success.^{††††} The NMS have been currently growing on average by close to 6% per year, the economic growth and stability in Western Balkans future member states (FMS) have markedly improved as well. GDP growth in Belarus, Kazakhstan, Ukraine and Russia – driven initially by the post 1998 financial meltdown, devaluations and high commodity prices, but with booming domestic demand and first signs of economic diversification recently emerging – continues to match, if not outperform, even the most successful NMS. All three groups of countries – the NMS, FMS and the CIS – are emerging as dynamic growth regions and are rapidly catching up (the latest wiiw economic forecasts confirm this positive outlook – see Havlik and Holzner, 2008). Disregarding global financial turbulence and signs of overheating in the region (in particular in the Baltic States as well as in Bulgaria and Romania), the investment flows have accelerated – and these flows are now moving not only from West to the East but, perhaps surprisingly and sometimes controversially, from East to West as well. Meanwhile, the trade integration of the European economy continues to increase: not only is the intra-EU trade of key importance especially for the NMS, but the EU (in particular after recent enlargements) has become the leading trading partner in particular for Russia (55% of Russian exports go to the EU), but for Ukraine (28%) and even for Belarus (45% of exports) as well.

The European economic integration is progressing “from the bottom”, driven by both the accession process (in the NMS and less clearly also in Western Balkans) and by growing business interests in rapidly expanding lucrative markets farther East (especially in Russia). EU trade and investments in these dynamic markets grow despite a 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, Stabilisation and Association Agreement with Serbia stalled over Kosovo’s independence declaration issue, etc.). 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 a global economy. Next integration steps are complicated not only by internal EU disputes, but also by a growing Russian assertiveness linked to its growing economic strength and attempts to restore 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 been at least in part apparently politically motivated, they are not instrumental to the promotion of economic cooperation within the region either.

†††† See Gligorov, V., Richter, S. et al., (2007).

Closer economic integration between the enlarged EU, the CIS and Russia in particular requires a stronger political commitment of all parties involved as well as further mutual trade liberalization and encouragement of cooperation in various fields such as in industry, transport infrastructure and research. The EU – the stronger side – should be expected to lead the process.^{††††} A contrasting view, increasingly popular in Russia, is that Russia is different from both the NMS and other CIS: it is big and does not wish, or need, to integrate with the EU. According to this view, 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, 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 Leonard and Popescu, 2008) more engagement of the EU is definitely needed. There is a broad agreement among economists 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 which 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. 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.^{§§§§§} These (and many other) issues should be addressed in a new (Partnership or Strategic) Agreement between Russia and the EU.

Summary conclusions

Russian economy has been booming in the past couple of years; the period of Putin’s presidency has been economically very successful. The per capita GDP reached 50% of EU average in 2007 and the speed of catching-up was even faster than that of the new EU member states from Central and Eastern Europe. Russian economic growth has been fuelled mainly by surging energy revenues which gave a boost to both private consumption

^{†††††} This argument was emphasised also by Tsoukalis (2007).

^{§§§§§} See Glinkina, S., Kulikova, N. (2007); Havlik and Astrov (2005), Yurgens, I. (2008).

and investments. The government external debts were paid back, foreign exchange reserves reached EUR 320 bn as of end-2007, the current account and state budget are both in surplus. However, the excessive dependence on energy represents – together with adverse demographic developments – a major challenge for the sustainability of growth in the medium and long run. Russian Rouble has considerably appreciated in real terms, the inflation remains in double digits and the cost competitiveness has deteriorated.

Policy makers are aware of these vulnerabilities and they launched an ambitious economic modernisation program which aims to diversify the economy and foster innovations with the help of Industrial Policy tools and public-private partnership financing schemes. There are serious doubts that these efforts will lead to desired results, inter alia due to the high risk of abuse, inefficiency and other institutional bottlenecks. In addition, there are also political risks related to the transition of power since the governing duo Putin-Medvedev can be potentially dissonant. The medium term growth outlook is still positive, although a growth slowdown appears inevitable and the current account surplus will soon disappear.

