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**COMMUNICATION FROM THE COMMISSION  
TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT**

**On relations with Russia**

## 1. Introduction

The European Council in December 2003 requested the Council and the Commission to draw up an assessment report and propose measures aimed at strengthening the strategic partnership between the EU and Russia and the respect for the values on which it is based. This Communication responds to the request of the European Council. Its aim is to steer a review of the EU's Russia policy at the February GAERC and to support the establishment of a more coherent and effective approach to relations with Russia, reflecting the views of the EU-25, in the first instance with a view to a successful Summit in May and to the further development of EU/Russia cooperation. This Communication also argues for a review of EU policy towards the southern Caucasus and the western NIS.

The EU's principal objectives in its relations with Russia were defined following extensive discussions amongst the Member States in preparation of the St. Petersburg Summit in May 2003. In that context, the Member States agreed with Russia to work towards the creation of four common spaces<sup>1</sup>. It was agreed to take forward this work, notably in the framework of the PCA. It is the priority of the EU at this stage to determine the most effective means to work towards the agreed objective of creating the common spaces. This work should draw on any elements of the EU's neighbourhood policy, such as the envisaged new neighbourhood instrument, that are of common interest to the EU and Russia.

Russia is an important partner, with which there is considerable interest to engage and build a genuine strategic partnership on the basis of positive interdependence. Russia is our largest neighbour, brought even closer to the EU by enlargement. Russia is not only a key actor at global level and in the UN Security Council but also has significant influence in the NIS. It is a major supplier of energy products to the EU and will in future become an even more predominant source of such products. Despite its relatively small economy, Russia is a large market for EU goods and services, with considerable potential for growth. It is in the interest of the EU for Russia to take forward its reforms and to modernise its economy. In this respect, the Commission welcomes Russia's recent economic growth.

The EU and Russia have every reason to cooperate on environmental issues, migration, public health, crime, research and other fields affecting the security, stability and well-being of Europe as a whole. Russia, for its part, has considerable desiderata in its relations with the EU, with significant and growing economic interdependence and the development of EU foreign and security policy.

EU and Russian positions converge on many issues, including support for effective multilateralism under the UN, the Middle East peace process and combating international terrorism and the proliferation of weapons of mass destruction. There has also been fruitful cooperation in the context of the Northern Dimension and the EU welcomes continuing Russian support on ITER. The promising experience of the energy dialogue launched at the EU-Russia summit in 2000 has delivered tangible and welcome results in an area of strategic importance to the EU and to Russia, which is currently the most significant single source of EU hydrocarbon imports.

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<sup>1</sup> A common economic space, a common space of freedom, security and justice, a common space of cooperation in the field of external security as well as a common space of research and education, including culture.

Relations have, however, come under increasing strain, with divergence between EU and Russian positions on a number of issues, including ratification of the Kyoto Protocol, Siberian overflight rights, PCA extension and veterinary agreement negotiations and export certification. This has been coupled with a more assertive Russian stance towards a number of acceding countries and the NIS. This may have implications for Russia's relations with the enlarged EU, for efforts to resolve frozen conflicts and for EU cooperation with the NIS in particular in the context of the European Neighbourhood Policy. The EU acknowledges the value of regional economic integration initiatives among parties who have decided to work together and which are compatible with their international obligations and aspirations. However, the implications of the signature in September 2003 of the Single Economic Space agreement by Russia, Ukraine, Kazakhstan and Belarus will need to be examined carefully in terms of their possible impact on work on the Common European Economic Space and on a possible future FTA.

Against this background, it is particularly important that the Commission and the Member States closely concert their positions and speak with one voice, with a view to making progress towards our agreed objectives.

## **2. Russia – recent developments**

President Putin's four years in charge have seen a drive to consolidate federal control and strengthen the state apparatus. This has produced more stability, in itself welcome after the uncertainty of the Yeltsin era. This period has, however, also witnessed a weakening of the values to which the EU and Russia (as a member of the Council of Europe and OSCE) are committed. Indeed, reports by international organisations, including the OSCE and Council of Europe, the conduct of Duma elections in December 2003, events in Chechnya and indications of the selective application of the law raise questions about Russia's commitment and ability to uphold core universal and European values and pursue democratic reforms.