Apart from the collapse of oil prices and potential spillover effects from global financial turbulence on Russia (which both seem manageable), other challenges relate to the future integration in the world economy, especially regarding Russian accession to the WTO (which may conflict with the planned Industrial Policy tools) and the relations with the EU. The latter have deteriorated recently owing to growing Russian assertiveness which went together with the economic recovery and the enlargement of the EU. Despite large economic asymmetries between Russia and the EU (which are most evident in areas of foreign trade, investments and economic size), and sometimes conflicting interests (in particular regarding energy supplies and the contest for influence on the post-Soviet space), the paper argues that mutual interdependence requires cooperative approaches which would serve best to interests of both Russia and the EU.

Table 1

Russia: Selected Economic Indicators

	2002	2003	2004	2005	2006	2007 ¹⁾	2008	2009	2010
	Forecast								
Population, th pers., end of period ²⁾	144,964	144,168	143,474	142,754	142,221	141,500	141,000	140,500	140,000
Gross domestic product, RUB bn, nom.	10,831	13,243	17,048	21,625	26,883	32,989	37,200	43,000	49,000
Annual change in % (real)	4.7	7.3	7.2	6.4	7.4	8.1	6.4	6	5.5
GDP/capita (EUR at exchange rate)	2,514	2,641	3,310	4,290	5,536	6,642	.	.	.
GDP/capita (EUR at PPP - wiiw)	7,680	8,310	9,170	10,030	11,070	12,320	.	.	.
Gross industrial production									
Annual change in % (real)	3.1	8.9	8.3	4.0	3.9	6.3	5.5	5	5
Gross agricultural production									
Annual change in % (real)	1.5	1.3	3.0	2.3	3.6	3.3	.	.	.
Construction output total									
Annual change in % (real)	2.7	14.4	10.1	10.5	18.1	18.2	.	.	.
Consumption of households, RUB bn, nom.	5,400	6,540	8,406	10,590	12,883	15,804	.	.	.
Annual change in % (real)	8.5	7.5	12.1	11.8	11.3	13.1	12	8.5	6.3
Gross fixed capital form., RUB bn, nom.	1,939	2,432	3,131	3,837	4,957	6,940	.	.	.
Annual change in % (real)	2.8	12.8	12.6	10.6	17.5	20.8	12.9	10.4	9.4
LFS - employed persons, th, avg.	66,659	66,432	67,275	68,169	68,693	70,528	70,300	70,500	70,600
Annual change in %	2.4	-0.3	.	1.3	0.8	2.7	.	.	.
Reg. employment in industry, th pers., avg.	15,135	14,934	14,775	14,469	14,325
Annual change in %	-1.2	-1.3	-1.1	-2.1	-1.0
LFS - unemployed, th pers., average	5,698	5,959	5,675	5,263	5,001	4,639	.	.	.
LFS - unemployment rate in %, average	7.9	8.2	7.8	7.2	6.8	6.2	5.8	5.5	5.5
Reg. unemployment rate in %, end of period	2.1	2.3	2.6	2.5	2.3	2.1	.	.	.
Average gross monthly wages, RUB	4,360	5,499	6,740	8,555	10,634	13,518	.	.	.
Annual change in % (real, gross)	16.2	10.9	10.6	12.6	13.3	16.0	.	.	.
Consumer prices, % p.a.	16.0	13.6	11.0	12.5	9.7	9.1	12	9	8
Producer prices in industry, % p.a.	11.8	15.6	24.0	20.7	12.4	14.1	15	13	10
General governm.budget, nat.def., % GDP									
Revenues	32.5	31.3	31.9	39.7	39.7	40	41	.	.
Expenditures	31.6	29.9	27.4	31.5	31.3	36	38	.	.
Deficit (-) / surplus (+), % GDP	0.9	1.3	4.5	8.1	8.4	5.5	3	.	.
Public debt, nat.def., in % of GDP ³⁾	37.0	28.6	21.6	14.9	8.9	4	.	.	.
Refinancing rate of NB % p.a., end of per.	21	16	13	12	11	10	.	.	.
Current account, EUR mn ⁴⁾	30,788	31,330	47,868	67,851	77,091	57,000	25,000	5,000	-15,000
Current account in % of GDP	8.4	8.2	10.1	11.1	9.8	6.1	2.4	0.4	-1.1
Gross reserves of NB, excl. gold, EUR mn	42,290	58,531	88,663	148,094	244,190	317,220	.	.	.
Gross external debt, EUR mn	147,067	148,776	156,689	216,553	256,609	310,000	.	.	.
Gross external debt in % of GDP	45.0	41.4	34.8	34.2	32.5	34.2	.	.	.
FDI inflow, EUR mn ⁴⁾	3,660	7,041	12,422	10,354	24,496	34,380	40,000	.	.
FDI outflow, EUR mn ⁴⁾	3,736	8,606	11,085	10,258	18,570	25,000	30,000	.	.
Exports of goods, BOP, EUR mn ⁴⁾	113,468	120,265	147,358	195,894	243,793	260,000	265,000	275,000	285,000
Annual growth rate in %	-0.2	6.0	22.5	32.9	24.5	6.7	3	4	4
Imports of goods, BOP, EUR mn ⁴⁾	64,470	67,304	78,327	100,787	132,106	165,000	200,000	230,000	255,000
Annual growth rate in %	7.4	4.4	16.4	28.7	31.1	25	21	15	11
Exports of services, BOP, EUR mn ⁴⁾	14,393	14,359	16,564	20,064	24,808	28,700	30,000	32,000	35,000
Annual growth rate in %	12.7	-0.2	15.4	21.1	23.6	15.2	7	7	9
Imports of services, BOP, EUR mn ⁴⁾	24,848	23,997	26,774	31,229	35,887	43,000	50,000	55,000	60,000
Annual growth rate in %	8.2	-3.4	11.6	16.6	14.9	20	16	10	9
Average exchange rate RUB/USD	31.35	30.69	28.81	28.30	27.34	25.58	25.3	25.5	26
Average exchange rate RUB/EUR (ECU)	29.65	34.69	35.81	35.22	34.08	35.01	35.4	35	35
Purchasing power parity RUB/USD, wiiw ⁵⁾	8.47	9.45	11.03	12.74	14.29	15.84	.	.	.
Purchasing power parity RUB/EUR, wiiw ⁵⁾	9.70	11.02	12.92	15.06	17.04	18.87	21.6	23.1	24.8

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) Resident population. - 3) wiiw estimate. - 4) Converted from USD to EUR at the official cross exchange rate. - 5) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics; wiiw forecasts (February 2008).

References

- Astrov, V. (2007), "The Russian Oil Fund as a tool of stabilization and sterilization". *wiiw Monthly Report*, No. 7, pp. 1-8.
- Astrov, V., Havlik, P. (2005), "The Enlarged European Union and Its Eastern Neighbourhood". In: K. Liuhto and Z. Vincze (Eds), *Wider Europe*. Esa Print Oy 2005, pp. 169-195. (published also in *Journal of East-West Business*, Vol. 11, No. 1/2, pp. 13-44).
- Astrov, V., Havlik, P. (2007), "Ukraine, Belarus and Moldova: Economic Developments and Integration Prospects". In: D. Hamilton and G. Mangott (Eds), *The New Eastern Europe: Ukraine, Belarus & Moldova*. Center for Transatlantic Relations, John Hopkins University, Washington D.C., pp. 127-147.
- Barisch, K. (2007), "Russia, realism and EU unity". Policy Brief, Centre for European Reform, July, London.
- Christie, E. (2007), "Oil and Gas Dependence of EU-15 Countries". *wiiw Research Reports*, No. 343, December, Vienna.
- Cheng Jian, (2008), "Relations between Russia and Europe from the Perspective of Energy Strategy". IFSH Hamburg, Heft 150, February.
- Dashkeyev, V. V. (2008), "Scenarios of macroeconomic development in 2008". (in Russian). Institute of the Economy in Transition, Moscow, January.
- Dollar, D., Hallward-Driemeier, M., Mengistae, T. (2006), Investment Climate and International Integration, *World Development* Vol. 34, No. 9, pp. 1498–1516.
- Emerson, M. (2007), "The wider neighbourhood is in not such good shape". *European Neighbourhood Watch*, No. 29, July, CEPS, Brussels.
- Gligorov, V., Richter, S. et al., (2007), „High Growth Continues, with Risks of Overheating on the Horizon“. *wiiw Research Reports*, No. 341, July, Vienna.
- Glinkina, S., Kulikova, N. (2007), "The Impact of EU Enlargement on Economic Restructuring in Russia and Future Relations between Russia and the European Union". *wiiw Research Reports*, No. 338, March, Vienna.
- Goldthau, A., (2008), "Russia's energy weapon is a fiction". In: *Europe's World*, Spring, Brussels, pp. 36-41.
- Grinberg, R., (2007), "Restructuring and Economic Reforms in Russia: A plea for effective Industrial Policy". INDEUNIS Paper (<http://www.wiiw.ac.at/indeunis>).
- Hamilton, C. B. (2005) Russia's European economic integration. Escapism and realities, *Economic Systems* Vol. 29, pp. 294–306.
- Havlik, P. (2003), "Russia and the European Union". In *Contemporary Europe. Social and Political Research Journal*. (in Russian). Institute of Europe, Moscow, No. 1, pp. 32-38.
- Havlik, P. (2004), „Russia, European Union and EU Eastward Enlargement“. In G. Hinteregger and H.G. Heinrich (Eds), *Russia – Continuity and Change*. SpringerWienNewYork, pp. 363-378.
- Havlik, P. (2007), "Structural Change and Trade Integration on EU-NIS Borders". *wiiw Research Reports*, No. 340, May, Vienna.
- Havlik, P., Holzner, M. et al., (2008), „Weathering the Global Storm, yet Rising Costs and Labour Shortages May Dampen Domestic Growth“. *wiiw Current Analyses and Forecasts*, No. 1, February.
- Hunya, G., (2007), "wiiw Database on Foreign Direct Investments in Central, East and Southeast Europe: Shift to the East". *wiiw*, Vienna.
- Jensen, C., (2006), "Foreign Direct Investment and Economic Transition: Panacea or Pain Killer?", *Europe-Asia Studies*, Vol. 58, No. 6, September, pp. 881-902.