President Putin has overseen a relatively strong economic recovery (from a low base) with, overall, positive economic fundamentals now in place. GDP growth averaged 6.5% p.a. between 1999 and 2003 and inflation has fallen to 12%. Better tax collection and spending discipline contributed to a federal budget surplus of 1.5% of GDP in 2003, while Russia's trade surplus has allowed it to maintain a strong current account position despite substantial foreign debt payments and capital exports. Partly as a result, President Putin enjoys public approval ratings of more than 70% and is in a very strong position ahead of the Presidential elections in March 2004. This should be seen against the backdrop of increasing inequality within Russia (according to the latest estimates 31 million Russian citizens now live below the official poverty line) and a declining and ageing population, which has not been offset by the immigration of ethnic Russians from other NIS. The potential significant decrease of the Russian population over the coming decades could be a source of long-term instability. All this has implications for sustainable development and economic growth. Annexes on the Russian economy and on demography are attached.

While the adoption of economic reforms since mid-2000 has been impressive, implementation and enforcement of legislation remain the key issues, while corruption is still a significant barrier. Reform momentum has been lost in recent months. Some reforms have been weakened or reversed as political energies have been redirected towards elections and more entrenched interests have been encountered. Much remains to be done to reform the natural monopolies (railways, energy – in particular the gas sector), the bureaucracy and the financial sector as well as the housing, communal services, healthcare and education sectors. Reforms

and economic recovery have not been accompanied by sufficient diversification of the Russian economy, which remains based on traditional rents (energy, basic manufactures). The large share of energy in Russian exports leaves the economy open to external shock. Meanwhile, Russia compares unfavourably with other emerging economies in terms of its ability to attract FDI, the result of which is ageing capital stock and decaying infrastructure.

### **3. The current relationship**

The EU and Russia have agreed ambitious political declarations (e.g. on the ‘common spaces’, the Energy Dialogue, environmental cooperation<sup>2</sup> and political and security cooperation) and developed strategies for their relations, including the ‘Common Strategy of the EU on Russia’ and Russia’s ‘medium term strategy for relations with the EU’. But, despite common interests, growing economic interdependence and certain steps forward, there has been insufficient overall progress on substance.

There is a need for increased EU coordination and coherence across all areas of EU activity - sending clear, unambiguous messages to Russia. It is only via engagement, making full use of our combined negotiating strength, that the EU can promote a fully functioning rules-based system in Russia, to the benefit of both.

This is relevant not only for upholding democracy and the core European values to which Russia is committed as a member of the OSCE and the Council of Europe but also for the development of our economic and overall relationship. The transparent and non-discriminatory implementation of rules is crucial for the Russian economy for example in the context of WTO accession. Russian convergence with universal and European values will to a large extent determine the nature and quality of our partnership.

The EU is seeking to strengthen its relations with the western NIS and the southern Caucasus. In this context, it should work with Russia whenever possible to resolve frozen conflicts, tackle political instability and promote economic growth.

### **4. The way forward**

It is in the EU’s interest to seek an open, stable and democratic Russia, acting as a strategic partner which can uphold European values, continue reforms, implement commitments and, in cooperation with the EU, play a constructive role in the NIS.

Several factors need to be borne in mind, in particular the EU’s need:

- to establish an effective, realistic, balanced and consistent approach;
- to engage with Russia;
- to maintain policy coherence and
- to improve the functioning of existing structures of cooperation.

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<sup>2</sup> Both Summits in 2001 reaffirmed the strong common interest in deepening co-operation on the environment

### *The need for an effective, realistic, balanced and consistent approach*

The EU should make full use of its influence with Russia to promote and defend EU interests and to ensure a balanced relationship.

This means bringing together issues in which Russia is anxious to see progress with our own goals. The EU needs to define realistic common positions, which can be used to present a firm EU line to Russian interlocutors. Care should be taken to avoid the politicisation of economic and technical issues, by ensuring that proposed links concern related issues.

Such an approach will enhance the EU's credibility and contribute to a more substantive, forward-looking partnership with Russia. This approach has proved to be effective in the negotiations on the transit of Russian citizens to Kaliningrad and has led to a certain degree of progress over Russia's application for WTO accession. It could also bring benefits in areas such as:

- The application of PCA provisions to the acceding Member States from 1 May 2004 and the application of certain trade preferences to Russia.
- Conclusion of an EU/Russia readmission agreement as well as the question of the facilitation of visa issuance (using existing flexibilities under Schengen).
- Active Russian cooperation with the EU to resolve frozen conflicts in our common neighbourhood and EU readiness to step up cooperation on crisis management and civil protection.
- Russian ratification of the Kyoto Protocol as well as increased cooperation on energy, including progress in negotiations on trade in nuclear materials.

### *Engagement*

The EU can influence developments in Russia if it is ready to take up difficult issues with Russia in a clear and forthright manner. The EU as a whole should confirm that shared European values remain the basis for deepening relations. Thus, for example, concerns over recent political developments, which demonstrate discriminatory application of the law, or the non-respect of human rights, should be raised vigorously and coherently by the EU and its Member States. The EU should also continue to take forward people to people 'grass roots' contacts, including partnerships in education, which promote European values.

The EU should demonstrate its readiness to engage with the NIS on the basis of its own strategic objectives, cooperating with Russia whenever possible.

Experience has shown that when difficult matters arise, Russia often seeks to treat questions by setting up new negotiating mechanisms. The EU should make clear its willingness to engage with Russia on all complex issues of mutual interest but continue to give priority to substance over form, with a view to obtaining concrete results.

### *Policy coherence*

Cooperation should reflect the mutual interest of the EU and Russia and be balanced. For example, in the field of JHA, the facilitation of visa issuance procedures is a top priority for Russia but the EU also has an interest in facilitating certain procedures on the Russian side.

One example of progress in this field is that the Commission will soon come forward with a proposal to facilitate visa issuance for third country researchers. Progress on visa facilitation should enable the EU to obtain progress on readmission, which is of great significance to the EU, but which is ultimately also in Russia's interest, as progress in this respect would contribute to building the necessary confidence to deal effectively together with illegal migration. The EU should continue to pursue broader JHA issues, such as cooperation on border management, the fight against organised crime, corruption and illegal migration. Progress achieved in the energy dialogue, too, is welcome. In order to ensure that the EU can speak with one voice, it is important that parallel initiatives are closely coordinated and support overall EU policy vis-à-vis Russia.

The EU needs to agree key objectives and clear positions<sup>3</sup>. This means, inter alia, drawing up an objectives paper for Summits, which should clearly draw 'red lines' for the EU, positions, beyond which the EU will not go. Agreed EU objectives and positions should guide all EU actors, in Moscow as well as in Brussels.

### *Structure of cooperation*

The current structure of cooperation and in particular the PCA is neither outdated nor exhausted. The PCA does not limit the scope for EU/Russia cooperation. Rather, the Commission should pursue increased Russian engagement in particular at working level.

The EU should aim to reach an overall agreement with Russia on structures without delay. It is in our interest to bring discussions on procedures to an end quickly in order to begin to make progress on our common agenda. The EU should base cooperation on the framework that is already in place.

The PCA institutions need to become more operational and flexible. The Permanent Partnership Council (PPC) should be set up in troika format. The PPC can then give a new impetus to EU/Russia relations, intensifying EU cooperation with 'line' Ministries, engaging the Presidential Administration and preventing initiatives, which are in the interests of both sides, from becoming bogged down. Indeed, the PPC offers all the flexibility and engagement Russia seeks, while maintaining EU coherence and transparency.

The EU should be ready to schedule PPCs in areas such as JHA, environment, energy, transport. In the field of JHA, Ministerial troikas have taken place since April 2001. Ministerial meetings in the new PPC format could bring together the Commission, Presidency and the Russian Presidential Administration (which can coordinate all Russian Ministries with an interest in establishing direct JHA contacts). The need for additional structures is not evident, but informal high-level meetings may be held when they appear useful. In this respect, the idea recently brought forward by Russia to discuss at high-level specific JHA matters should be given particular consideration.

The Commission should revitalise the sub-committees. If the Commission is able to offer more substantive discussions in these fora, the Russian side will have a greater incentive to respond. For example, a sub-committee dedicated to JHA could be set up. The EU also needs

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<sup>3</sup> Community positions for issues, where progress is currently blocked by Russia but which are priorities for the EU, are included in Annex: Kyoto ratification, maritime and nuclear safety, readmission negotiations, the facilitation of humanitarian aid delivery, the ratification of border agreements with Latvia and Estonia, PCA extension, Siberian overflight payments, cooperation on Galileo, energy sector reform and Russian safeguard measures.

to reconsider the scale of its assistance to Russia, bearing in mind that it has produced at best mixed results and that satisfactory operating conditions (notably exemption from VAT and other local charges, appropriate operating and security conditions for humanitarian aid) have not been established.