- Kaufmann, D. –Kraay, A. – Mastruzzi, M. (2006), *Governance Matters V: Aggregate and Individual Governance Indicators for 1996–2005*, WPS 4012, The World Bank, Washington, D. C.
- Kuznetsov, A. V., (2007), „Russian direct investments in EU countries“ (in Russian). In *Contemporary Europe*, IE RAN, Moscow, No. 1, pp. 37-50.
- Leonard, M., Popescu, N., (2008). “A five-point strategy for EU-Russian relations”. In: *Europe’s World*, Spring, Brussels, pp. 20-30.
- Libman, A. M., Kheyfets, B. A., (2006), “Expansion of Russian Capital in the CIS Countries” (in Russian). *Ekonomika*, Moscow.
- Mille, W. L. (2006), “Corruption and Corruptibility”, *World Development* Vol. 34, No. 2, pp. 371–380.
- Maincent, E., Navarro, L., (2006), “A Policy for Industrial Champions: from picking winners to fostering excellence and the growth of firms”. *Industrial Policy and Economic Reforms Papers*, No. 2, EU DG Enterprise and Industry, Brussels, April.
- Pankov, V., (2007), “Integration and Desintegration on the Post-Soviet Area” (in Russian). In: *Mir Peremen*, Moscow, No. 3, pp. 128-132.
- Pindyuk, O., (2007), “Foreign trade restructuring in Belarus and Ukraine: a comparison”. *wiiw Monthly Report*, No. 6, Vienna, pp. 4-13.
- Shleifer, A., Treisman, D. (2000), *Without a Map. Political Tactics and Economic Reform in Russia*, MIT Press, Cambridge, Massachusetts.
- Tsoukalis, L., (2007), “Global, Social & Political Europe”. *ELIAMEP*, July, Athens.
- Vavilov, A., Viugin, O., (1993), “Trade Patterns After Integration Into the World Economy”. In: Williamson, J. (ed.), *Economic Consequences of Soviet Disintegration*, Institute for International Finance, Washington D.C., pp. 99-174.
- Yurgens, I., (2008), “Forget politics; What Russia and the EU need is a shared economic space”. In: *Europe’s World*, Spring, Brussels, pp. 43-47.
- Zashev, P., Vahtra, P., Luihto, K., (2007), “Outward FDI of Russian enterprises: lessons and policy recommendations”. In: Kaartemo, V. (ed.), “New role of Russian enterprises in international business. PEI, Turku (see also : <http://www.wiiw.ac.at/indeunis>).
- Zhuravskaya, E., (2007), “Whither Russia? A Review of Andrei Shleifer’s A Normal Country”. *Journal of Economic Literature*, Vol. XLV, March, pp. 127-146.