## **5. Conclusion**

The strategic objective of EU/Russia relations agreed at the St. Petersburg Summit in May 2003 remains valid. The goal is to establish the common spaces (a common economic space, a common space of freedom, security and justice, a common space of cooperation in the field of external security as well as a common space of research and education, including culture) in the framework of the PCA. To reach this objective, the EU needs to improve the manner in which it works with Russia.

There is a need for strengthened coordination of policy towards Russia. The Commission therefore recommends to the Council that the EU:

- engage with Russia to build a genuine strategic partnership, moving away from grand political declarations and establishing an issues-based strategy and agenda. The EU should be ready to discuss all matters with Russia and should not hesitate to defend EU interests vigorously;
- underline that such a partnership must be founded on shared values and common interests. This implies discussing frankly Russian practices that run counter to universal and European values, such as democracy, human rights in Chechnya, media freedom and some environmental issues;
- pursue a more balanced cooperation agenda with Russia and promote policy coherence. The EU should establish a list of key issues of EU interest at the beginning of each Presidency, with clear objectives and common positions;
- bring together related issues, where relevant, to promote the EU interest;
- launch the Permanent Partnership Council forthwith and examine ways to improve the efficiency of other PCA institutions.

A clear understanding of EU interests, objectives and priorities, as well as a more coordinated EU policy towards Russia, will allow us to move ahead on the creation of the four common spaces.

The EU should therefore make concrete proposals to Russia on the development and content of the common spaces. It should present a draft joint Action Plan to Russia covering all four spaces, including and with specific reference to energy matters. This should be consistent with the EU's neighbourhood policy and incorporate relevant elements of this policy that are of common interest to the EU and Russia as well as draw on ongoing positive cooperation in specific fields. A pro-active approach, in which the EU defines precise, realistic objectives on the basis of reciprocity, will send a strong signal of EU engagement to Russia. Progress with Russia towards agreement on the main lines of an Action Plan could be sought by the Summit in May, with a view to an agreement on a joint Action Plan by the Summit in the autumn. An agreed action plan could then replace the unilateral EU common strategy on Russia. However, the EU should not engage in substantive discussions with Russia on the Action Plan before agreement is reached on PCA extension.

The Commission also recommends that the EU pursue a more coherent policy towards the southern Caucasus, including through the good offices of the EU Special Representative, and western NIS, wherever possible, in co-operation with Russia. The aim should be to promote the EU's relations with these countries and further their economic development and political stabilisation, including the resolution of frozen conflicts.



## ANNEXES

## THE RUSSIAN ECONOMY: RECENT DEVELOPMENTS AND PROSPECTS FROM AN EU PERSPECTIVE

### Important progress has been achieved since 1998

Since the 1998 financial crisis that marked the end of the first period of Russia's bumpy post-Soviet transition, Russia has come a long way on the road of growth and economic stability. Indeed, in sharp contrast to the previous decade of economic and social dislocation, in the years 1999-2003 Russia not only progressively established a more stable and predictable political environment but also built up a fairly respectable record of economic growth, macroeconomic stabilisation and policy reforms.

In these five years, thanks to 1) high prices for Russia's main exports (primarily oil and gas), 2) the devaluation of the rouble and 3) prudent macroeconomic policies, real GDP has grown by nearly 40%, or by an annual average rate of 6.5% (*see table*). The country has achieved macroeconomic stability: inflation has been cut drastically, public expenditure has been brought under control; following lessons learnt from the 1998 crisis, higher oil revenues have not been spent but translated into four years of budget surplus; the exchange rate of the rouble, after losing in 1998-9 half of its value (in real terms), has been steadily appreciating – in real and, lately, even nominal terms. Growth and financial stabilisation have led to a large and continuing increase of disposable income (in the first 10 months of 2003 alone, real personal cash incomes rose by 16%) and to a reduction in poverty levels (which decreased from a peak of about 40% of the population in 1999 to about 25% in 2003). The external balance also improved dramatically: the current account registered surpluses of up to 15% of GDP; capital outflows decreased and were even reversed at some point in 2003; international reserves were multiplied by six since the end of 1999. Russia took advantage of this favourable environment to normalize its relations with foreign creditors and reduce dramatically external debt, which, at a mere 28% of GDP, is no longer a matter of concern.

### Russia : Key macroeconomic indicators, 1998 - 2003

	1998	1999	2000	2001	2002	2003 latest	As of :
GDP, real % growth	-5.3	6.4	10.0	5.0	4.7	6.7	1-9/03
Industrial production, real % growth	-5.2	11.0	11.9	4.9	3.7	6.8	1-11/03
Fixed investments, real % growth	-12.0	5.3	17.4	8.7	2.6	12.2	1-11/03
Unemployment, %, end of period	11.8	11.7	10.2	9.0	7.1	8.6	11/03
Exports, \$ billion	74.4	75.6	105.0	101.9	107.2	134.4	1-11/03
Imports, \$ billion	58.0	39.5	44.9	53.8	61.0	74.8	1-11/03
Current account, \$ billion	0.2	24.6	46.8	35.0	32.8	39.1	1-11/03
Inflation (CPI), 12-month % change	84.4	36.5	20.2	18.6	15.1	12.0	12/2003
Federal government balance, % of GDP	-5.9	-1.4	1.2	2.9	1.4	2.6	1-10/200
Foreign currency debt, % of GDP	50.1	87.7	55.3	44.4	36.2	28.3	9/2003
Foreign currency and gold reserves, US\$ bn	12.2	12.5	27.9	36.6	47.8	76.9	12/03
RUB/US\$ (end of period)	20.65	27.00	28.16	30.14	31.78	29.45	12/2003

On the structural side, too, progress was achieved; particularly since 2000, the government pushed forward a more coherent reform strategy. Important reforms encompassing wide segments of the economy (such as business deregulation, taxation, pensions and land ownership) have been—or are being—implemented since then. In the area of social policy, a major overhaul of the pension system aimed at putting pensions on a sound financial basis was launched. Yet, in other important areas, such as the energy and financial sectors and housing, key measures still remain to be taken. Also, much remains to be done in the area of state reforms (covering the public administration, the civil service, and the judiciary).

Altogether, with a GDP of close to US\$ 450 billion, per capita income of around US\$ 3000, a score of close to 3 out of 5 on the EBRD's transition indicator and a ranking of 63 out of 175 countries in the UNDP development index, Russia has an economy equivalent in size to that of the Netherlands or one third of China's, a level of prosperity some 20% higher than Romania's<sup>4</sup>, a transition status close to that of Romania and a development status similar to that of Brazil.

The above developments in terms of macro-economic indicators and economic reforms, impressive as they are, should not lead to an overestimation of the strength of the Russian economy or to an underestimation of the challenges it faces. A number of other factors must be taken into account, when defining a meaningful strategy for the medium and long term.

### **Long-term prospects are uncertain**

Building on the achievements of the last years, the Russian political leadership has set an ambitious long-term target of raising dramatically the living standards and transforming the Russian economy into a modern, diversified and competitive economy fully integrated in the global economic system. In this context, the growth of the last years is viewed merely as the beginning of a long process of even stronger sustained growth. The main element in this strategy is the objective, set by President Putin in early 2003, to double the size of real GDP in ten years' time, requiring an acceleration of growth to 8% per year.

In order to assess how realistic these objectives are and the conditions for their achievement, it is necessary to review the main constraints and challenges to Russia's economic development. In spite of the progress made, the economy's performance over the last decade is less impressive than that of comparable transition economies. Furthermore, a deeper analysis reveals that it remains constrained by substantial structural and social imbalances.

- Russia's economy is not sufficiently diversified. Reliance on natural resources, in particular oil and gas, has not been reduced but, on the contrary, has grown. More than 80% of all exports are natural resource-based, of which nearly 60% are oil and gas. This makes the economy vulnerable to any sudden collapse of oil prices.<sup>5</sup>
- There has been only limited restructuring of many traditional large industrial enterprises and the growth of new firms, particularly SMEs, is slow, owing to weak enforcement of competition rules and considerable bureaucratic obstacles. Hence, the weight of SMEs in

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<sup>4</sup> In purchasing power parity terms, Russia's GDP per head was US\$8490 in 2002, compared to US\$6976 for Romania.

<sup>5</sup> According to the IMF, a decline of US\$1 in oil prices leads to a 0.5 percentage-point decline in GDP growth, a US\$1 billion (0.3% of GDP) drop in federal budget revenues and a US\$2 billion reduction in export revenues.

GDP, generally estimated at just 20%, is only about half of that of the advanced transition economies.

- The result of the over-reliance on natural resources and insufficient competition is the concentration of market power and wealth in a small number of large financial-industrial groups with linkages to political power. The core of their activities is mainly export-oriented production related to natural resources, reflecting the above-mentioned lack of diversification. The recent spectacular moves against the leaders of some of these groups are very popular with domestic public opinion, but do not necessarily mean that the Kremlin is committed to moving away from the current model of “oligarchic” capitalism; they may simply be aimed at keeping the Russian big business away from active politics.
- Chronic underinvestment is a major problem. Despite the recent growth in investment (over 9% per year on average since 1999), capital spending as a share of GDP remains low; furthermore, most investment has been concentrated in the oil and gas sector and in construction, leaving out the infrastructure and the manufacturing sector. Hence, the infrastructure remains in an advanced state of decay, while much of industry has not been restructured, nor has adopted state-of-the-art technology from abroad. The inflow of FDI remains low, as investors continue to view Russia as a risky market<sup>6</sup>.
- Despite the amelioration since 1999, social indicators remain weak. In particular, income inequality in Russia is among the highest compared to other transition economies and seems to have increased further in recent years, despite a sizeable pickup in real wages. Income inequalities across the country’s regions are even more striking: differences in income and economic performance are huge and have worsened over the last decade.
- Russia’s demographic situation has deteriorated over the past ten years, when the population decreased by some 3 million, despite net immigration. This was the combined result of lower fertility and a sharp increase in adult mortality, in particular among the male population (life expectancy of Russian men is 58.4 years). Both developments are largely due to precarious social conditions and the dislocation brought about by the transition years.
- Russia’s geography, consisting of long distances, harsh climate in large parts of the country and sparse population, translates into high transport costs and represents a structural constraint to growth and to the reduction of regional imbalances (transportation costs in Russia are about three times above international standards when measured by cif/fob margins).

As regards long-term growth prospects, it is very difficult to offer a reliable estimate. Apart from the government’s target rate of close to 8% per year on average for the next ten years, some current estimates project annual average growth at about 5% per annum in the coming decade. Other, less optimistic estimates, project annual real growth at 2½-3% on average as a baseline scenario. These lower rates would still allow a gradual reduction in poverty levels, but would not be sufficient to generate broad-based, sustainable development beyond the current natural resource-based structure. In this scenario, there is also a clear risk that, if the two key factors behind Russia’s growth (improved competitiveness resulting from the

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<sup>6</sup> Over the 1992-2002 period, Russia received only US\$ 23 billion in FDI, one twentieth of the amount received by China, while at the same time US\$ 245 billion in capital is estimated to have flown the country.

exchange rate depreciation and high oil prices) gradually wane, the current growth pace slows down further and Russia enters a stagnation phase.

### **Policy choices will determine whether the economy will stagnate or catch up**

In order to achieve permanently higher growth rates, a more diversified economy, higher employment and greater poverty reduction, structural, social and institutional reforms should be accelerated and aimed at markedly improving the investment climate and generating higher productivity, notably in the struggling manufacturing sector. If instead complacency—bred by today's high oil prices—conservatism and protectionism prevail, Russia is bound to remain a petro-economy, dominated economically, and probably politically, by a few large oligopolies, and incapable of generating the Schumpeterian processes vital to reinvigorating its industry. Russia would not necessarily face a crisis such as in 1998, but be subject to a long period of modest growth, possibly lapsing into stagnation in times of low oil and gas prices, combined with a gradual depletion of natural resources.

In addition to maintaining a sound macroeconomic framework, the main policy priorities facing Russia are to (i) improve the investment climate, (ii) further integrate into the world economy, (iii) reform the State administration and the civil service, (iv) enhance human capital and (v) protect the vulnerable.

#### ***Improving the investment climate***

Improving the investment and the business environment requires a number of measures in several related areas. Among the most important issues that need to be tackled are the following:

- Progress in the reform of utilities -power, gas, railways and oil transportation. These sectors are still dominated by monopolies benefiting from uneconomic pricing systems and large subsidies (annual gas and electricity subsidies could be as high as 30% of GDP). These subsidies keep inefficient enterprises alive, are often provided on a discriminatory basis, lock up scarce human, financial and physical resources in low productivity sectors and harm the environment by encouraging waste of natural resources. Although the government recognises that a phasing out of energy cross-subsidies and hence an increase in prices is necessary, reforms in this politically sensitive area have yet to gather momentum (except perhaps in the electricity sector), especially because many Russian cities are almost totally dependent on a single large industrial company, which might be bankrupted by a cut in subsidies. The reluctance to tackle the low energy efficiency of Russian manufacturing is also apparent in Russia's growing reluctance to ratify the Kyoto treaty *rebus sic stantibus*.
- Despite recent progress in deregulation, a pervasive system of government licensing, inspections and authorization requirements allows considerable scope for government interference in economic activity and for corruption, particularly at the local level, representing a serious obstacle to productive investment and the development of a vibrant private sector. More generally, the practical implementation of law is often highly uneven if not arbitrary.
- The reform of the banking and financial sector is proceeding slowly, depriving the country of much-needed financial intermediation. After the collapse of some of the largest private banks in 1998, the sector is dominated by the State savings bank, which attracts almost

70% of deposits. Given institutional problems, significant private competitors have little real chance of emerging.

- Despite undeniable progress, the tax system should be simplified further and made more coherent.
- Stricter enforcement of corporate governance rules and the reform of the judiciary, with a view in particular to increasing its independence from the executive, is crucial to the effective rule of the law.

### ***Internationalisation of Russia's Economy***

Greater integration in the global economy by improving market access for Russian goods, could lead to a dramatic improvement in economic performance, but only if greater openness is accompanied by structural and institutional reforms that support the adjustment process. On that condition, Russia's accession to the WTO can be a powerful stimulant for growth.

### ***Government Reform***

Reform of the public administration and civil service, both at federal and regional levels, is key for the successful implementation of structural and institutional reforms in other areas. While relatively large layoffs, abolition of overlapping government functions and a revamping of intra-governmental fiscal relations should be offset by a significant increase in salaries, most of these reforms are politically difficult.

### ***Enhancing Human Capital***

One of the main tasks facing Russia is to reverse the erosion of human capital and to address such issues as the growing brain drain, the deterioration of the education and health system and inequality of access to public services.

### ***Protecting the Vulnerable***

The country's social safety net is largely insufficient, as the limited resources available are spread over a large number of recipients. Social security should be targeted toward the most vulnerable, such as those most affected by increases in utility prices and by industrial restructuring. This requires phasing out untargeted benefits and privileges, redirecting expenditure toward health and education, and developing a modern family and child welfare system.

### **The EU can influence important aspects of the reform process, but needs to prioritise**

The above analysis has clear implications for our relations with Russia. EU policy should be geared towards stabilising Russia both in economic and political terms and towards creating the conditions for sound economic growth and the integration of Russia into the European and World economy. Russia's economic self-sufficiency and geopolitical history imply that the EU's leverage should not be overestimated; nevertheless, the EU's position can have a significant direct impact on some of Russia's strategic interests and indirectly influence others.

After EU enlargement, Russia will become an even closer neighbour, geographically and economically. The EU is by far Russia's most important trading partner, accounting for around 37% of its overall trade, a figure that will rise to over 50% after EU enlargement. For

the EU too Russia is significant: exports to Russia have grown at double digit rates since 1999, despite low world economic growth, so that the country was the EU's fifth largest trading partner in 2002 and the second trading partner of the ten acceding countries. In 2002, two-way trade in services (with EU-15) amounted to €9.4 billion; two-way trade in goods amounted to €78.1 billion, of which €5.8 billion was in agricultural goods. In this latter regard, the EU is concerned to conclude negotiations on certification issues in the context of a veterinary agreement, to avoid the risk that additional Russian certification requirements effectively halt EU exports. Under these circumstances, the EU has a clear interest in supporting Russia to become a stable partner, with a dynamic, open and diversified economy. There is close complementarity between the EU and Russian economies, hence significant advantages from deeper economic integration will accrue to both sides. The interdependence in the energy field further reinforces this assessment.

In this context, the EU's main priorities should be to continue to provide active support to Russia in its WTO membership bid and to actively engage in the creation of a Common European Economic Space (CEES). The EU has until now been a key partner for Russia in the WTO accession process. By joining the WTO, Russia will gain in terms of: 1. increased predictability, stability and transparency of its investment climate in Russia; 2. tariff reductions (that will increase the efficiency of resource allocation in the Russian economy and the competitiveness of Russian industry but without exposing the Russian economy to an unsustainable effort of adaptation; 3. increased global integration, with consequent increases in FDI inflows bringing technology and know-how to the manufacturing and services industry; and 4. access to third country markets and the protection of WTO rules and principles in those markets.

The EU wants Russia to accede to the WTO on economically sustainable terms, i.e. allowing Russia to maintain a sufficient degree of protection for the Russian agricultural, industrial and services sectors, which will not jeopardize its medium-term and long-term development, while at the same time enhancing competition and technology transfer through the gradual liberalisation of the Russian economy. The CEES should be our priority following Russia's accession to the WTO. It will contribute to the economic integration of the Russian economy with that of the enlarged EU. It should, in Russia's own interest aim at the gradual harmonisation of parts of Russia's economic legislation with the rules applicable in the EU, at trade facilitation notably by way of procedural improvements and at the same time create trade preferential relations between the two economies beyond the WTO accession terms. It will also take into consideration the different degree of development and the particularities of the EU and Russian economies and societies.

Investment is a key factor in sustaining economic growth and enabling Russia to "turn the corner" in terms of diversifying its economy, modernising its industrial base and benefiting from technology transfer. However, expanding investment flows from the EU is also key to the development of the Common European Economic Space. Through regulatory convergence with EU internal market standards and legislation, Russia will become more attractive to foreign and domestic investment which may enable it to reverse capital flight. In addition, further elements of importance to promoting investment are enhanced provisions on investment-related issues, including the provision for national treatment in a number of listed sectors; an effective competition policy; the development of bilateral agreements on protection and promotion of investments (where appropriate); the development of information mechanisms about mutual investment opportunities; and uniform and simplified administrative procedures.

## DEMOGRAPHIC TRENDS IN RUSSIA

### State of Play

Russia's population is steadily decreasing, as the last census of October 2002 and later data issued in 2003 confirmed. From the previous, 1989 census (under the USSR), Russia's population fell from 147.5 million to 144.4 million, or 1.7%, as of September 2003 (latest update of the 2002 census). Some experts have questioned that the census failed to interview 7% of the population; data giving Chechnya's population at 1.1 million have been particularly surprising. As deteriorating living and health conditions prompt emigration, and as immigration only partly compensates (4.5%) for the rapid population fall, experts argue that the latter should be encouraged.

### Women/men, mortality/birth rates, life expectancy

There are fewer than 1.2 births per 100 women of childbearing age, while a birth rate of 2.2 is necessary to avoid a population decrease (official data showed a slight increase in birth rate in 2003). Together with migration toward non-NIS countries, these are the main causes of population decrease. 77.7 million of the total population are women and 67.8 million are men. The 10-million gap, the largest in the world, has not changed since WWII and is typical of countries at war. The general death rate is 16.2 per 1,000 persons and is steadily rising. Many children die before reaching 1 year. Men's average life expectancy is 58.4 years, i.e. at an economically active age; women's is 71.9; making 64.8 years the general average life expectancy. Heart disease, general poor health, accidents at work, suicide, alcoholism, and generally deteriorating living conditions are the main causes of death.

### Distribution of population

The Central Federal District has the highest concentration (26.2%) of the country's population. The Volga Federal District - 21.5%; the Southern District - 15.8%; the Siberian - 13.8%; the North-West - 9.6% and the Ural District - 8.5%. The Far East District, with 4.6%, has suffered most from depopulation. Since 1989 the population has increased mostly in the Southern (Rostov) and Central (Moscow) Federal Districts. Russia's Northern and Far East regions have suffered the largest losses. Since 1989, the North-West Federal District has lost an average of 10% of its population, while Dagestan is the republic with the highest population growth - 43%. Chechnya follows with 23%. 73% of the population live in cities/towns, 27% in the countryside, a stable trend since 1972. 12 cities have a population exceeding 1 million. Over 13,000 villages have become uninhabited; 35,000 villages have no more than 10 inhabitants.

### Migration trends and mobility; ethnic composition

Almost 11 million migrants have come to Russia since 1989, while over 5 million have left the country, thus causing a net inflow of 5.5 million migrants mainly from the NIS and Baltic countries. This has compensated for only 4.5% of the population loss. Despite many obstacles to mobility, *internal migration* is rising. The trend is mostly from East to West Russia and from North to South and primarily involves young people with higher education. Apart from ethnic Russians (who make up around 120 million of the total population), there are numerous minorities. The three largest groups are the Tatars (5 million), Ukrainians (4 million) and Chechens (1.1 million).



## **Projections**

Some estimates suggest that a continuing decline will cut the population by 30% (to around 101 million), and, under a worst-case scenario, by up to 47% (to some 76 million) by 2050. The trend is towards a steadily ageing population. Some forecasts warn that pensioners will represent 35.2% of citizens in 50 years' time, compared with 20.6% today. This would confirm Russia's need for increasing immigration.